Scott Shane, *Editor*

Enhancing the Managerial DNA of Your Small Business

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This book is dedicated with great love and gratitude to our spouses:
Calvin (Ken), Edith, Vicki, George, and Sumitra

Abstract

Most people who start businesses do so with little or no formal education in business or management training and experience. This book has been written expressly for these people, as well as for others with similar backgrounds who aspire to start their own businesses. The aim is to help fill in some critical gaps in managerial knowledge that cause many of the problems that small business owners face as they try to navigate the business world with inadequate knowledge of how to manage a business.

With no attempt to compete with conventional small business textbooks or catchy "how to" books on small business management, this book is deliberately focused on five core topics: strategic planning, financing, marketing, managing cash flow, and managing costs. The authors believe these to be the essential building blocks for enhancing the managerial DNA of a small business. Equipped with this enhanced DNA, the small business owner is postured to think about and take actions on behalf of his or her business that will lead to optimal success. In addition, the book incorporates as appendices three topics that are very important to small businesses: break-even analysis, legal business structures, and intellectual property protection.

Informed by state-of-the-art academic knowledge but conveyed in a practical way that is replete with examples which small business owners can relate to and easily understand, the book has been written collaboratively by a team of experts who worked with hundreds of small business owners over a period of almost a decade. It incorporates the topics and methods that consistently proved to be successful with those practicing small business owners.

Keywords

break-even analysis, business structures, financing, intellectual property, managing cash flow, managing costs, marketing, small business management, strategic planning

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Preface

For small business owners who are already running a business (as well as for those desiring to start a small business), this book strives to serve as an executive guide that will concisely fill in some of the critical gaps in your managerial knowledge and skills. As we will discuss later in the background section, years of expert consultation with small business owners led to the determination of the topics covered within these pages.

Background

Under a grant from the U.S. Small Business Administration (SBA), the authors conducted an intensive weeklong pilot program for 30 small business owners. The program content consisted of all of the topics presented in this book, along with several others. However, program participants expressed in program evaluations and subsequent contacts that the topics included in this book were the most useful and had the most impact when applied to their businesses.

In the aftermath of the pilot program, the authors conducted a 12-city tour to cities in every corner of the continental United States, as well as Alaska. Focusing, during that tour, only on the topics that proved most useful in the pilot program, the authors received rave reviews from small business owners in every city (and were asked to return to two cities to repeat the program).

Like you, the participants in these programs were very busy small business owners. In the case of the pilot program, these owners set aside an entire week to devote uninterrupted time and efforts to learning (and catching up on) how to properly manage their ventures. Participants in the tour program only spent a day covering the content, but found the time to have been highly beneficial.

The pilot program and the tour led to a series of programs that focused on the same content (and sometimes other advanced coverage). In some instances, the format of these programs was the same as for the pilot pro-

gram (intensive weeklong programs); while, in other cases, programs were spread over several weeks, with a full day having been devoted each week to a single topic. These sessions were conducted with small business owners and were continuously refined over a period of almost a decade. Now you have the opportunity to benefit from the content presented to your counterparts over the years, with the added benefit that you can maintain a copy of the coverage for your reference whenever you find the need.

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CHAPTER 1
Introduction

This introductory chapter is designed expressly to give you an understanding of what this book seeks to accomplish, as well as why and how. With this understanding, it is hoped that you will be persuaded to read the entire book with the determination to make the perspectives that are shared here a part of your regular thought process as you go about the day-to-day management of your business. It is the firm belief of the authors that, if you do, you will greatly increase your ability to steer your business toward the accomplishment of your goals. As you will learn, this book is intended as a valuable handbook for small business owners and consultants, rather than as a textbook. Therefore, the approach here is not to overwhelm you with all (or even most) of the things that a small business owner needs to know. It is unlikely that any single book could thoroughly accomplish that feat and, even if one could, you would not likely have (or take) the time to read it. Instead, our goal is to share with you what we believe to be the most important things that small business owners need to know in order to have a reasonable chance of guiding their businesses to success.

About This Book

This section provides the definition of *small business* that guides this book. It also describes the almost decade-long executive training program for small business owners that helped to determine and fine-tune the topics that are included in this book. Subsequently, we discuss the assumptions that we have made about you and your business. We further discuss why it is important for you to know as much as possible about how to manage your business, and end the section by presenting a rationale for and an overview of the book's contents.

Small Business—Defined

At the outset, it is acknowledged that definitions of small business can vary widely, depending on the source (government versus private-sector advocacy groups), as well as the measure employed (e.g., revenues versus number of employees) or industry (a larger number of employees is allowed for small manufacturing firms as compared with professional services firms). However, using the U.S. Small Business Administration (SBA) definition, a small business is an independently owned and operated entity that is organized for profit but is not dominant in its industry.[1] This definition reflects the concept of a small business that is used in this book.

Assumptions About You and Your Business

This book begins with the premise that, if you are like most small business owners, you began your business with little or no formal education or managerial experience that equipped you to start a successful business. The typical story goes something like this: You had what you believed to be a good idea; or what seemed to be a great opportunity came along; or you lost your job or simply became fed up with working for someone else. You decided that you should start your own business, so you did. However, over time, you have had so many unforeseen problems making the business work that you have thought more than once that you should simply shut the doors, walk away, and go find a job.

If that is not your story, you are very fortunate. However, for centuries, it has been an all-too-familiar story for millions of entrepreneurs and small business owners. It was for this reason that this book was developed. The express purpose of this book is to try to fill some critical gaps in the preparation of the typical small business owner described earlier. This is not a conventional small business textbook, for, if it were, it would cover considerably more topics. Instead, this book centers on topics that the authors have found to be frequently addressed by experts, as well as areas of insecurity among small business owners who started businesses, while having knowingly been managerially unprepared.

One of the most interesting articles and one that you should consider reading is, "A Small Business Is Not Just a Little Big Business."[2] Why? By virtue of its very title, the article points to the fact that many of the things that are known about business are based on studies of big businesses. As a

consequence, many of the things discussed and solutions offered in typical business research are more applicable to large than to small businesses. For example, as a small business owner in the United States today, you are in the vast minority if you have employees. Only 17.4% of businesses in the United States employed people in 2008 (down from 21.8% in 2007, possibly due to the recession).[3] However, the larger businesses always have employees, for the obvious reason that a number of people are needed to spread the workload associated with producing the products and services of such businesses. If a large business wants a change in how it markets its products, it can turn to the marketing vice president or director of marketing and simply assign the task. As an individual owning and managing your own venture alone or with a partner, you will often find that, if you do not do something, it will not be done. Of course, small businesses differ from large businesses in a number of other ways (e.g., availability of funds, in-house expertise, access to markets, etc.).

Book Contents—Description and Rationale

The foregoing point acknowledged, the focus will now shift to you—as a small business owner trying to manage a business—and what can be done to help you master a critical learning curve to make your business successful. In this regard, there are four questions that will be addressed here to orient you to what you will find within these pages, and why.

Why Are Management Knowledge and Skills So Important for Business Success?

Unless you are one of the few exceptions, you can probably answer this question very easily. Why? If your story is something like that of the typical entrepreneur who was described earlier, although you had the courage and determination, you began your business with some concerns about whether your management knowledge and skills would be adequate. In fact, small business owners typically cite "management problems" or "lack of management knowledge and skills" or "lack of management experience" among the problems encountered in managing their businesses.[4]

The truth of the matter is that even the best ideas at some point must be tested by the reality of how business works. Successfully starting and

growing a business requires a fundamental appreciation of business basics. If you do not know these basics, the business will either suffer or fail. Yet, you need more than a command of basics. You need to develop an informed managerial mindset that equips you to see and deal with your business as a whole. If you cannot take the pieces of your business and blend those together in such a way as to make the business operate effectively, you are not fulfilling your role as the head of your company. For this very reason (managerial skills deficiencies), leadership roles have been lost by some very successful founders of entrepreneurial ventures (e.g., Will Durant at General Motors); while some business founders either voluntarily enlisted the services of people experienced in management (e.g., Filo and Yang at Yahoo!); or were involuntarily forced out (e.g., Steve Jobs, who left but later returned to Apple and led it until shortly before his death). Hence, even with tremendous and highly marketable ideas, the success of a business over time is highly dependent upon the quality of management leading that business.

So What Are the Most Important Things for Me to Know and Why?

While many individuals who have owned and managed businesses recognize management deficiencies, some of these deficiencies cause more immediate concern than others. As Figure 1.1 shows, beyond conducting your business competently and ethically, and paying your taxes, there are five aspects of management that you need to understand and embrace at a core level. These should become a part of your managerial DNA. The reasons for this statement are explained below.

Strategic Planning. It would be somewhat unusual to find strategic planning as a topic of discussion among small business owners concerned about how to manage their businesses. A distinct reason is that lack of knowledge of how to plan is a major pitfall that keeps entrepreneurs and small business owners from developing strategic plans, while other reasons include such considerations as time, concerns about cost, owner attitude, and the like.[5] However, this is unfortunate, because strategic planning has been shown to increase small business performance.[6] For this reason, it is important as a beginning point for the topics to be covered in this book.

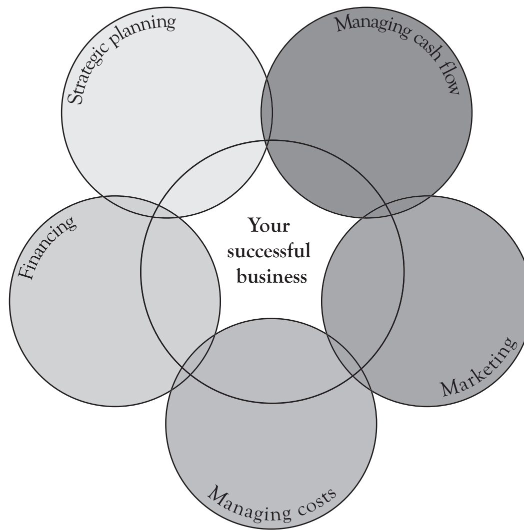

Figure 1.1 Critical management skills for small business

One of the most compelling articles in the business literature in the latter part of the 20th century, "Marketing Myopia,"[7] made some very memorable points about the importance of a business owner understanding the true nature of the business. Fortunately, as you will find in Chapter 2, the very first step of the strategic planning process addresses this issue by requiring that you develop a mission statement that expresses precisely what your business is (what it does and why it exists). Unless you have previously given this issue some very deliberate thought, you should not dismiss it as obvious. A very intentional business definition is a vital part of framing the direction of your business. From that point of clarity, everything else related to your planning for the future of your business will flow.

Financing. If you were to ask almost any business owner (and most experts) what the biggest problem is for small businesses, the answer would be financing or access to capital. Businesses that start out undercapitalized (i.e., without sufficient money for start-up) often experience considerable difficulty trying to make the businesses work. Clearly, then, getting on

top of this issue would be a critical leap forward for you, as a small business owner—at least from the perspective of your knowing what options are available to help you avoid funding problems as you prepare to start your new business, or reduce such problems after having started your business.

For example, in the high-tech industry, Small Business Innovation Research (SBIR) grants (discussed in Chapter 4, Marketing), credit cards, and earnings from salaried positions (in rank-order) were recently found by one study to be the major sources of initial and early-stage financing;[8] although, financing sources can vary by industry. Chapter 3 provides a comprehensive discussion of the various sources of entrepreneurial financing that you should consider for your business. It also explains the requirements that are typically imposed by various sources in order for you to receive funding.

Marketing. A marketing orientation (being driven by a focus on customers and gaining intelligence on competitors) can increase small business profitability.[9] Owners of businesses that ceased operations named concerns about the competitive environment among the factors that led to businesses failure. Assessing and planning for effectively competing in your chosen market are among the topics that will be covered in Chapter 4.

A recent survey by Web.com and the National Association of Women Business Owners found that women business owners expressed concern about attracting customers (40%).[10] Fully 71% of the respondents expressed intent to invest more in marketing, focusing on social media marketing (35%), and search engine optimization (36%). However, 52% indicated that website design had the greatest impact on the bottom line. Clearly, then, women business owners in this sample believed that the Internet is going to be very important to the success of small businesses in the future.[11] Consequently, Chapter 4 addresses the role of the Internet and social media in helping your business to be more competitive in the marketplace of today and the future.

Managing Cash Flow. In much the same way that the history of people who win the lottery is to end up in bankruptcy and abject poverty down

the line, so it is with business owners who do not keep a watchful eye on the money brought into and spent by the businesses. As we will discuss in Chapter 5, nothing is more critical to the success and survival of a potentially viable business than the proper management of the cash at its disposal. In fact, improper management of operating cash flows was found in one study to be the greatest distinction between firms that succeeded and those that failed in the healthcare industry; and, by merely reviewing financial statements, failure could be predicted as early as five years prior to filing for bankruptcy.[12] By comparison, manufacturing and retail firms that efficiently managed cash conversion cycles were found in a recent study to be more liquid, have less need for debt or equity financing, and to also produce higher returns.[13]

Managing Costs. Virtually everything associated with running a successful business has some form of cost associated with it. If you think that your business would do better if you had more money to work with, whether you get that money through debt or through equity investment, there is a cost of capital that you will incur and efforts will be made to measure and control what those costs will be.[14] If more and better conventional or Internet marketing is what you think you need, you will have to pay for that marketing. If you need better employees, or facilities, these come at a cost. Even the methods you might decide to put in place to prevent theft and fraud will likely cost you something.

Given that the things that you need to produce revenue and profit require that you pay some costs, you need to posture yourself and your employees to be very vigilant about keeping business costs as low as possible. It is because of concerns about cost that many small firms prefer cost-based pricing of contracts rather than fixed-price contracts.[15] Regardless of the type of business that you have, Chapter 6 provides valuable information that you can use to help your business better control its costs.

Bonus Content. Three brief appendices have been added to assist you in learning about break-even analysis, legal business structures, and intellectual property. These are topics that are often mentioned in discussions

about business, with the assumption that everyone knows what each means. In fact, many business owners operate with little or no knowledge of one or more of these topics. Inclusion in this book gives you the opportunity to have at your disposal a quick reference for each topic. You are encouraged to consult additional sources if you believe that you need additional information on either topic.

Why Can't I Just Pay Someone to Handle the Important Management Tasks for Me?

Actually, you can—at least to some extent. As a business grows, owners typically find it necessary to bring on middle managers who can handle many of the day-to-day tasks, so that the focus of the owner can shift to the most important concerns of the business. However, this delegation of duties should not extend to every aspect of the business, unless you are incapacitated at some point or you are moving toward retirement. Ask yourself this question: Would you turn over your bank account to someone else and simply leave your money to that person's oversight and management? If you would, you should rethink your approach to your money. By the same token, unless someone else has an equal interest (equal ownership) in the business, no one else is going to take the time and interest in your business that you would. For you, while running your business is certainly hard work, it is also likely an everyday labor of love as you nurture *your baby* to become the success that you want it to be. In order for that to happen, you need to know as much about management as you possibly can.

Using This Book

As you read this book, you will find that the focus is on presenting key topics and concepts in ways that are designed to cause you to think and personally integrate what you are learning into how you operate your business. It is recommended that you read the chapter contents thoroughly on your first reading. Later on, you can return to particular content that you found to be highly significant. You should read with pen in hand so that you can highlight areas that are of particular importance to you. Also, keep in mind that your perspective on what is highly beneficial

to you may change over time. Abundant examples have been incorporated so that you will know exactly what the authors are trying to share with you. The examples used are often of small businesses but are sometimes of larger businesses that are familiar companies. This was done to make certain that your time is not spent trying to understand the nature of the businesses. However, in each instance, the intent is that the concepts imparted will be relevant and useful to you in your efforts to more effectively manage your own business.

As you finish each chapter, you will have the opportunity to check whether you grasped the lessons intended by each author. This will be verified by your completing the Chapter Summary Checklist that you will find at the end of each chapter. The checklist at the end of this chapter serves as something of a self-assessment of your knowledge of the topics covered in this book, in advance of your reading it.

Writing the Last Chapter

In many ways, what you do with what you learn from this book can be viewed as your authorship of its last chapter. After all, this journey was begun for the express purpose of helping you to make your business future more successful than it would have been had you not spent the time to read what is presented here.

With the firm belief that you will certainly oversee a more successful business if you understand, embrace, and put into action what this book provides, a final challenge is offered. The late Jeffrey Timmons, one of the premier scholars in the field of entrepreneurship, found that three practices were common among very successful entrepreneurs.[16] Those practices were as follows:

1. Following the Golden Rule (treating others as they wished to be treated);
2. Sharing the wealth with those who helped to create it; and,
3. Giving back to the community.

May your business be very successful and may you follow the example of the very successful entrepreneurs whom Timmons described. Our efforts will then have been completely worthwhile.

Chapter Summary Checklist

(X) Check all that apply

☐	01.	I understand why I need to know as much as possible about how to manage my business.
☐	02.	I believe that I know what I need to know about managing my business for maximum success now and in the future.
☐	03.	I understand the difference between knowing management basics and having an effective managerial mind-set for running my business.
☐	04.	I understand how the authors tested and refined the materials that are presented in this book.
☐	05.	I already have a clear understanding of strategic planning and how to conduct it to plan effectively for the future of my business.
☐	06.	I already have a firm command of financing sources that are available to me as a small business owner and how to satisfy the requirements of those sources.
☐	07.	I understand how to effectively market my business to obtain optimum returns in revenues for the dollars that I spend.
☐	08.	I know how to effectively manage and track the flow of cash into and out of my business.
☐	09.	I understand the importance of managing costs and understand how to establish the systems and employ the techniques that ensure effective cost control in my business.
☐	10.	I already fully understand break-even analysis, legal business structures, and forms of intellectual property protection.

CHAPTER 2

Strategic Planning

In deep despair, and headed anywhere, I plunged, I dangled, I fell, and landed: nowhere

—© 2013 Sage Sayings™

Introduction to Planning for Your Firm's Long-Term Future

There is an old adage that says, "If you do not know where you are going, any road you take will get you there." With the heavy investment you will have to make to have your business become the successful firm that you want it to be, you can ill-afford such a haphazard and lackadaisical approach to managing it. Strategic planning is the way for you to plan for your business's future.

Strategic planning is the process your business should use to make specific decisions and take specific actions that can affect your business's future outcomes and determine whether you reach your goals and objectives.[1] The results of the strategic planning effort, the strategic plan, serves as a basis for action, a road map that provides directions for the future actions of your business, such as resource allocation and specific steps toward goal accomplishment. In addition, strategic plans define both the markets in which your business will compete and the ways in which it competes in those markets.

Strategic planning is essential for organizations of all sizes and types. Small businesses, in particular, can benefit greatly from engaging in the strategic planning process. Strategic planning goes beyond just identifying effective strategies; it also includes developing plans to ensure that those strategies are put into action. The process, therefore, involves strategy formulation, strategy implementation and execution, and the evaluation of organizational accomplishments through strategic controls.[2]

Results of Effective Strategies

The development of effective strategies can be crucial for the survival and success of a small business in today's business world. Strategic planning can serve as a major tool for meeting the challenges of the 21st century. For small businesses, effective strategic planning can:

1. *Provide a clear sense of direction***.** Small businesses can use the strategic planning process to set strategic goals and objectives and choose the means (strategies) to achieve those goals and objectives. Strategic goals are major targets or end results that relate to the long-term survival and success of your business. Typical strategic goals include growing, increasing market share, improving profitability, boosting return on investment, fostering and enhancing quality of outputs, increasing productivity, improving customer service, and contributing to society.[3]
2. *Focus efforts.* As you certainly know, a small business has limited resources and a wide range of possible ways to use those resources. In selecting strategic goals and strategies for your small business, you can establish specific priorities and make commitments about the ways that you will use your scarce resources. If your business begins to stray off course or encounter unforeseen contingencies, you can develop strategies to refocus your business and take timely corrective actions.
3. *Help in the evaluation of progress*. Clearly stated, measurable strategic goals and strategies, with specific deadlines, can become standards of performance that can help you, as a small business owner or manager, evaluate your progress and success. Thus, strategic planning serves as an essential precursor to and link with the *control function* of management, the function responsible for making sure that business actions are in keeping with strategic goals and the strategies created to achieve those goals.

It should be clear that strategic planning is not a single event. It should be an ongoing process that reflects and adapts to changes in the environment(s) surrounding your business. Unlike linear planning, strategic planning assumes that a business situation may change; therefore,

change must be accepted and even embraced, where possible. Whether positive or negative change occurs, strategic planning encourages flexibility in dealing with it.

In addition, central to the concept of strategic planning is the notion of *competitive advantage*—the aggregation of factors that sets a small business apart from its competitors and gives it a unique position in the market superior to that of its competitors.[4] Developing a strategic plan is critical to the creation of a small company's competitive advantage.

Today's business environment places a great premium on competitive advantage and how it is achieved, or not, through strategy and strategic management.[5] Through strategic planning, small business owners or managers like you can develop strategies for achieving and maintaining a sustainable competitive advantage over other businesses in your industry.

Benefits of Strategic Planning

Strategic planning requires a great deal of managerial time, energy, and commitment. To justify these efforts, strategic planning should produce tangible benefits.

Research suggests that the benefits of the process are both economic and behavioral.[6] From an economic perspective, a number of studies suggest that organizations that plan strategically outperform those that do not. Research findings on a variety of financial measures, such as return on investment, return on equity, and profit margin, suggest that there are financial benefits associated with strategic planning.

Research findings also suggest that strategic planning can produce behavioral benefits. These benefits include[7]

- an increase in the likelihood of identifying organizational and environmental conditions that might create problems;
- better decisions as a result of the group decision-making process; and,
- more successful implementation of strategies because organizational members who participate in the planning process understand the plan and are more willing to contribute to implementation.

The overall goal of strategic planning is to take a business from where it is to where it wants to be. Given the potential benefits of strategic planning and the potential costs of the failure to engage in such planning, as a small business owner striving for optimal success, you must recognize that strategic planning is essential.

Each step of the strategic planning process can make a contribution to the overall success of a business. This chapter examines the strategic planning process and the product of that process: the *strategic plan*. So that you can complete this chapter with a sense of understanding and ability to implement the process in your business, special attention will be given to each step in the strategic planning process.

The Strategic Planning Process

Businesses use a strategy-making process to create strategies that produce a sustainable competitive advantage.[8] The strategic planning process model presented and discussed in this chapter consists of seven steps (Figure 2.1).

This model is simple, straightforward, and applicable to a wide variety of small businesses. The process itself, however, does not have to be truly linear. Steps may overlap or occur in a different order, depending on the needs of your business. In addition, some activities, such as analyzing the environment, can be continuous throughout the strategic planning process. Nonetheless, each step should be completed because each makes a

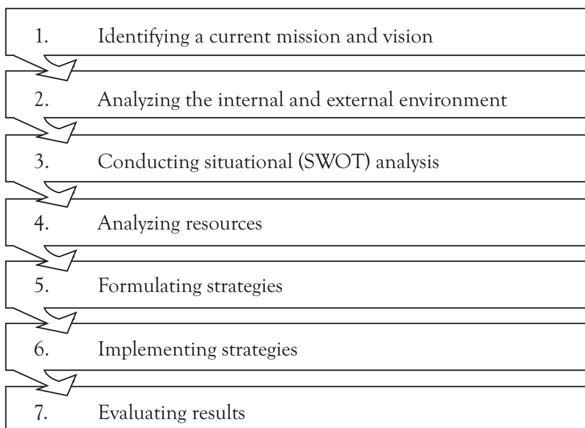

Figure 2.1 Strategic planning process

valuable contribution to the overall purpose of getting the small business to where it would like to be.[9]

You should make an attempt to free your mind to work in a focused way to complete the strategic planning process, particularly the first time that you engage in the process. With that in mind, it is now time to examine each of the steps in the process in some detail.

Step 1. Identifying and Analyzing Your Business's Mission and Vision

Your business might have a mission statement but no vision statement, or vice versa. Also, both could actually be present or absent. However, both can add considerable value by clarifying the focus of your business.

The Mission

The most common initial act in the strategic planning process is the identification of the mission of the business. The mission is the purpose for which and the reason that a business exists. A clear, formal, and publicized mission statement is the cornerstone of any planning system that will effectively give a business a sense of direction.[10]

Every business should have a written mission statement that defines its purpose and answers the following key questions (which have been deliberately personalized for you to encourage your being introspective about each question):

- What is my business, really? Why does it exist?
- Who are my customers and key stakeholders?
- What are the basic products and services provided by my business?
- In which market(s), or market segments, will my business compete?
- What are my business's values and beliefs?[11]

By answering such basic questions as these, you can help to guide your company to a much clearer picture of what your business is, what it

stands for, and what it wants to be. You should be aware that a mission statement need not be lengthy to be effective. A short paragraph or a couple of sentences is the norm.

The mission is usually expressed in writing to ensure that all organizational members have easy access to it and thoroughly understand exactly what the business is trying to accomplish. The mission statement will be a relatively permanent part of your business's identity and can contribute significantly to unifying and motivating members of your business organization.[12]

For small businesses in early phases of operation, it is likely that the small business owner will make the decisions about the strategic direction of the business, including its mission, using input from only a select group of advisors. As the business grows, however, small business owners must create a clear mission statement through consensus. While formulating and reaching consensus on a mission statement can and probably will be time-consuming, every unit, department, and employee within the business will take direction from it.[13]

A good mission statement provides a focal point for the entire strategic planning process. An accurate description of the purpose of the business, provided in the mission statement, drives the strategic plan. It embodies, in a few words or sentences, a concise profile of the business (purpose, values, etc.). Effective strategic planning cannot occur without a clear understanding of what the business does. The mission statement is, therefore, the beginning of effective strategic planning.

Strategy consultants believe that a mission should represent what the strategy or underlying business model is trying to accomplish.[14] For example, Starbuck's mission is to be "the premier purveyor of the finest coffee in the world, while maintaining our uncompromising principles as we grow." At Mary Kay, Inc., the mission is "to enrich women's lives."[15] Another example is Patagonia, a California-based company that sells top-quality and highly priced outdoor clothing and gear, which has the mission to "build the best product, cause no unnecessary harm, use business to inspire and implement solutions to the environmental crisis."[16] This mission provides not only a business direction, but also a distinctive value commitment—one that gives Patagonia a unique identity as it competes with much larger rivals in the industry, such as North Face and Sierra Trading Post.

The mission statement is also the foundation for all the strategies and plans in which the business will invest its resources. A properly developed mission statement will give members of your organization general, but useful, guidelines about how resources should be used to best accomplish your business's goals and objectives. In addition, the existence of a mission statement can help you to pinpoint broad, but important, job areas within your business. A well-developed mission statement generally can help define critical jobs that must be accomplished.[17]

For most business owners, defining the mission might seem to be an exercise in the obvious; but, exactly the opposite is true. Some small businesses drift along without a clear mission, while others lose sight of the original mission. Also, sometimes a business might find that its original mission is no longer acceptable to key stakeholders. Therefore, periodically redefining the mission of a business can prove to be necessary in a business environment of rapid change.[18]

Finally, the mission statement has meaning only if it serves as a driving and unifying force for guiding the strategic planning process and for helping the business achieve its short- and long-term goals. "The mission statement should stimulate those in the organization to think and act strategically, not just once a year, but every day."[19]

The Vision

Some business owners develop a vision statement that is different from their mission statement. The vision, quite simply, is a realistic picture of where you want your business to be in the future. A vision expresses an organization's fundamental aspirations and values, usually by appealing to its members's hearts and souls. A vision statement adds soul to the mission statement, if it lacks one.[20] It needs to be a "stretch," but achievable, within the current context of your organization's resources. The vision statement, when used properly, can motivate and inspire your employees and lead to successful goal accomplishment.

A vision statement can accomplish all of the following:

- Create an inspiring vision of what the business can be and can do
- Outline how the vision is to be accomplished

- Establish key priorities
- State a common goal and foster a sense of togetherness
- Create a philosophical anchor for all organizational activities
- Generate enthusiasm and a "can do" attitude
- Empower present and future employees to believe that every individual is key to the success of the business[21]

The purpose of the vision statement is to focus everyone's attention on the same target. The vision touches everyone associated with your business—employees, investors, lenders, customers, and the community. It is an expression of what you stand for and believe in, most fundamentally. Highly successful entrepreneurs are able to communicate to others what the business vision is, as well as enthusiasm about that vision. Following are two examples of a vision statement:

1. Underlying the mission of Ben and Jerry's is the determination to seek new and create ways to make, distribute, and sell the finest quality of all natural ice cream and euphoric concoctions, while holding a deep respect for individuals inside and outside of the company and for the communities of which they are a part.[22]
2. The vision of Under Armour, which started as an athletic-wear company by producing undershirts in the basement of the owner's grandmother's house is: "To empower athletes everywhere through passion, design and the relentless pursuit of innovation."[23]

Finally, your vision statement must be consistent with your mission statement. Taking the time to seriously contemplate and shape a vision for your business is an important step in strategic planning, for it is a formative step in establishing goals and strategies and a blueprint for the future. The more widely the vision is shared, the greater the chance of success.[24]

Step 2. Analyzing Your Business Environment

One of the most important steps in the strategic planning process is an analysis of the environment. A successful business strategy will be one that aligns well with the environment because your business's environment, to

a large degree, defines your options.[25] Likewise, a small business like yours can be successful to the extent that it is appropriately matched with its environment.

Business owners commonly perform *environmental analyses* to facilitate understanding of what is happening both outside and inside the businesses. You must understand what is taking place in the external and internal environments in order to make sound decisions as to how to run your business and how to position your products and services for success.[26]

Environmental analysis, or *environmental scanning*, as it is popularly called today, involves searching the environment for important events or issues that might affect your business. You should continuously scan your environment to stay up-to-date on important factors that affect your industry. You should pay particularly close attention to the trends and events that are directly related to your company's ability to compete in the marketplace.[27]

There is no magic formula for conducting an environmental analysis. It is important, however, for you to assess each of the relevant environmental forces that could affect the direction of your business.

For purposes of environmental analysis, the business environment is typically divided into two distinct levels: the general environment and the task or specific environment, also called the operating environment. The importance of formulating your business strategies in response to your informed understanding of your business environment cannot be overstated.[28] Each type of environmental analysis will now be discussed.

The General Environment

The general environment, sometimes called the *macro-environment* or *indirect action* environment, includes external factors that usually affect all or most businesses. The general environment includes the conditions that exist outside the organization, such as the nature and state of the economy, the social milieu (sociocultural environment), legal-political, technological, and natural conditions.[29] International considerations (foreign markets and competition, exchange rates, etc.) are also included in the general environment.[30]

For example, the general environment includes the following:

- The type of economic system (i.e., free enterprise, socialist, or planned demand)
- Economic conditions (expansionary or recessionary cycles, and the general standard of living)
- Type of political system (e.g., democracy, dictatorship, or monarchy)
- Conditions of the ecosystem (extent of land, water, and air pollution)
- Demographics (age, gender, race, ethnic origin, and educational level of the population)
- Cultural background (values, beliefs, language, and religious influences)

These aspects of the general environment spawn the cultural, competitive, technological, and political-legal forces that can impinge on small business activities.[31] Although each force is considered separately in the following, these forces are largely interrelated (e.g., political actions in the United States can influence both the international and domestic economies, which, in turn, can impact on demographics, such as levels of education of the relevant populations, etc.).

The Economic Environment. The economic component is the part of the general environment that indicates how resources are being distributed and used within the environment. This component is based on economics, the science that focuses on understanding how people of a particular community or nation produce, distribute, and use various goods and services. Important issues considered in an economic analysis of the business environment generally include the wages paid to labor, inflation, the taxes paid by labor and businesses, the cost of materials used during the production process, and the prices at which produced goods and services are sold to consumers.[32]

The United States has an economic system in which privately controlled markets based on supply and demand prevail over governmental control of production and prices. Free market competition, private

contracts, profit incentives, technological advancement (which will be discussed later), and labor with collective bargaining rights (where desired) are essential elements in this system.

Economic issues, such as those listed earlier, can significantly influence the environment in which a small business operates and the ease or difficulty that business experiences in attempting to reach its goals and objectives. Clearly, your business strategy should reflect the economic conditions in your business environment.

As a small business owner, you should be concerned about economic conditions in the general environment, particularly those that influence customer spending, resources or supplies, and investment capital. It is always important that you maintain awareness of the overall health of both the domestic and global economies (e.g., financial markets, inflation, income levels, and job outlook). Economic conditions are key factors to be assessed, forecasted, and considered when you make decisions about your business strategies and operations.

The Sociocultural Environment. The sociocultural component is that part of the general environment that describes the characteristics of the society in which a business exists. Sociocultural conditions are exemplified by the norms, customs, and demographics of a society or region, as well as social values on such matters as ethics, human rights, gender roles, and lifestyles. Patterns and trends in these sociocultural factors can have major consequences for your small businesses and how your business needs to be managed.[33]

Two important features of a society that are commonly studied during environmental analysis are demographics and social values. With respect to demographics, you should stay abreast of educational, racial, or ethnic, gender, and generational trends and changes. Changes in demographics play an important role in marketing, human resource management, finance, and other aspects of business. These demographic changes can influence the responsiveness to goods and services within your business environment and thus should be reflected in your business strategy.

For example, due to the rise in the number of Americans who speak English as a second language, a growing number of ads for familiar products are in Spanish as well as English, and all safety instructions are in

both English and Spanish. Salsa is a staple in many households and now outsells ketchup. Burritos are popular substitutes for sandwiches in many college and university student centers. A small business wishing to capitalize on these demographic realities should keep these trends in mind.

Social values are the relative degrees of worth that society places on the ways in which it exists and functions. However, over time, social values can change dramatically, causing obvious changes in the way people live. For example, for years, most married women stayed home; but, now, most adult females work. In addition, women have dramatically increased in representation in occupations and industries from which women were once excluded (or at least not encouraged to enter)—including, for instance, business, engineering, medicine, and law. Due to the rise in women who have degrees from business schools, the number and percentage of women in middle and top management positions has risen significantly. These changes have increased the amount of business for a variety of small businesses, such as daycare centers, fast-food and conventional restaurants (two-income families eat out more frequently), home security systems, grocery stores, hospitality and travel companies, and the number of computers in the home, to name a few. Changes in social values alter the business environment and, as a result, should have an impact on your business strategy.[34]

Another example is that populations in developed countries are aging, while those in less-developed countries are increasingly dominated by young people. Such trends present many challenges and opportunities for businesses across the globe. Specifically, in the United States, nearly half of the labor force now comes under the protection of the Age Discrimination in Employment Act. This Act, which provides protection against age discrimination in employment for workers aged 40 and older, has affected major human resource management decisions made by American businesses concerning older workers.[35] In addition, the aging population in the United States has caused the demand for retirement housing to rise. Effective business strategy would include a mechanism for dealing with this demographic shift within the construction industry, as well as other industries such as household equipment and furniture.[36]

Likewise, underlying a society and surrounding an organization are various sociocultural forces, which often are not as visible as other general

environmental forces. Culture can be defined as the shared characteristics (e.g., language, religion, and heritage) and values that distinguish one group of people from another. A value is a basic belief about a condition that has considerable importance and meaning to individuals and is relatively stable over time. A value system comprises multiple beliefs that are compatible and supportive of one another. For example, beliefs in private enterprise and individual rights are mutually supportive. These cultural and value systems have specific implications for small businesses.

The Legal-Political Environment. In order to protect the future of your small business, you must also stay abreast of developments in legal-political conditions in the general environment. These conditions are a result of existing and proposed laws and regulations, government policies, and the objectives of political parties. For example, in the aftermath of the recent economic recession, U.S. lawmakers examined many issues such as the regulation of banks and the financial services industry, foreign trade agreements, and protection of U.S. jobs and industries. As a small business owner, you must also follow such debates to monitor trends that can affect the regulation and oversight of your business.[37]

Some examples of legislation specifically aimed at the operation of businesses include the Fair Labor Standards Act, the Equal Pay Act, Title VII of the Civil Rights Act, and the Family and Medical Leave Act. Federal, state, and local governments all influence what small businesses can and cannot do. Business owners should be aware of these laws and the changes that take place from time to time.[38]

The political component is the part of the general environment that contains the elements related to government affairs. Examples include the government's attitude toward various industries, lobbying efforts by interest groups, progress on the passage of laws, and political party platforms and candidates. Some examples of trends and forces that small business owners should assess in the political environment include the following:

- What will be the blend of services offered by the government, nonprofit, and corporate worlds? How will this blend change over time?

- Will there be more or less privatization of government services? What will be the role of nonprofits?
- What will be the trend in your industry with respect to cooperation and competition with allied agencies or organizations, governmental, or nongovernmental service providers?
- Will political trends affect your suppliers in the same way that your business is affected? Are there other trends that affect suppliers?[39]

In addition, legal-political conditions in the global business environment vary from one country to the next. Just as foreign companies like Toyota have to learn to deal with U.S. laws and political conditions, so too must U.S. companies have to adjust to the legal-political environments of foreign countries.[40]

It is obvious that the political-legal environment can be highly complex and very time-consuming to monitor, to say nothing about trying to influence it on behalf of your business. For this reason, some small businesses, such as construction companies, join industry trade associations for the express purpose of monitoring and influencing legislation that can impact the industry (and individual businesses, as a result). This is an option that you might want to consider.

The Technological Environment. Perhaps nothing gets as much attention these days as developments in the technological conditions in the general environment. Technological forces include the use of and changes in technology that affect the way businesses operate or the products and services provided by these organizations. Technological forces can include new procedures, as well as new equipment. To keep up to date on technological trends, many businesses engage in *technology forecasting*. Such forecasts identify trends in technology that require adaptation on the part of the business. The success of many organizations is dependent upon their ability to identify and respond to technological changes.

For example, one of the most significant technological trends in the past several decades has been the increasing availability and affordability of management information systems. Through these systems, owners have

access to information that can improve the operation and management of small businesses. The retail industry, for example, has been transformed by the introduction of scanner technology. Not only have scanners improved the efficiency of the checkout process, but these scanners also provide important inventory management information to support procurement and warehousing efforts. Small retail operations that do not take advantage of such technology are at a competitive disadvantage.[41]

The role of technology in businesses is advancing as quickly as the use of YouTube, Facebook, Google Maps, and apps on smartphones. For example, customers of USAA, a financial services company for military families, can take photos of checks, use an iPhone app to send the checks to the bank, and then spend the deposited money within minutes.[42]

Social media are now all the rage, but for business owners like you, it can be both an opportunity and a problem. Americans now spend more time in the world of social media than with e-mail. One of the growing concerns of employers is just how much time tech-savvy employees spend browsing the Web and engaging in online diversionary pastimes while on the job.[43]

A survey of 1,400 chief information officers found that only one in 10 said that company employees were allowed full access to networking sites while on the job. One concern is the potential for too much social networking, while another is that of protecting the privacy of privileged information and communications. The term *Enterprise 2.0* describes how businesses use social networking and blog technologies to open up communications, while keeping the focus on work and protecting the privacy of information exchanges. An example is Yammer, a business communication tool centered around the question: "What are you working on?"[44]

On the small business employee side of the technology equation are the issues of know-how and work–life balance. The concern is whether or not employees know, understand, and use the technology required for their jobs as well as how easily technology drives the penetration of work responsibilities into life outside the job. Employees often complain about "never being free from the job," and that work follows every step taken—whether at home, on vacation, or just about everywhere, in the form of a notebook or network computer and smartphone device. On the flipside, these technological devices also allow employees to work from home,

when possible, to avoid commuting or leaving the children alone on snow days, for example.[45]

Therefore, when engaging in the environmental scanning of technology, you should assess the following trends and forces, at a minimum:

- What changes in computer and communications technology are likely to affect business operations?
- What impact will energy-saving devices have on the business?
- How will transportation technology affect business operations and employees?
- What other technological trends could be expected to affect the business in the future?[46]

The Natural Environment. Small business owners and entrepreneurs must also take into consideration the conditions of the natural environment. Debates about being carbon neutral, green, and sustainable are big issues on college campuses, in local, national, and international communities, in everyday lives, and in large businesses. Small businesses are not exempt. Initiatives to reduce paper usage, recycle, use local produce, and adopt energy-saving practices abound.[47]

Businesses are increasingly expected to supply environmentally friendly products and to operate in ways that preserve and respect the natural environment. When businesses fail to do this, public criticism is likely to be vocal and harsh. For example, outrage quickly surfaced over the disastrous BP oil spill in the Gulf of Mexico, with calls for stronger governmental oversight and control over business practices that put the natural environment at risk.[48]

There is now growing interest in the notion of *sustainable business*, where businesses are expected to operate in ways that both meet the needs of customers and protect or advance the well-being of the natural environment. What makes a business sustainable is how it operates and whether what it produces has minimum negative impact on the environment and helps preserve it for future generations. A truly sustainable business operates in harmony with nature rather than by exploiting it. Hallmarks of sustainable business practices include but are not limited to

less waste, fewer toxic materials, resource efficiency, energy efficiency, and renewable energy.[49]

Other political and economic conditions in the United States have led to a renewed environmentalism. It is recommended that businesses take the following steps in heeding the call for renewed environmentalism:

- Cut back on environmentally unsafe operations.
- Compensate for environmentally risky endeavors.
- Avoid confrontation with state and federal pollution control agencies.
- Comply early with government regulations.
- Promote new manufacturing technologies.
- Recycle wastes.[50]

The Task Environment

In addition to the general environmental issues listed earlier, you, like all small business owners and entrepreneurs, must deal with the *task or specific environment* on a daily basis. Often called the *operating environment*, these forces are within a company's operational arena and can directly influence or be influenced by the business itself. By contrast, the general environment exhibits indirect influence on the business, as it influences the entities in the task environment of the business.

The task environment consists of the critical components and constituencies that can positively or negatively influence the company's effectiveness. The task environment is also unique to each business and changes with different conditions. It includes those external groups or entities that directly influence the growth, success, and survival of a business; thus, the task environment includes suppliers of inputs, customers or clients, competitors, labor, government agencies or regulators, and public interest pressure groups.

Suppliers. The supplier component of the task environment involves other companies, agencies, or individuals that provide a business with the resources needed to produce its goods and services, such as raw materials and equipment, office supplies, hardware, bricks, or concrete. Suppliers

also include stockholders, banks, insurance companies, pension funds, and other similar institutions needed to ensure continuous access to capital and other resources and services.

As you know, you are ever-striving to ensure a steady flow of needed inputs at the lowest price possible. You go to great lengths to maintain a predictable flow of these inputs, because each input can represent a critical uncertainty, such as lack of availability or delay that can reduce the effectiveness of your business. As you are no doubt aware, issues such as how many suppliers offer specified resources for sale, the relative quality of the materials offered by various suppliers, the reliability of supplier deliveries, and the credit terms offered by suppliers, all become important in managing a business effectively and efficiently in today's business environment.[51]

Customers. Customers are always key stakeholders, for these are the buyers of the goods or services provided by a business. Individuals, groups, government agencies, and even other businesses can be major customers of a given business. Businesses exist to meet the needs of customers or clients. However, customers and clients obviously represent potential uncertainty for a business. Customer tastes can change. Customers can also become dissatisfied with the product or service of a business. Customers can be very demanding in desires for low prices, high quality, on-time delivery, and great service.[52]

You can conclude that, if every customer or client contact with your business proved to be a positive experience, those customers would return again and again, and would also tell friends and associates, thus expanding the customer base of your business. Many organizations now use the principles of customer relationship management (CRM) to establish and maintain high standards of customer service. Businesses also use consumer profiles or consumer studies (detailed descriptions of customers who buy organizational products). Developing such profiles helps a business generate ideas for improving customer acceptance of organizational goods and services.[53]

Competitors. All organizations have competitors, those companies that battle with your business for customers. Macy's has Bloomingdale's

and General Motors has Ford, Chrysler, and several foreign competitors. A local hair salon competes with others in the neighborhood, and a local computer repair company competes with others like it in the same city.

Competitors are generally of considerable concern for small businesses. No small business can afford to ignore its competition, including international competition. When a small business does ignore its competition, it is likely to pay a very serious price because a small business usually has fewer prospects available to compensate for its mistakes.

Understanding the competitive environment is a fundamental challenge that all nonmonopolistic business owners must face. In terms of pricing, products, and services offered, new products developed, and the like, competitors represent an important environmental element that you must monitor and be prepared to respond to effectively.[54] Furthermore, understanding competitors is a key factor in developing effective strategy. Overall, your strategy should be to search for a plan of action that will give your business a competitive advantage over your competitors.

Labor. The labor component of the task environment comprises factors influencing the availability and accessibility of qualified workers to perform the necessary tasks of your small business. While not all small businesses have employees, the growth of a business is very closely tied to its ability to attract and hold onto qualified workers. Therefore, as your company grows, issues such as skill levels, trainability, desired wage rates, and the average age of potential workers will become increasingly important to the operation of your small business.[55]

Government or Regulators. Federal, state, and local governments influence what small businesses can and cannot do. Some federal legislation has tremendous impact on small businesses. For example, federal and local laws require that businesses pay all hourly workers time and a half for each hour worked over 40 hours per week. Likewise, for the same types of businesses, the Civil Rights Act of 1964, as amended, makes it unlawful for an employer to discriminate against employees because of

race, color, religion, sex, or national origin. Focusing on a totally different domain, another federal law, the Occupational Safety and Health Act of 1970, established an extensive list of safety and health standards that businesses are required to maintain.

Several legal statutes, executive orders, and court decisions are mandated measures designed to protect the rights of employees. Given that associated regulations exist across a very wide span of business operations (e.g., taxes, banking and financial services, environmental issues, etc.), the preceding examples of employee-oriented regulations simply demonstrate the constraints that government regulations can place on small businesses.[56]

Pressure Groups. Small business owners cannot fail to recognize the special interest groups that attempt to influence the actions of businesses, such as Ralph Nader's Center for Responsible Law and other lobby groups. As social and political causes change, so too does the power of pressure groups. You should be aware of the power that these groups can have with respect to decisions that impact your business.[57]

Stakeholders. Members of the specific or task environment are often described as stakeholders (e.g., other companies, institutions, groups, or persons who affect a business).[58] Stakeholders are key constituencies that have: (1) a "stake" in how a business operates; and, (2) a relationship of mutual influence with the business. Members of the task environment of your business are major stakeholders. "Society-at-large" and "future generations" are also stakeholders. Among other things, stakeholders introduce concerns regarding such issues as sustainability and the natural environment. Business decisions are often made with an analysis of the extent to which a business is creating value for and satisfying the needs of its multiple stakeholders.[59] Keep this in mind.

Completing Step 2 of the strategic planning process will allow you to evaluate environmental conditions (both general and specific) faced by small businesses like yours. The information gathered in this step (Step 2) and in Step 3 (which will be discussed shortly) can serve as a foundation for the formulation of business strategy that will operate as your guide to the future direction of your business.

Step 3. Conducting a Situational (SWOT) Analysis

A situational analysis can also help you develop strategies that will facilitate accomplishment of your business's mission and goals. You should systematically analyze specific factors and forces that affect your business's ability to meet its goals in both the short term and in the future. Such factors and forces exist both inside your business and outside in the environment.

A popular planning technique used to analyze a business situation is known as a SWOT analysis. A SWOT analysis is a planning exercise through which you can identify internal business strengths (S) and weaknesses (W), and external (environmental) opportunities (O) and threats (T).[60] See Figure 2.2.

Ideally, a SWOT analysis can help your company determine how to increase internal strengths and minimize internal weaknesses, while maximizing external opportunities and minimizing external threats.[61] The SWOT analysis will cause you to look very critically at your business, perhaps in ways that you might not have ever considered. Moreover, recall that, in Step 2, forces in both the general and task environments were discussed from the perspective of potential effects on a business. The SWOT

	Internal	**External**
Enhance/ exploit	Strengths	Opportunities
Reduce/ eliminate	Weaknesses	Threats

Figure 2.2 SWOT analysis

analysis will help you to identify those forces that can produce opportunities that your business can take advantage of and threats that can harm your business's current or future situation.

Identifying Strengths and Weaknesses

The first step in a SWOT analysis is to identify your business's strengths and weaknesses. *Strengths* are skills and capabilities that enable your business to conceive and implement its strategies and to accomplish its mission, goals, and objectives. Among other possibilities, business strengths can include the following:

- Well-trained, competent employees
- Supportive customer base or constituency
- A customer-oriented organizational culture
- Professional expertise
- Strong financing
- Superior reputation
- Ownership of intellectual property (patents, trade secrets, etc.)

In the early 1990s, three approaches to analyzing and building internal strengths became prominent. The first approach was developed by two noted researchers and consultants, C. K. Prahalad and Gary Hamel, who proposed that an organization's key strengths are its *core competencies*—the organization's collective learning, especially as related to the technology and management processes that make a firm competitive. For example, by reputation, Honda knows how to make engines better than anyone else. This has allowed Honda to make automobiles and motorcycles that have given Honda a dominant position in both markets.[62] A small business like a small law firm or medical practice should develop core competencies such as specific knowledge or specific expertise in a particular area of law or medicine.

Next, McKinsey and Company consultants, George Stalk, Philip Evans, and Lawrence E. Shulman, developed a broader concept than core competencies. This team put forth the term, *capabilities*, which refers to collective, cross-functional, value-adding organizational processes that

create competitive advantages. Capabilities require investment in support activities beyond what might seem necessary on the surface. For example, Wal-Mart has developed a superior logistics system that has enabled it to beat K-Mart's prices.[63] A similar example would be a small business that develops a superior logistics system that will enable it to reliably beat its competition in getting its product to customers because the company's suppliers are able to deliver ready-to-ship goods more quickly.

Broader still is the concept of competing through *resource bases*. A number of management experts have suggested the need to build substantial resources, including those consisting of intangible assets such as employee skills and organizational knowledge. These resources then serve as a basis for competition; hence, the term "resource-based strategies," which allow companies to seize opportunities and ward off threats. Many experts consider this approach critical to strategizing in complex, dynamic environments.[64]

Thus, examining the strengths of a business has become an exercise in identifying an organization's core competencies and analyzing its capacity to achieve its goals and objectives. Strengths can be capabilities that, by virtue of being rare, costly to imitate, and nonsubstitutable, can become potential sources of competitive advantage. Core competencies can also be found in special knowledge or expertise, superior technologies, or unique distribution systems, among many other possibilities.[65]

Business weaknesses are the other side of the coin. The goal of the analysis of weaknesses is to identify those things that inhibit performance and hold your business back from fully accomplishing its goals and objectives. Some examples of business weaknesses include the following:

- Outdated products
- Outmoded technology
- Lack of capital
- Lack of properly trained employees
- Loss of market share

In practice, small businesses have a difficult time focusing on weaknesses, in part because the owners of such businesses are often reluctant

to admit deficiencies in skills and capabilities. Evaluating weaknesses can also call into question the judgment of the business owner who chose the organization's mission in the first place, and who might have failed to invest sufficiently in the skills and capabilities needed to accomplish it. From the perspective of an effective SWOT analysis, identification of weaknesses should never be viewed as a finger-pointing exercise, but rather as an opportunity to step back, take a fresh look, and get right what might have been missed or inadequately accounted for earlier.

Businesses that fail to either recognize or overcome weaknesses are likely to suffer from competitive disadvantages. A business has a disadvantage when it is not implementing valuable strategies that are being implemented by competing businesses. Not unexpectedly, businesses with competitive disadvantages can expect to attain below-average levels of performance.

Strategies can be developed to eliminate or reduce identified weaknesses, or to possibly convert the weaknesses into strengths. Even if some weaknesses cannot be corrected, you need to understand what those weaknesses are.

As a result of completing this first step in the SWOT analysis, strategies can be developed to build upon business strengths and to eliminate or at least attempt to minimize some of the negative impacts of weaknesses that have been identified.

Identifying Opportunities and Threats

Evaluating opportunities and threats requires an analysis of an organization's external environment. Business opportunities are areas that might generate higher performance for your business; whereas, business threats are forces that can compromise the survival prospects or hinder the growth of your business. Consider that the emergence of the Internet as a viable marketplace has provided both opportunities and threats for small businesses like yours. Businesses that have approached the Internet strategically and have used it effectively have succeeded, while many businesses that have ignored it or used it ineffectively are likely to have achieved much less success.[66]

Based on the strengths and weaknesses of the business and analysis of the environment, among other considerations, opportunities might include, for example:

- Lower interest rates, which can make infrastructure investments less costly
- New markets to explore
- A stronger economy with increased consumer purchasing power
- Competitor weaknesses
- Emerging technologies

Business threats are areas that make it difficult for a business to perform at a survival or even higher level. Threats can include a wide range of possibilities (e.g., a poor economy, declining resources, new government regulations, and changing consumer tastes, etc.).

A well-known model, developed by noted Harvard professor, Michael Porter, identifies five competitive forces, or potential threats, in the external environment that have the potential to affect how much profit businesses competing in the same industry can expect to make.[67] Those threats are as follows:

1. Rivalry among competitors
2. New entrants into the industry
3. Emergence of substitute products or services
4. Bargaining power of suppliers
5. Bargaining power of customers

Porter argues that business owners should pay particular attention to these five forces. Once pertinent threats have been identified, strategies can be developed and enacted to nullify, as much as possible, the threats that might actually emerge.

With the SWOT analysis completed, and strengths, weaknesses, opportunities, and threats identified, you can continue the strategic planning process by identifying specific strategies for achieving the mission and goals of your business. The resulting strategies should enable your business to attain its goals by building upon its strengths and correcting

its weaknesses (where possible), while taking advantage of opportunities and avoiding or countering threats.

Step 4. Analyzing Resources

After completing Steps 1 through 3 of the strategic planning process, you should then examine your resources and ask the following questions:

- What skills and abilities do my employees have?
- What is my cash position?
- Can my business raise additional capital?
- Can my business develop new and innovative products?
- How modern and efficient is my physical plant?
- What is my business reputation in terms of quality, efficiency, and customer service?
- Are we keeping up with important trends in our industry?
- Where should my time and attention be focused?

This step forces CEO's and presidents like you to recognize that every business, no matter how large or small, is constrained in some way by the resources and skills it has available. For example, a maker of office furniture cannot, at the drop of a hat, decide that the business is going to make airplanes. The furniture maker most likely does not have the talent, capital, physical plant, and so forth, to accomplish the goal of making airplanes that fly. Therefore, as a small business owner, you should take a look at the resources available to you and then develop strategies for success in the near future. Available resources that are valuable, rare, hard to imitate, and organized can be viewed as your core competencies.[68]

Step 5. Formulating Strategies: Choosing Among Alternatives

In strategy formulation, business owners work to develop a set of strategies that will allow the business to accomplish its mission and achieve its goals. *Strategies are major courses of action that a business takes to meet its goals and objectives.* Strategy formulation involves the development of concrete and measurable action plans, policies, and budget allocations.[69] Organizational

resources such as time, money, and people can sometimes be wasted on things that do not really contribute much value. A strategy helps to ensure that resources are used with consistent strategic intent, with all energies directed toward accomplishing the mission and goals of the business.[70]

Your reason for formulating strategies (courses of action) is to move your business from where it is to where you want it to be. In this step, you will encounter several general and business-specific strategies that small business owners like you can develop to steer your business toward goal accomplishment and success. Although larger organizations tend to be more precise in the development of organizational strategy than smaller businesses, every organization should have a strategy of some sort. For strategy to be worthwhile, however, you should develop clear business goals and objectives, which, in turn, must be consistent with the mission of your business.

Accordingly, while many people assume that strategy is the exclusive domain of top management, this simply is not true. Its relevance for those lower in the organization might not be as apparent, but it is relevant for everyone in your business. Managers and staff employees at all levels need a general understanding of your company's strategy.[71]

Understanding Levels of Strategy

Three levels of strategy can be found in most organizations. These are corporate-level (grand) strategy, business-level strategy, and functional-level strategy. Following is a discussion of each of these levels of strategy.

Corporate-Level Strategy. Corporate strategy (often referred to as "grand strategy") provides guidance for your business as a whole and describes the scope of business operations by answering the strategic question: "In what industry(ies) and market(s) should my business compete?"[72] The purpose of corporate strategy is to set direction and guide resource allocations for the entire enterprise.

Business-Level Strategy. Business strategy is the strategy for a single business, strategic business unit (SBU), or product line. It involves

answering the strategic question: "How will my business compete for customers in this industry and market?"[73] Most small businesses fall into this category, because, for small businesses with a single product or service, the business strategy is the corporate strategy. By comparison, a large enterprise or conglomerate will have a corporate strategy covering the entire organization, and each of its business units (SBU's) will have its own business (or business-level) strategy.

Typical business strategy decisions include choices about product or service mix, facilities, location(s), new technologies, and the like. Resource allocation within the business is also a major concern.

Functional-Level Strategy. Functional strategy guides the use of organizational resources to implement a business strategy. This level of strategy focuses on activities within functional areas such as manufacturing, marketing, finance, and human resources. As a business owner, you must decide how to best utilize resources within each functional area to implement your business strategy. This generally involves choosing among management practices to improve such things as operating efficiency, product quality, customer service, and innovativeness.

Examples of issues addressed by functional-level strategies include the following:

- How should suppliers be selected?
- Should the focus be on production runs for inventory or production primarily in response to customer orders?
- What production operations should be changed?
- How should products or services be marketed and distributed?
- What features and image should be emphasized in marketing?
- What should be the criteria for issuing credit to customers?
- How should the performance of employees be reviewed?[74]

Formulating Your Grand Strategy

While the previous discussion addressed levels of business strategy, focus will now shift to examining the different types of strategies (alternatives) that you can select from to best accomplish the mission and goals

of your business. A grand strategy is a comprehensive, general approach for achieving the strategic goals of a business. Sometimes called a master strategy, the grand strategy provides the basic strategic direction for the business. Fundamentally, an overall grand strategy for your business can be designed to help your business: (1) maintain its current position in the industry (stability strategy); or to, (2) expand (growth strategy); or to, finally, (3) subject it to planned reductions in size or scope, or both (retrenchment strategy).[75]

Stability Strategies. Stability strategies are intended to ensure continuity in the operations and performance of a business. A grand stability strategy for a small business generally means that the business will remain in the same line(s) of business as it has in the past. No new product lines will be added, and no product lines will be eliminated. The business will generally maintain a stable and unchanged corporate portfolio. For example, a small law firm specializing in personal injury cases will continue doing so and will not take on criminal cases in the near future. Similarly, a regional beauty supply business will continue to sell beauty products and will not introduce a clothing line.

At the business level, stability strategies require very little, if any, change in the organization's product, service, or market focus. Businesses that pursue stability continue to offer the same products and services to the same target markets. This strategy could include maintaining the status quo or growing in a methodical, but slow manner. This does not mean that a business will not make more money with this strategy. The business might attempt to capture a larger share of the existing market through market penetration, better marketing, or by raising prices.

A stability strategy can also mean continuing to do what the company has been doing, but in a better way. In using this strategy, you might decide to try to improve products, increase quantity, or improve the way that you sell the same products.

When should a company pursue stability? A stability strategy is appropriate when a business owner views the company's performance as satisfactory and the environment appears stable and unchanging. If your company is doing reasonably well, or if you might not want the risks or hassles associated with aggressive growth, or if your business is now

stable after having struggled through periods of explosive growth, stability might provide a welcome respite for you. Small, privately owned businesses constitute the largest segment of businesses that are most likely to adopt a strategy of stability.[76]

Growth Strategies. Growth strategies are designed to increase profits, revenues, market share, or the number of places (stores, offices, locations) in which the company does business. A growth strategy usually begins with increasing the level of an organization's operations. This usually involves such measures as more revenues, more employees, and more of the market share. For small businesses, growth can be achieved through direct expansion, a merger with similar firms, or diversification, which will be discussed later. Growth strategies can also involve the development of new products or services for new or existing markets, or the entry into new markets for existing products or services. The purpose of growth strategies is to increase the sales and profits for your small business in the long term and to enhance the positioning of your business in its market(s).

At the corporate level, growth strategies imply the addition of one or more new business(es) to the corporate portfolio. This may be accomplished by adding a business that has synergistic (mutually beneficial) potential when joined with the existing business, or by adding a business that is unrelated to the existing business(es). A small business example would be a daycare center or an ice cream parlor that adds a new center or parlor or buys out a competitor in a nearby neighborhood.

In many cases, however, growth strategies focus on being innovative, seeking out new products or services or opportunities, or taking new risks. Such strategies are suitable for businesses that operate in dynamic, growing environments, where creativity and organizational responsiveness are key factors, as is the case with electronics, wireless devices, or custom construction.[77]

Growth can also be achieved through *diversification*, where expansion takes place in new or different business areas, or both. A strategy of related diversification (also called horizontal integration) pursues growth by acquiring new businesses or entering business areas that are related to the business that already exists. A strategy of unrelated diversification

(a conglomerate) pursues growth by acquiring businesses or entering business areas that are different from the one that already exists.

Diversification can also take the form of vertical integration, where a business acquires suppliers (backward integration) or distributors (forward integration). A small business example of backward integration would be a regional construction firm purchasing a local small supplier of building materials. An example of forward integration would be that same construction company purchasing a small real estate company to sell the condos that it builds. On a larger scale, an example of forward integration occurred in the beverage industry when both Coca-Cola and PepsiCo purchased some major bottlers.[78] Also, PepsiCo's purchase of KFC, Taco Bell, and Pizza Hut is another example of forward integration (which, in this instance, allows PepsiCo to sell Pepsi soft drinks in these restaurants without competition).

Retrenchment and Restructuring Strategies. When businesses are in trouble, perhaps experiencing problems brought about by a bad economy or too much growth and diversification, often the solution employed is a strategy of retrenchment and restructuring. The purpose of a retrenchment strategy is to turn around poor business performance by shrinking the size and scope of the business.

Sometimes called a defensive strategy, retrenchment is designed to reduce business losses, usually through cost reductions, such as cutting back on nonessential expenditures, instituting hiring freezes, closing poorly performing businesses or subsidiaries, or selling entire lines of products or services. Cost-cutting can also take the form of asset(s) reduction, such as selling off land, equipment, plants, and so forth. An example of this is a small radio station that decided to sell a parcel of land adjacent to the station to raise capital for new equipment that it needed to expand its range. See Chapter 6 for a more thorough exploration of cost-cutting strategies, as well as a better understanding of various cost-cutting approaches.

Retrenchment and restructuring can also include downsizing, divestiture, turnaround, bankruptcy, and liquidation. Restructuring by *downsizing* decreases the size of operations, often by reducing the workforce. Such cutbacks are most successful when done in targeted ways that advance

specific performance objectives, rather than being simple "across-the-board cuts." The term, *rightsizing*, is sometimes used to describe downsizing with a clear strategic focus.

Restructuring by *divestiture* means that a business will sell off part(s) of the company to refocus on core competencies, cut costs, or improve operating efficiency. For example, a real estate company might sell off its rental business to concentrate on housing sales that are on the rise. Restructuring by *turnaround* focuses on fixing specific performance problems, such as improving customer service through proper training to increase sales.[79]

There is no shortage of companies that have used retrenchment strategies—General Motors, Sears, and Pillsbury, to name a few. Many small businesses are included in the number of retrenchments, due to the downturn in the economy, foreign competition, government regulations, mergers and acquisitions, and changes in technology. Thus, the need for retrenchment is not a reason to be ashamed.

After cutting costs and reducing the size and scope of a business, a second step in a retrenchment or restructuring strategy is *recovery*. Recovery encompasses the strategic actions that a business takes to return to a growth strategy. The purpose of the retrenchment-and-recovery process is to restore a business to "good health."[80] Of course, if a business cannot recover, the worst-case scenario is *total liquidation* of the company, where a business ceases operation and its assets are sold to pay creditors.

Generic Business-Level Strategies

Business-level strategies define the major actions that a business takes to build and strengthen its competitive position in the marketplace. While there are no two businesses or strategies that are exactly alike, some strategy characteristics are common to many businesses. Michael Porter, the well-known Harvard professor of industrial economics who developed the five forces model that was described earlier, has also identified three generic strategies that characterize the ways that many businesses can compete in pertinent markets. These strategies are referred to as: (1) cost leadership; (2) differentiation; and, (3) focus.[81]

Cost Leadership Strategy. Most businesses try to hold down costs; however, a cost leadership competitive strategy goes further. A business that pursues this strategy aims to be the *low-cost leader* in its market. Using a cost leadership strategy, a business competes on the basis of price. The low-cost structure allows the business to make profits even when selling at lower prices than competitors. To do so, a business must be highly efficient so that it can achieve a low-cost position. It usually does this by minimizing costs across the board.[82]

With a low-cost strategy, businesses try to gain a competitive advantage by focusing the energy of all business functions and units on driving costs down below the costs of industry rivals. Costs can be minimized by maximizing capacity utilization, achieving size advantages (economies of scale), capitalizing on technology improvements, or employing a more experienced workforce, among other possibilities. For example, this strategy could require that manufacturing managers search for new ways to reduce production costs; or research and development (R&D) managers to focus on developing new products more cheaply, or marketing managers to find ways to lower the costs of attracting customers.

As previously mentioned, companies pursuing a low-cost strategy enjoy a competitive advantage based on low prices. Illustrations of this are that BIC sells razor blades that are cheaper than Gillette's and ballpoint pens that are cheaper than Cross or Waterman pens, due to low manufacturing costs. In the financial services industry, the Vanguard Group is an example of cost leadership. By keeping costs low, the company attracts customers by being able to offer mutual funds with low expense ratios.[83] Similarly, a small business that bids on a government contract and can provide quality service at a lower price (perhaps, due to lower overhead expenses) will often get that government contract, beating out its competitors.

Differentiation Strategy. Businesses that pursue a differentiation strategy compete by offering products or services that are, or are perceived to be, different from those of competitors along some dimension(s) that customers perceive as important. Distinctive characteristics can include such things as better quality, product design, reliability, availability,

exceptional customer service, after-sales service, innovativeness, or image. This strategy can require more spending on design or R&D to differentiate the product or service; and, costs might rise as a result. However, the business will often charge a higher price for the differentiated product or service feature than the price(s) charged for similar products sold by low-cost competitors. The premium price, as it is called, allows the business to recoup higher production or design costs. An example would be a small architecture firm that sells its specialized "green" products to environmentally-conscious clients who are willing to pay higher prices for the products.

Many companies use a differentiation strategy; for example, Revlon (product image), Apple Computers (usability), Volvo (safety), and Mercedes (quality). Significant attention and money are devoted to marketing to differentiate products and create unique product images. However, this strategy can benefit your business by allowing for premium pricing that can result in high profits.[84]

Focus Strategy. A focus strategy occurs when a business targets a specific, narrow segment of the market and thereby avoids competing with other, often larger, competitors that target a broader segment of the market. Businesses that choose this strategy attempt to serve the needs of a niche customer group, geographic area, or product or service line in ways that are better or cheaper than competitors.

Companies that pursue a focus strategy can compete in the chosen niche market with either a cost leadership or differentiation strategy. Company examples of the focus strategy include: Rolls Royce, Ferrari, and Maserati, which use a differentiation strategy to cater to buyers who can afford the sticker prices; Jet Blue and Easy Jet, which focus on no frills flying using a focused cost leadership strategy; and, Fiesta Mart, which caters specifically to Hispanic customers.[85]

Smaller businesses with limited resources often choose one of the two versions of the focus strategy (i.e., cost leadership or differentiation) and apply it within a specific niche market. An example is a small business that concentrates on marketing its services to the local community or the federal government.

Step 6. Implementing Strategy

After identifying appropriate business and corporate strategies to accomplish your business's mission, goals, and objectives, you are confronted with the challenge of putting those strategies into action. The importance of strategy implementation should never be underestimated, for the best-formulated strategy is worthless if it cannot be implemented effectively.[86] This means that, if your business is to achieve the best results from its strategic planning efforts, you must make sure that the chosen strategy is put into action.

Strategy implementation can be described as a five-step process:[87]

1. Assign responsibility for implementation to the appropriate individuals or groups, or both.
2. Draft detailed action plans that specify how a strategy is to be implemented.
3. Establish a timetable for implementation that includes precise, measurable goals linked to the attainment of the action plans.
4. Allocate appropriate resources to the individuals or groups responsible for implementation.
5. Hold specific individuals or groups, or both responsible for the attainment of corporate, business, and functional goals.

Unfortunately, some business owners simply underestimate and under-manage the strategy implementation process. Businesses that achieve strategic success commit a tremendous amount of time, energy, and effort to making sure that the strategy is implemented effectively.[88]

Strategy implementation answers the question, "How can I get my business to where I want it to be?" Answering that question requires that functional strategies be developed and implemented, and your business systems must be designed to ensure that selected strategies can be implemented. In addition, strategic control mechanisms should be put in place, as will be discussed shortly.

Step 7. Evaluating Results

The last step of the strategic planning process is evaluating and monitoring the strategic plan, as a whole, to make sure that it is being implemented

properly. *Strategic control* (a popular term for this step) involves ensuring that all steps of the process are executed appropriately and compatibly, and are functioning properly. Most importantly, strategic control requires reviewing results to measure progress, identify and resolve problems, and make changes if progress toward mission accomplishment is not being made. Without strategic controls, you would never know whether or not your strategic plan is working.

Instituting strategic control includes using information systems that provide feedback on the way strategic plans are being carried out, as well as on the apparent effects. Such systems enable managers to make adjustments in the implementation of strategic plans, as necessary. An effective control system identifies problems and signals you and pertinent entities within your business when a change might be needed.[89]

Strategic goals and strategies should be the basis of the review process. Company presidents or CEO's, managers, teams, and individuals should review results at the relevant levels and actively participate in evaluating those results. In general, control mechanisms can be either feed-forward or feedback controls. Feed-forward controls are designed to identify conditions or changes in the external environment or in internal operations of the organization that can affect its ability to fulfill its mission and meet its strategic goals. Feedback controls compare the actual performance of your business to its planned performance.[90]

Small businesses, in particular, should maintain both feed-forward and feedback controls. For example, *screening* controls (another name for feed-forward controls) are important as a means of protecting your business from ill-effects that could be avoided by taking front-end action. In other words, screening controls are designed to serve as an organizational filter to prevent undesirable inputs into your business. As an illustration, if you owned a daycare center, you would certainly have background checks done on any prospective employee. Why? You would do so to prevent (or greatly reduce the likelihood of) employing a pedophile. This would be viewed by the public as a basic action that should be taken by any responsible organization aspiring to be paid for caring for children. Therefore, any such action that you might take to enhance your chances of employing the right people

(background checks, requiring and checking references, etc.) would be considered screening (or feed-forward) controls. Similarly, you would likely find it well worth your while to ask for an exit interview with any valued employee who voluntarily decides to leave your business. Doing so should give you the benefit of honest feedback about departing employees's perceptions of your business's major strengths and weaknesses, and possibly opportunities and threats that you might not know about—in other words, how you might be able to improve your business.

Finally, corrective action based on evaluation and feedback should take place throughout the strategic planning process to keep things moving in the right direction.[91] The control systems that are put in place should be carefully thought through and not merely tacked on as an afterthought. The ultimate goal of a strategic control system is to, in a timely manner, detect and correct problems that can and sometimes do occur. Ultimately, your purpose is to keep strategies updated and on target, without sacrificing innovation and creativity.

A Final Note

Strategic planning is a critical business activity that can affect the short-term and long-term performance of a small business. It is a comprehensive and ongoing process aimed at formulating and implementing effective strategies for business success. Effective strategies help a business to identify its distinctive competencies through its mission and vision statements, carve out its scope, and deploy its resources to achieve targeted goals and objectives. Seriously embracing and investing in the process should yield considerable benefits for you and your small business. Good luck as you strategically plan for business success!

Chapter Summary Checklist

(X) Check all that apply

☐	**01.**	I have established a clear mission and vision for my company and have ensured that all of my employees know and understand these.
☐	**02.**	Well thought out goals and objectives have been set to accomplish my company's mission and support our vision.
☐	**03.**	The environment in which our company operates has been scanned and my team understands the economic, political, sociocultural, and technological environments that affect our company.
☐	**04.**	A SWOT analysis has been conducted and our company is well aware of our strengths, weaknesses, opportunities, and threats and will keep these in mind when developing strategies.
☐	**05.**	I am well aware of the resources on hand and those that are available to our company as we move forward in accomplishing our mission and goals.
☐	**06.**	Well-developed strategies have been established at the corporate, business, and functional levels of my business.
☐	**07.**	Implementation action plans and an implementation schedule are in place for the implementation of well-developed strategies.
☐	**08.**	Appropriate resources have been allocated and responsible individuals have been assigned to implement the strategies that have been selected.
☐	**09.**	A strategic control system has been established to evaluate the results of our strategic plan.
☐	**10.**	Any adjustments or changes that are necessary will be put in place to assure the success of my business.

CHAPTER 3

Financing

A prom without dancing, like a courtship without romancing, is steeped in illusion and mired in confusion, its failure a foregone conclusion.

—© 2013 Sage Sayings™

Introduction to Financing Your Firm's Growth

Some things are wanted but not essential. A major essential for each business is the financing of the enterprise. Business owners generally are more focused on product or service quality, production, marketing, and management. Financing is usually an afterthought. That being the dominant situation, an overview of both the sources of financing, and the process of obtaining financing specific to the needs and stage of your firm is absolutely essential; since, as your firm grows, your need for financing expands substantially. To achieve this growth, you must be prepared to respond effectively to several challenging questions in the area of financing: (1) What are the various sources and types of financing that are available? (2) Who are the providers of this financing? (3) What do the providers of this financing look for in making their decision of whether or not to provide financing to your firm? (4) What do you need to do to meet the specific requirements of funding providers?

This chapter provides an overview of both the sources and types of financing available to small businesses, as well as a review of the processes associated with obtaining such financing. It is designed to assist you in understanding and finding the various sources of financing that you might need for the specific stage(s) of your business as well as the costs of such financing, and what you can do to obtain that financing. You are encouraged to be proactive in searching for sources that might be specific to your individual circumstances.[1] For example, there are sources

set aside for minority-owned firms, firms operating in the inner cities, women-owned firms, and firms owned and operated by military veterans. These sources might be made available by various levels of government (local, state, federal) as well as foundations, in various forms—including loans and grants. As your business grows, new sources will be needed; it is imperative that you familiarize yourself with the various sources available, and anticipate when you will need these. You should also strive to formulate a set of financial statements that will allow for easy access to funds. Table 3.1 provides a list of sources that will be covered in this chapter.

Each of these sources of financing will be reviewed in detail. As Table 3.1 shows, in addition to yourself, friends, family, and associates (FFA), financing providers include community development banks and

Table 3.1 Sources of financing

Self-Financing
Personal Savings
Mortgages and Home Equity Loans
Pension Funds
Whole- and Universal-life Insurance Policies
Credit Cards
Friends, Family, and Associates
State and Local Government
Community Development Corporations
U.S. Small Business Administration
Liability-Based Financing
Accounts Payable
Accruals: Wages and Salaries
Asset-Based Financing
Inventory
Accounts Receivable
Specialized Assets: Sale and Leaseback
Real Estate
Patents, Copyrights, etc.
Profit from Operations
Finance Companies
Commercial Banks
Credit Unions
Angel Networks
Venture Capital
Crowd Financing
Initial Public Offerings

credit unions, state and local government programs, the U.S. government's Small Business Administration (SBA), finance companies, commercial banks, venture capital firms, and angel networks—individuals with a strong interest in achieving the types of objectives your company epitomizes. Each provider has different criteria and different expectations. Some, like FFA and angel investors, are more strongly interested in the type of product or service that your firm provides, with profitability playing a secondary role (for these people, the service is most important). Others, such as finance companies and commercial banks, are more interested in your past and future financial and profitability performance, with a particular interest in your ability to pay both the principal and interest on your loans. Governmental providers are specifically interested in your ability to add to the growth, employment, and development of the community in which your business operates; thus, various agencies provide such things as direct grants, incentives (e.g., reduced taxes), and loans with lower requirements. Providers such as the SBA offer a number of venues of support for your business, the most important for our purposes here being the provision of backing your commercial bank loan up to 70% in some cases. This typically results in a lower interest rate for your loan, due to the substantial reduction in the probability of a loss by the bank if your firm fails to repay.

A major question that will be answered for each type of financing is what you need to do to meet the requirements of your source. For many of the sympathetic sources, your business model itself answers that question. However, for finance companies, banks, venture capitalists, and equity investors, the answer is embedded in your financial statements and financial performance, both historically and in the future. The assessment includes the effectiveness and quality of your management team, the ability of your company to pay its debt, your ability to control costs, the strength of your market, and the quality of your marketing strategy. Commercial banks and finance companies will require you to create a strong loan package. Later in this chapter, there will be a review of the major financial ratios that these lenders examine, as well as the most important factors lenders consider in the loan package that you submit. The review will also include a list of the top qualities that most bankers and investors find important in making loan decisions.

Overview of Sources and Types of Financing

Over the years, in the course of interviewing and training entrepreneurs, the authors of this book have seen that, typically, in the beginning stages of a business the primary financing sources tended to be from personal savings, second mortgages on a home, home equity loans, and systems of revolving credit cards. While these sources can often work temporarily, as the business grows, more funding is needed than these sources can provide. The next set of sources tapped is relatives and friends. These sources are often quite sympathetic to the efforts and concept of your business, and are generally very supportive and often happy to provide such assistance. Indeed, it is for this reason that funds secured from FFA are often referred to as *love money*. You might, actually, find many friends through modern social networks such as Facebook. However, at a certain point in the growth of your firm, these sources also are exhausted. It is important to note here that the major sources of financing listed in Table 3.1 are in an approximate order of alignment with the general growth stages of your firm. That is, in the early start-up stage, you will tend to draw from self-financing, family or friends, and possibly angel investors. At the middle stage of growth, you will need to shift to finance companies, then commercial banks. At some point, you might then decide to access external equity investors, through such mechanisms as crowd financing, venture capital firms, and initial public offerings (IPO's). In addition, the external sources (those beyond self-financing and friends) tend to progress from debt to equity.

Self-Financing: Using Your Own Resources

In the early stages of an enterprise, financing from outside sources such as banks and finance companies is difficult to obtain, since these sources usually require a three-to-five-year financial performance history. Therefore, most of your initial financing must come from your own sources, such as personal savings, real estate, pension funds, whole-life and universal-life insurance, and credit cards.

Mortgages and Home Equity Loans

A natural first place to raise financing is through real estate that you already own, such as a home. If you already have a mortgage on your property

and the market value of the property is substantially greater than what you owe on the existing mortgage, you might be able to obtain a home equity loan, a second mortgage, or if mortgage rates are low you might consider refinancing your existing mortgage. Indeed, in recent years, low mortgage interest rates have provided a great opportunity for this type of financing, especially if the market value of your property substantially exceeds the balance on the existing mortgage. In terms of prioritizing, generally, refinancing—that is, paying off your old mortgage completely with a new mortgage—is the most preferred method since first mortgages have fewer restrictions and penalties. Of course, the downside of using mortgages and home equity loans is that, if your business fails and you go into bankruptcy, you will lose your home. Also, if you used a home equity loan, it is a recourse loan, and therefore, even if you sell your house at a loss, the lender will have recourse to the full value of the loan.[2]

Pension Funds

If you have a defined contribution pension fund, such as a 401(k) or 403(b) plan in which you are currently vested, you may be able to draw or borrow from it. Most other pension plans such as Individual Retirement Accounts (IRA's), Simplified Employee Pension Plans (SEPP's), and so forth, do not allow you to borrow. Moreover, if you are age 59.5 or older, you are also able to withdraw funds from your pension fund without penalty. Generally, if you have 401(k) or 403(b) accounts and are younger than 59.5, you will be allowed to borrow up to 50% of the amount vested. However, plans do have different rules, and you should check your specific plan for the details.

In the case of borrowing, you will be charged an interest rate and will be given a time period in which to restore the amount borrowed. Also, you may face a 10% penalty from the Internal Revenue Service if you fail to restore the amount borrowed. In the case of a withdrawal, you should be aware of the fact that the plan will distribute to you the after-tax amount. Thus, if you need $20,000, you should request a higher pretax amount. For example, if your tax rate is 20% you would need to request approximately $25,000 in order to receive $20,000 after taxes.

Whole- or Universal-Life Insurance Policy

Another option for borrowing is your whole-life or universal-life insurance policy. In most cases, you should be able to borrow against the full cash value of your whole-life insurance policy. Fundamentally, you are obtaining a loan from your insurance company, which is holding your cash value as collateral. Again, this type of borrowing may come with several charges. For one, you will usually sacrifice any dividend payments that would have been earned on the cash value of your policy; in addition, you will usually be charged an interest rate on the amount borrowed. In general, there is usually no set repayment schedule. The interest rate is usually a fixed rate, and may be as high as 7%. However, this 7% plus the lost dividend payment can add up—especially over time. Furthermore, the interest charges will be accumulated in the loan balance. Universal-life loans differ from whole-life loans in that the loan balance on a Universal-life loan is usually placed in a guaranteed fund which earns a much lower interest rate than your policy. Thus, the total interest cost to you is the interest charged plus the difference between what you would have earned on the universal policy and what you earn on the guaranteed fund. Borrowing from your whole-life policy certainly trumps borrowing at high rates from your credit cards, and, it is also tax free. However, it does have the additional downside that, if not paid back, your death benefits will be reduced by the unpaid interest charges and the balance of your loan. Overall, you should discuss this with your life insurance agent or customer representative of your insurance company to obtain the full set of charges that you will incur.

Credit Cards

While not highly recommended, many entrepreneurs have effectively used credit cards as a source of financing. Still, it is a good idea to obtain more credit cards and extend your credit limits while you are employed, if you are thinking of starting a business in the future. Credit cards are easier to obtain than most other financing. On the other hand, the use of credit cards does require continual attention to payment plans and details. You should consider taking advantage of offers such as 0% interest for

six months, no fee charges for one year for balances and transfers, and bonus points and rewards such as gift cards for a certain amount of purchases made within three months (say $4,000). However, many credit card companies are aware that consumers take advantage of these promotions and are beginning to charge higher fees.

A major downside of using credit cards is, of course, the high interest rates that must be paid—as much as 19% to 26% or higher. It is imperative that you read *every* detail of your credit card contract and fully understand all the charges that you may face, such as high late payment fees and jumps in interest charges when late payments occur. Generally, firms that overuse credit cards during the earlier phases of the businesses have a high percentage of failure rates. Personal credit card debt or business credit card debt, if you are not incorporated, will be a debt that needs to be paid by you in the case of bankruptcy. Many business owners have used credit cards to make payroll during emergencies. However, if you do use credit cards, these should not be used for high capital expenditure purchases. High credit card debt and slow payment will also hurt your credit rating and compromise your ability to obtain a bank loan. In addition, missed payments can cause significant jumps in your interest rate—up to 29%+. Nonetheless, there is a positive aspect to using a business credit card and paying on time. Obtaining a good payment record will help to improve your credit rating and provide a credit history that will assist in getting a bank loan.

Credit cards also carry insurance and provide protection against fraudulent suppliers. In essence, a judicious use of credit cards can be helpful, but extraordinary caution must be used to avoid overusing these cards and incurring heavy debt. It is true that 33% to 40% of small business start-ups use credit cards. The key is to use this financing source to enhance your credit rating.

Network Funding: FFA

Depending on the projected size of the business, few people will find personal sources of money to be sufficient to fund the business start-up. This means that, even if the business is initially financed by your own money, your own cash will need to be augmented by other sources of financing.

It is at this point that most people will resort to tapping into personal and business networks.

You might consider relatives as a supportive funding source. Many relatives are eager to see another relative succeed in business. Similarly, close friends with whom you have established a good relationship over the years might also be very prone to provide financial support. Earlier, these sources of financing were referred to as love money. In addition, people in your personal or business network, who are not as close to you as your relatives or friends (associates), sometimes will also tend to be quite supportive. One marvelous feature of this is that these are folks who know you well (relatives and friends) or well enough (associates), and have great or sufficient trust in your character, prudence, and integrity, and are generally patient in terms of waiting for a financial return. These people are usually willing to invest at a lower interest or payout rate. Of course, the risk is that, over time, the initial enthusiasm might dissipate, and hard feelings could develop. Nonetheless, for many, this is a good source of funding.

There are, however, two major caveats that you should always consider before resorting to using FFA financing. First, remember that your spouse has an important role in your financial matters, even if not directly involved in your business. This means that you must be cognizant of the fact that, in the unfortunate case of a divorce, community property states can wreak havoc on a business. Secondly, you should not borrow from any single member of your FFA a dollar more than these individuals can afford to lose. In this way, you are able to avoid the painful situation of any one of these supporters losing entire savings or a home due to the losses resulting from having invested in your business.

Exploring Public Funding

Public entities are typically quite interested in promoting the start-up and growth of businesses. The reasons for this are twofold. For one thing, small businesses create anywhere from 67% to 75% of new jobs, depending upon the source consulted. Clearly, all levels of government are very much invested in the notion of ensuring that the population is maximally employed. Another reason for interest in business start-ups

and expansion (not totally distinct from the concern about employment) is that such businesses add to the tax base. While the federal government is not mentioned as a direct funding source in the section that immediately follows, it is quite prominently engaged in guaranteeing small business financing through the SBA, which is, thus, included in this section.

Community Development Funds

Throughout the nation, there exist numerous community development institutions. These institutions are provided funding by the Community Development Financial Institutions Fund, backed by the U.S. Treasury Department. Various types of financing are then provided to community development financial institutions, such as banks and credit unions, which, in turn, provide financing for businesses to enhance the development or redevelopment of specific communities. The most recent development in this area has been the CDC/504 plan, which is discussed later in the section regarding SBA programs.

State and Local Government

In anticipation of exhausting self-financing and funding from FFA, you should begin to look to state and local governments for any special financing programs that have been specifically developed for businesses with your profile. There are many programs offered by state and local governments for various areas. For example, at just about every state and local website, you can find lists of sources of loans, tax shelters, as well as other incentives for assisting your business.

SBA Loan Guarantee Programs

The U.S. Small Business Administration (SBA) assists small businesses in a number of areas in terms of obtaining loans. The major programs are the microloan, the 7(a) loan, the CDC/504 loans, as well as a number of other guaranteed loan programs for debt financing. Overall, the SBA programs provide longer terms, lower interest rates, lower down

payments, and more flexible payment options. If there is any downside to SBA-secured loans, it is that, for the most part, these loans are only offered by banks and financial institutions at reference rate + a premium (i.e., these are floating rate loans). In a period when interest rates are low but there are inflationary expectations, such loans could become less attractive than a higher fixed rate loan.

Microloan Program. Through the microloan program, the SBA provides short-term funding to nonprofit financial intermediaries that then make short-term loans to small businesses and nonprofit organizations. These funds are usually used to support working capital needs, such as for inventory, supplies, equipment, machinery, furniture, and fixtures. The maximum amount available to a firm is $35,000.

7(a) Loan Program. The *7(a) program* is perhaps the oldest loan guarantee program of the SBA. Under this program, the SBA guarantees loans made to small businesses by banks and other financial institutions. The maturity of these loans can be up to 10 years for working capital such as inventory, 15 years for equipment, and 25 years for fixed assets, land, and buildings up to $5,000,000. *There are four general classes of the 7(a) guarantee program: Express Loans (maximum $350,000, variable rates, revolving lines of credit or term loans up to 25 years), Export Loans, Special Purpose Loans, and the Rural Loan Advantage Program.* For more in-depth information on the details of each of these programs than is found in this chapter, you should visit the SBA website at sba.gov.

Depending on the loan type and amount, the SBA generally guarantees these loans for amounts between 75% and 85%. In addition, loan amounts can range on the high side to amounts between $500,000 and $5,000,000, depending on the type of loan. Again, depending on the term of the loan, the interest rates on these loans usually run between prime+2.25% to prime+2.75% (short-term loans are typically one-month LIBOR +3%). In addition, you will be charged an SBA guarantee fee that varies based upon the size of the loan from 2% for loans of $150,000 to 3.75% for loans above $1,000,000. More specifics on each type of program can be found at sba.gov, and usually terms and rates can be obtained

from the websites of lenders that participate in the programs. At this writing, the Wall Street Journal (WSJ) prime rate is 3.5%.[3]

The 7(a) program provides a source of funding if you need a substantial amount of money. It will provide a maximum of $5,000,000. In sum the SBA guarantee has the benefits of lower interest rates, longer maturities, and a lower down-payment requirement. The standard maturities are 7 years for working capital, 10 years for equipment, and up to 25 years for real estate. The SBA will guarantee up to 75% of the loan (up to a maximum of $3.75 million).

The *SBA Express* term loan will provide up to a maximum of $350,000. It can also have the same maturities as the regular 7(a) loans, but has the additional benefits of a more rapid process for obtaining the loan, as well as the ability to finance the SBA fees. It also differs from the typical 7(a) loans in that the SBA will guarantee a maximum of 50%.

In addition to the SBA Express, there are two subexpress types of loans. The first is the patriot express for which veterans and family members of veterans may be eligible. The *Patriot Express Loans* are for up to $500,000 for the purpose of starting a business and are guaranteed up to 85% by the SBA. The second type of express loan is the *Export Express Loans*, which may also be up to $500,000 and are available for companies that export goods and want to expand or need working capital to enter a new overseas market. There is also *an Export Trade Funding Program* for longer terms which provides up to $5,000,000.

Guaranteed Loan Program for Debt Financing. There are two basic SBA programs for line of credit financing: the SBA Line of Credit Express and the CAPline. The SBA Express will provide a line of credit for short-term cash management by providing a revolving line of credit for up to three years. In addition, the SBA fees may also be financed. The Express has an accelerated process and the SBA guarantees up to 50%.

The CAPline is designed to fund short-term cyclical working capital. Terms for this line are set by the lender. The lender can provide, for example, a line of credit for $350,000 to $5,000,000 for a term up to 24 months that is renewable for 12 months at a time, thereafter. The SBA guarantees up to 75%.

CDC/504 Loan Program. Community development companies (CDC's) are charged with assisting the development of their local communities. The SBA CDC/504 Loan Program differs from the other programs in a number of ways. There is generally no maximum loan amount. This is due to the fact that both the private lender and the business owner can put up as much as each desires. However, the SBA will fund up to 40% of the loan or $5,000,000 ($5,500,000 for a manufacturing firm), whichever is lower. In addition, the business receiving the loan must generate one job for every $65,000 of the loan amount (or one job for every $100,000 of the loan amount for a manufacturing firm). CDC/504 loans are quite recent and are a result of the Jumpstart Our Business Startups (JOBS) Act. These loans are long-term loans made by CDC's and are provided to small businesses that enhance the economic development of the community.

The CDC/504 loans have basically three additional features. First, the loan from the private-sector lender is secured with a senior lien covering up to 50% of the project cost. Second, a CDC loan which is backed by a 100% SBA-guaranteed debenture (bond) is also secured with a junior lien covering up to 40% of the project cost. Third, the borrower must contribute at least 10% of the financing in the form of equity. This program is designed for projects that range in cost from $100,000 to $12,000,000.

Looking Within the Firm for Financing

Sometimes, the answers to your funding problems can be as close as your own business's financial position. Knowing the details of your firm's financial position can be of great help in leading you to viable options for gaining the funds that you need. Many of the alternatives are explained further in this section.

Using Your Firm's Liabilities and Assets

All businesses have things that the company owns (assets) and things that are owed to others (liabilities). What is useful for you to consider is that both assets and liabilities represent channels for you to achieve the financing that you need. We will now discuss the various ways that this may be done.

Using Firm Liabilities. You might be surprised to learn that you can manage some of your business debts in ways that translate these into quasi-funding sources; but, it is, indeed, possible. This section of the chapter explores how this can be done.

Accounts Payable. Often, in the early periods of a business, the entrepreneur needs to cover periods where the inflow of cash from sales is slow, or the timing of the cash inflows does not match the timing of payments that are due to suppliers. To overcome this temporary mismatch, you might be tempted to stretch the accounts payables, that is, to pay late. One way to avoid this situation is to try to negotiate with your supplier to modify your payment terms so that payments match your cash inflows from your customers. For example, if your customers tend to pay at the end of the month, then try to negotiate end of the month payment terms with your suppliers.

Stretching accounts payables can be costly, however. Suppose your supplier allows you to pay 2/10 net 30, that is, you will receive a 2% discount if you pay in 10 days; otherwise, you must pay the full amount in 30 days. Not taking this discount can be costly. In fact, if you miss the discount consistently for a whole year you will effectively be paying 37.2% more for your supplies! Moreover, if you do not make the payment by day 30, you risk lowering your credit rating, and losing the ability to receive a discount in the future, or you might even be required to pay immediately upon the receipt of supplies. Some finance companies will realize this and will pay your suppliers on time, but they will also charge you a substantial interest rate and other fees for doing so. Overall, stretching accounts payable, or not paying on time is not recommended if it can be avoided.

Accruals: Wages and Salaries. The largest and most easily used accruals are employee wages and salaries. The key aspect of dealing with these is in the structuring of the payments to employees. To optimize savings on these accounts, you should examine whether to pay weekly, biweekly, or monthly. Obviously, more is saved by paying monthly, or biweekly, rather than weekly. Paying wages and salaries monthly will allow more flexibility in your cash management and will also allow more interest to be earned on cash invested in bank accounts.

Using Your Firm's Assets. Remember that assets are those things that your company owns or possesses. These things can include anything from the tangible items shown on a balance sheet (cash, inventory, accounts receivable, marketable securities, and fixed assets) to intangibles, such as goodwill. When you understand how to convert these assets to relieve your financial burdens, you will have gone a long way toward increasing your ability to make all aspects of your company work to your optimal advantage. Here, coverage will extend to consideration of a number of ways that your company's assets may be used for this purpose.

Finance Company Loans—What You Need to Know

Finance companies provide a chief source of asset-backed funding. However, funding from finance companies is not inexpensive. You will be charged higher interest rates and other costs, and there may be significant penalties for late payments. Finance companies provide funding predominately by using the firm's various assets as collateral—most commonly, inventory and accounts receivable.

Using Inventory as Collateral. For many businesses which carry high levels of inventory, such as auto dealers, and so forth, finance companies will provide loans which use inventory as collateral. Such loans allow firms to have expensive inventory on hand and readily available. As the borrower makes payments on the loan, the lender releases inventory for use by the borrower.

There are four types of inventory loans: field warehouses, terminal warehouses, trust receipts, and floating lien loans, each designed to serve particular, specialized needs of the business. *Field warehouses* set up a warehouse on the business's plant or store premises, and inventory is not released from the warehouse until the lender provides permission. As inventory is sold, the lender is paid for the inventory, and the borrower retains any profit on the sale.

A second form of inventory loan is a *terminal warehouse*, which is a central warehouse that is set up reasonably close to the business of the borrower and is used for inventory that is easily and inexpensively transported. This gives the lender more control over the releasing of the inventory.

A *trust receipt loan*, also called a floor planning loan, is typically used for businesses such as auto dealers. For these loans, the borrower retains physical possession, which means the auto dealer keeps the automobiles on the business's lot. Once an automobile is sold, the dealer reimburses the finance company for that portion of the loan, and retains the profit.

The final type of inventory loan is the *floating lien loan*. A floating lien loan is also known as *a blanket loan*, and covers all types of inventory of a firm. The loan is usually made for a percentage of the book value of the inventory (e.g., 40%). Floating lien loans are usually made at a high interest rate. Consider a situation where you need a loan for $100,000 for the next 45 days. Suppose the finance company offers you a floating lien loan for prime + 6% (say prime is 3%); thus, your interest rate would be 9%.[4] Let us further assume that the finance company will advance you 40% of the book value of your inventory. In this case, you would need to put up collateral of $250,000 (or $100,000/0.4). The cost of your loan will be ($100,000 × 0.09 × 1.5/12) or $1,125. Note that the 9% has been annualized for the 45-day loan period (0.09 × 1.5/12).

Clearly, using inventory as collateral can assist the firm through early years. However, like most asset-based financing, it is ultimately more expensive than a bank loan, and in all cases the finance company usually only provides a loan for a percentage of the value of the inventory, and imposes a substantial interest charge.

Accounts Receivable. Accounts receivable represent an asset which may be used for raising funds, either through a process known as pledging or another process known as factoring.

In the pledging process, a lender selects the accounts that it wishes to purchase, usually the accounts receivables of your customers who have the best credit history. The lender will first adjust the accounts receivables for any potential returns or discounts. For example, if the face value of the receivables is $1,000, the lender will adjust the amount to, say, $950. The lender will also apply an aging schedule to your receivables and only accept those that are not well past the normal payment date. Next, the amount the lender would loan you for the $950 pledge will be reduced to, say, 85% of the $950, or $727. The collection of the receivables may be on either a non-notification basis or a notification basis.

The non-notification basis means that you will collect the receivables from your customers and then pay the lender yourself. The notification basis means that your customers will be notified that they are to pay the lender directly. Clearly, the non-notification basis is preferred, since some customers might be fearful of the fact that you are using a lender and, therefore, might be concerned that your financial viability is at risk. This could, in turn, cause them to turn to another supplier.

An alternative to pledging is factoring. Factors look for stability and sustainability in your business, customers with excellent credit ratings, and a customer base that is reasonably large with high average size of receivables.

Factors will purchase your accounts receivables at a discount and then proceed to collect the debts. A factor will also select the best accounts receivables, that is, the ones for which there is a high probability of being paid. Factors will also examine the aging schedule of your receivables and, similar to pledging, will only accept those that are not beyond a reasonable payment period. Generally, the factor will collect the accounts receivables directly from the customers. Factoring can be done either on a recourse or nonrecourse basis. The recourse basis provides the factor with the right to demand payment from you if your customer fails to pay. You will be paid when the factor collects the account, or on the last day of the net credit period, whichever comes first. You may receive advance payments prior to the due date of the receivables, and the factor, of course, will impose an interest charge on any advances. However, in the case where surpluses occur and you do not draw on the advance payments, you may also earn interest.

Typically, the factor will keep a reserve of 5% to 10% for protection against any returns or cash discounts. Factors generally will earn a commission of 2% to 4% of the face value of the accounts receivables to cover their administrative costs. In addition, the interest on advances is usually 2% to 5% above the prime rate.[5] Also, the interest rates paid on surpluses are generally much lower, most likely equivalent to the rate on commercial bank savings accounts.

Both pledging and factoring have two positive aspects. First of all, as your sales grow, they provide you with greater flexibility in financing your business. Secondly, they provide some assistance in your decisions regard-

ing whether to extend credit to a given customer. Pledging provides you with an analysis of the relative strength of each of your customers, while a factor will make all credit decisions on each customer for you. In some cases, factoring may eliminate the need for an entire credit department, since the factor makes all the decisions on whether or not a customer obtains the ability to purchase on credit. Furthermore, the factor shoulders all of the costs of the collection process.

The two major negatives of pledging and factoring are that customers and potential customers may view the use of either of these as a weakness. Additionally, both pledging and factoring can be very costly—ranging from effective rates of 18% to 30%.

Sale and Leaseback of Real Estate and Specialized Assets. In addition to financing assets such as receivables and inventory, some firms may have some very specialized assets such as the real estate used for the business, very expensive technological equipment that is used by biotech firms, or patents and copyrights. Each of these may have a significant value that can be used to raise financing through the process of sale and leaseback.

Fundamentally, the finance company will buy these items from you and then lease them to you at a monthly fee. Each of these types of financing has the positive aspect of allowing the firm to raise some capital for current use. Often, after the leasing period is over the firm has the right to repurchase the asset that it has been leasing. The sale and leaseback provides the entrepreneur with immediate cash, which can then be reinvested in the business to fund growth. The downside of this type of funding is that it is usually at high interest rates, and the leasing period may extend beyond the true useful life of the assets.

Using Your Firm's Profit from Operations

When your firm begins to generate profits, it is imperative to reinvest as much of those profits as possible back into the business. Reinvesting profits provides savings in terms of interest costs on other types of financing, and also provides future lenders with a positive view of your performance and ability to pay debt. Indeed, reinvesting profits also sends a positive signal to potential lenders and investors, since it further demonstrates

that you have strong confidence in your company's business model and future performance.

Clearly, lenders and future investors look very carefully at the percentage of profit that goes to owners; a high percentage can be a significant negative insofar as obtaining financing is concerned. Reinvesting profits also assists in maintaining ownership and control. However, in many cases, profit is the only source of remuneration for the owner so it might be difficult to maintain a prudent level of restraint with respect to forgoing some things that profits could allow you to afford on a personal level. Nonetheless, you must remember that such restraint is crucial to the growth and solvency of your business—especially in its early stages.

Finally, profit goes into the retained earnings account, and lenders look very carefully at this account. Negative retained earnings imply bankruptcy. Retained earnings represent the cumulative reinvestment of profits over the life of the firm, and are counted as part of equity. Higher retained earnings imply a lower debt to equity ratio.

External Sources of Funds

In the previous section, we looked at utilizing your company's assets and liabilities to find needed financing. In this section, we look outside the firm to find sources of funding that may be secured as either debt or equity. In this discussion, we also seek to provide you with an understanding of the criteria that are typically used by the various sources, so that you can make an intelligent assessment of what sources are more suited to your company's financial performance profile and funding needs.

Debt Financing

This form of financing provides funds to you, based upon a promise that you will repay the funds, usually with interest and within a specified period of time. Coverage in this section will include nonpersonal loans and other forms of debt financing. First, however, it is very important that you gain an understanding of how your credit impacts on a lender's decisions, as well as what lenders and investors generally consider when making decisions about extending loans to small business owners.

Bank Loans—What You Need to Know: The 5 C's of Credit

Traditionally, bank loan officers talk about the five C's of credit. These are capacity, collateral, credit, capital, and character. The fifth C, character, may be a key factor especially for local small-town banks, as well as credit unions. Character refers to the reputation that you and your family hold in the community. Are you known as a person of honor and integrity? Capacity refers to your firm's financial ability to pay back your loan and make your interest payments. It refers to the profitability of your firm. Is your firm generating sufficient profit to make required payments? Collateral refers to the level of assets that you have to support your loan in the event of bankruptcy. Collateral can be assets in your firm, or personal assets such as real estate that has no other encumbrances. Credit refers to your history regarding paying your suppliers and other lenders on time. This is reflected in your Duns PAYDEX[6] number. Capital refers to the equity base you have invested in your business; in particular, your retained earnings and equity. The key element of all of these factors is your ability to pay both the interest and the face value of the loan. Others might add a sixth C—economic conditions: Are the general economic outlook for your particular industry and the local market conditions suitable for the sustainability of your company?

What Is a Ratio and Why Is It Important?

Ratio analysis is a critical determining factor used by banks, as well as finance companies, and other lenders and investors in measuring your ability to pay. These ratios fall into four basic categories: liquidity, asset utilization, debt, and profitability. The two ratios that interest lenders most are liquidity ratios (which indicate the ability of your firm to make short-term payments) and debt ratios (which measure the ability of the firm to take on more debt financing). Key liquidity ratios are the current ratio (current assets divided by current liabilities) and the quick ratio (current assets less inventory and less aged receivables

divided by current liabilities). Again, the current ratio represents your ability to make your short-term payments. Generally, a bank looks for a current ratio of at least two times and quick ratio of at least one time. Other important ratios are the earnings before interest and taxes divided by your interest charges—called the times interest earned; and, finally, total debt to total capitalization ratio, as well as the total debt to equity ratio. All ratio measures are compared against the industry median for firms of your size (as measured by sales or assets). Some industries might have both a current and quick ratio that is lower than the ones just suggested, while others might have a higher requirement. The key question is how your ratios stack up against the median ratios for your industry. One way for you to check this is to look at the RMA ratios for your specific industry.[7] Your business's financial ratios should be at or slightly better than the median ratios for companies in your industry with asset and sales levels similar to yours.

Banks might also impose covenants, both positive and negative. Covenants often take the form of requiring that your business maintains certain levels of specific financial ratios, such as a liquidity or debt ratio, as well as paying on time, and usually, also impose restrictions on taking out any other loans.

The Lender's Perspective

Bank loan officers and investors in general ask specific questions in determining whether or not to make a loan. Usually, the first question in the minds of bankers is the quality of the management. Does the business have high quality, reputable managers of high ability and integrity running it? Secondly, bankers and investors want to know whether the business has an effective business model that will be sustainable in the long run. In addition, other central questions include: Can the firm adequately service the debt (i.e., repay the funds) that it is seeking? Does the firm have a good credit history? Does it have a good collateral position? Does the firm have a good marketing plan and a strong sustainable position in its market? Does the firm have good cost control? Is the firm's risk exposure limited? Is the owner risking a substantial amount of his or her own capital? Finally, are the firm's financial projections reasonable and accurate?

The previously asked questions are central to all investors. Indeed, from the most recognized investor such as Warren Buffet, to the smallest local bank, the same questions are asked, and all should have the positive answer of "yes." Table 3.2 provides a listing of the primary factors considered by investors.

Banks as Sources of Business Loans. Banks provide three basic forms of financing: a revolving credit agreement, line of credit, and term loans, the latter being made available for approximately one to seven years. In a revolving credit agreement, the bank guarantees the availability of a certain amount of funds in exchange for a commitment fee (to be paid on the unused amount of the credit line). The interest rate charged would be floating and usually tied to the prime rate. The borrower is allowed to draw down on the credit line and then repay. Revolving credit lines assist the business in bridging cash flow gaps (gaps between receipt of payments from customers and payments due to suppliers), and also can provide a needed cushion during cyclical or seasonal fluctuations.

A line of credit is somewhat different from a revolving credit line. Banks would authorize but not guarantee loans up to a certain amount during the year (e.g., $100,000 to $500,000+). Interest rates vary usually with the prime rate. You can expect to pay an annual fee, as well as the interest charge in most cases. Historically, banks also required that the firm maintain a compensating balance with the bank, but few banks still have this requirement.

Table 3.2 Major factors that bankers and investors consider

- Strong and Ethical Management
- An Effective Business Model
- Strong Ability to Service Debt
- Solid Equity Position
- Good Collateral Position
- Good Cost Control
- Owner Risking Own Capital
- Limited Risk Exposure—Especially for Banks
- Good Credit History
- Good Marketing Plan and Strong Market
- Company Has Secure Position in Market
- Solid and Accurate Financial Projections

Both revolving lines of credit and lines of credit may be either secured (i.e., you must put up some collateral) or unsecured (no collateral is required). The interest rate spread between a secured line of credit and an unsecured line of credit can be significant. For example, a secured line of credit might have a rate of 10%, while an unsecured line of credit might have a rate as high as 23%. Generally, when you use either the revolving line of credit or a line of credit, you will be billed monthly, at which time you pay both interest and at least a partial payment on the amount used.

Credit Unions as Business Loan Providers. Generally, credit unions have not been a large provider of business loans. Indeed, credit unions provide a small percentage of business loans, approximately 1.3% of business loans compared to banks which have provided over 90.2% of business loans.[8]

Historically, credit unions have operated under a number of regulatory rules that have limited their ability to be a large provider of business loans to members. These constraints include the fact that a credit union's member business loans (MBL's) above $50,000 cannot exceed 1.75% of net worth or 12.25% of the credit union's total assets, whichever is lower.

Secondly, borrowers must be within the credit union's geographic area, and cannot include CEO's or Directors, or family members, and borrowers must provide personal liability and guarantee of principal. These last two conditions are legal terms which in essence mean that if there is any default on the loan the lender can automatically garnishee the wages of the borrower, as well as take any personal assets, such as personal bank accounts and real estate not associated with the business, to collect what is owed. Moreover, the loan-to-value ratio of any loan cannot exceed 80%. Banks do not operate under any of these restrictions. Moreover, while credit unions might be a good source of financing during periods when bank lending is tight, credit unions generally have higher interest rates than banks.

Recently, there has been a modest push for congressional legislation to relax the credit union restrictions, such as increasing the 12.25% of total assets restrictions to allow member business loans up to 27.5% of total credit union assets. In part, this legislation has been motivated by the fact that, during the tight loan period subsequent to the 2007 crash, credit unions were one of the few sources that small businesses could turn to for

loan financing. However, banks strongly oppose these regulatory changes. As banks began to offer more funding in 2013, the motivation for such regulatory changes has become weaker.

Crowd Financing. Crowd funding is expected to be a huge source of financing in the future. A large number of portals, at this writing, are setting up for the purpose of providing crowd funding. This process is expanding exponentially, not only for crowd funding in the United States, but globally.

In 2012, the passage of the Jumpstart Our Business Startups (JOBS) Act introduced a potentially less costly, more effective, and efficient way for entrepreneurs to raise equity capital. The JOBS Act provides firms with less than $1 billion in sales the ability to go public much more readily than in the past. The Act allows firms to secure up to $50 million in equity funding. A major component of the Act is the provision for the allowance of broad advertising of public securities. The goal is to provide an easier, faster, and less costly method for small firms to raise equity. A second significant component of the Act allows smaller investors to invest in the company. Anyone can invest a minimum of $2,000 in the IPO or 5% of the investor's annual income, whichever is higher. In addition, individuals with an income of $100,000 may invest up to 10% of annual income. This is a major change since previously only accredited investors could invest (accredited investors are defined as those with net worth in excess of $1 million, or individuals who have earned an income of $200,000 per year for the last two years).

At the time of this writing, the Act has yet to be fully implemented. Once the U.S. Securities and Exchange Commission (SEC) institutes the operational rules relaxing financial reporting and accounting standards, the process will be less cumbersome for small businesses. Firms will be able to broadly advertise their equity offerings through social media sites such as Facebook, Twitter, and other websites. The goal is for the entrepreneur to reach investors who are especially attracted to the type of service or product that the firm is offering.

In anticipation of the Act's full implementation, a number of groups and websites or portals are already preparing. However, some key issues that still must be resolved are cyber security and whether there will be a

sufficient number of firms that will be willing to use this IPO method. Additionally, there is the question of whether there will be a sufficient number of interested investors. There is also the possibility that the SEC rules might still be so restrictive as to make it almost impossible for a small firm to raise funds in this manner. Finally, all investors need to be aware that there is a high failure rate among start-ups. Indeed, recently the rule of thumb is that only one out of every 15 to 20 start-ups succeeds. This causes pause for many who believe that few small investors will have a solid grasp on the riskiness of investing through the crowd funding process.

Angel Investors. Angel investors usually are involved at the seed or even preseed stage of your firm. These investors also look for the same features as a venture capitalist. Angel firms try to seek out specific high-wealth individuals who would have a strong interest in the product or service that a firm offers. Thus, if your product is a medical service, the angel firm would look for wealthy physicians who would be interested in investing. On the other hand, if your firm had something to do with sports or athletics, the angel firm would look to successful professional athletes as potential investors. However, by current laws, they can only seek out qualified or accredited investors.[9] A firm owner who seeks out angel investors must sit down with each qualified investor, one at a time, to find the right funding. However, the concept of crowd funding, discussed previously, seeks to expand this opportunity so that many investors who have an attraction and passion for your type of product may be reached and allowed to invest.

Equity Financing

Of course, equity financing provides some share of ownership of your company in exchange for receipt of funds or other valued resources. Quite often, aspiring entrepreneurs are very leery about giving up *any* of the ownership of the company, fearing a loss of control. However, it is useful to consider the reality that 100% of nothing is nothing. Sometimes, in order to move your company to where you want it to be, you will need

to consider trading a portion of the ownership for funds that you need to help the company grow. Keep in mind that, as long as you own 51% of the shares in your company, you are still in control.

Using Convertibles. Convertibles come in a variety of forms (bonds, preferred stocks, and stocks with warrants and options, etc.). What distinguishes convertibles is that, as compared with standard instruments, these are developed with provisions for repurchase or resale at specified prices within certain time periods.

Convertible Bonds. In the early stages of your business, investors such as venture funds may be interested in investing with convertible securities. In many cases, these types of convertibles charge low interest and have long, delayed principal repayment periods.

Convertibles usually have a specific conversion ratio and, therefore, a conversion price. The conversion ratio indicates how many shares of stock the bond may be converted into, if desired (e.g., 50 shares of stock per bond). Thus, for a $1,000 face value bond, the conversion price is $1,000/50 shares = $20 per share. Hence, if the stock goes above $20 per share, the bondholder will find it beneficial to convert it into equity. The main reason that investors like convertibles is that, in the event that the business becomes quite successful, the ability to share in that success can be achieved by converting the convertible security into equity.

Convertible Preferred Stock. Preferred stocks usually have a fixed dividend rate, and normally dividend payments for preferred stock are cumulative, so that, if the firm is unable to pay a dividend in one period, it must pay the cumulative amount when it does pay. Preferred stocks are termed as such because these stockholders must be paid their dividends before any dividend payments are made to owners of common stock. These stocks are like convertible bonds, except that convertible preferred stock prices do move with the market. An example of a convertible preferred stock would be a share of preferred stock that can be converted into four shares of common stock any time after a period of two years.

Common Stock with Warrants & Options. *Warrants* give the investor the right but not the obligation to purchase a prespecified number of shares of common stock at a certain price, by a certain time. The main difference between a warrant and an option such as a call option is that warrants are usually detachable and may be traded or sold separately from the stock or bond. Call options associated with either common stock or bonds are not detachable and also usually have a shorter exercise period than a warrant.

Venture Capital and Private Equity. Venture capitalists as well as private equity firms look for very specific opportunities. The first and perhaps most important thing they look for is the uniqueness of the product or the business model. In concert with uniqueness, a key factor is the size of the market. Does the product or service represent the potential of having a huge market both in terms of the U.S. market and globally? There is also major attention directed toward whether the product carries with it a strong competitive advantage. Furthermore, the huge market potential must be able to be achieved quickly. One aspect of the competitive advantage is whether the product can be brought to the market at a highly accelerated speed. Another aspect can include a unique patent or a copyright. An advantage that cannot be quickly replicated is essential.

In addition, like most other investors, venture capital firms also look for a high-quality management team. However, as a business owner, you should be aware of one important fact: If you do not have a powerful vision for your product or the future of your business, investors perceive you as impeding the growth of your firm. This means that, although you founded the firm, you might be replaced at some point. A readily available example of this fate was Steve Jobs, to whom this very thing occurred (remember this and other examples from the introductory chapter of this book). Venture capital firms as well as private equity firms invest in a number of new potential start-ups with the hope that at least one or two will have a significant payoff.

Venture capital generally has four stages of investment after the angel stage: seed or start-up, early development, expansion and growth, and exit. The initial hope is always that your firm will be a successful national or global company in the end. At the seed stage, the venture capitalist will want a position on your board, and the ability to hire or bring on a more seasoned management team. In addition, venture capitalists at seed stage will want a solid equity (ownership) position in your firm. As your firm

grows, the initial venture capitalist firm will assist you in getting further investment funds from other venture capitalists.

In seeking to understand how venture capitalists operate, you should be aware of the fact that *each venture capitalist firm tends to be focused and have expertise in specific stages of a business's growth*. Some will only invest in your industry at the seed stage; while others focus on providing investment for the early development stage, and still others only invest in the expansion and growth stage. With the addition of a venture capitalist firm at each stage, you will be giving up more equity, and you will be receiving greater expertise for operating in each specific stage. It is the goal that the value of the equity holding is increased substantially at each stage.

While you likely view your business with some degree of emotional attachment, you should know that *venture capitalists enter business investment arrangements with a plan for exit. A venture capitalist or private equity firm always has an IPO as the firm's final exit goal.* Nonetheless, it should also be noted that, even in the event of a desired IPO, venture capital firms will not be able to exit for a period of one or two years, due to SEC regulations.

Despite working toward an IPO, in many cases, other exits will be more beneficial. These exit options include the sale of your firm to another firm, the sale to another venture capitalist or private equity firm, the sale back to you, or the options might even include bankruptcy (the latter is, of course, not an intended or preferred goal).

Exploring Small Business Investment Company (SBIC) Funding.

The SBA also sponsors the SBIC's—small business investment companies. These companies specialize in providing venture capital-like funds to small businesses (small being currently defined by net worth of $18.0 million or less, with average after-tax net income for the prior two years not exceeding $6.0 million—inclusive of all affiliated enterprises of your company). The SBIC's provide both convertible debt and equity financing. In addition, each SBIC is set up to specialize in a particular industry. Historically, SBIC's have funded such companies as Microsoft and Apple, Inc. SBIC's are licensed and regulated by the SBA and there are over 300 SBIC's operating today. SBIC's use their own capital, but their funds have an SBA guarantee. You can find more information on SBIC's located in your state at the sba.gov website.

Engaging in Private Placements. As your firm continues to grow beyond funding from, say, venture capital and private equity, the next step for funding might be private placement of debt or equity. This type of funding is usually done through an investment bank, which will find a single or a few accredited investor(s) willing to purchase bonds or stock in your business. These investors are usually insurance companies, pension funds, and mutual funds. Since these are all highly qualified investors, private placements do not require all of the stipulations and rules of a public offering as required by the SEC. Private offerings are done under the SEC rules (which include Regulation D) and do not require the same financial reporting as a public placement. There are also savings in terms of commissions, since not many intermediaries such as brokerage firms are involved.

In addition (similar to angel investors), with private placements, you have an opportunity to select the types of investors you wish. This generally makes private placements a less costly financing option relative to public offerings. However, private placements can only be made to accredited investors.[10] As a consequence, it is possible that there might not be many sympathetic investors with sufficient wealth to fully fund your needs. Alternatively, there might not be as many sympathetic accredited investors who are interested in your business. Moreover, private placements have the additional potential downside that the pricing of your securities is usually lower since you are facing sophisticated investors who will bargain for much lower prices.

The IPO. If your enterprise achieves a substantial national market and has the opportunity to grow even further, both nationally and perhaps internationally, it will become a candidate for an IPO. At this point, you would need the services of an investment bank. The rules of an IPO are very cumbersome and require the assistance of attorneys, accountants, investment bankers, and others to be certain that you are in compliance with all SEC regulations. SEC requires the preparation of financial statements such as 10K's and 10Q's, and the preparation of a prospectus which meets all legal requirements. The process also requires a network of investment banks to market your securities. An IPO is a large undertaking, and requires tremendous detail which is beyond the scope of this chapter. Few enterprises reach this level, but those that do will need the assistance of a cadre of experts.

Chapter Summary Checklist

(X) Check all that apply

☐	No.	Item
☐	01.	I have planned for the financing of my company well in advance of my start-up date.
☐	02.	I have judiciously used my credit cards and other payment methods and have built a solid credit history and solid credit score.
☐	03.	I have purchased and invested in whole-life or universal-life insurance plans from which I will be able to withdraw funds if needed for investing in my company.
☐	04.	I have invested in pension funds such as 401(k) or 403(b) plans and if needed I will be able to withdraw funds to invest in my company.
☐	05.	I have built up substantial equity in my home and if needed I will be able to withdraw funds to invest in my company.
☐	06.	I have established a strong relationship of trust and integrity with family, friends, and associates who would be pleased to support the funding of my company.
☐	07.	I regularly monitor my financial statements in order to ensure that I meet the major factors and financial ratio targets that investors require.
☐	08.	A system is in place for constantly reviewing and helping me to maintain my 5 C's of credit.
☐	09.	A system is in place for establishing a financial plan and monitoring it on a regular basis.
☐	10.	A system is in place for studying the following comparative financial ratios: liquidity, asset utilization, debt, profitability in order to meet and maintain the industry standards for my company's classification.

CHAPTER 4

Marketing

No one came to the banquet; no one ate the delectable food; for, to not come when not invited, simply can never be construed as rude.

—© 2013 Sage Sayings™

Introduction to Effective Marketing of Your Small Business

You can have the best product ever made, but if no one knows that you have it or how it can be obtained, it will simply set on your shelves and accumulate dust. Developing and implementing marketing strategy is not only needed but it is also a must for *all businesses* (large and small). It is a critical process for the survival of all organizations (profit, not-for-profit, private, or government) competing in the domestic and global business (and nonbusiness) environments. Marketing strategy is also applicable to: *people* (ranging from political candidates to athletes); *places* (tourism: I love New York); *causes* (do not drink and drive); *event*s (from sports events to the American Cancer Society's Relay for Life); and, *organizations* (United Way, U.S. Postal Service). Hence, small business is no exception.

In this introduction, the aim is to provide a basic framework that will help you to understand: (1) what marketing is; (2) the importance of the marketing concept or philosophy; (3) what key factors are fundamental components of marketing; and, (4) how those key factors relate to the development of marketing strategy.

Marketing—Defined

Marketing in simple terms can be explained as an exchange process between two or more people or organizations where each has something to offer that the other needs. A more formal definition of marketing is: "Marketing is an

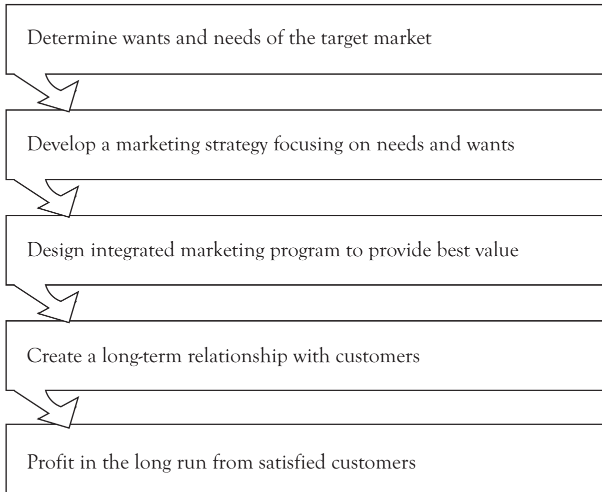

Figure 4.1 Steps in the marketing process

Source: Adapted from Armstrong and Kotler (2013).

organizational function and a set of processes for creating, communicating, and delivering value to customers and for managing customer relationships in ways that benefit the organization and its stakeholders."[1] See Figure 4.1.

Marketing Concept or Philosophy

The marketing philosophy (concept) emerged over nearly 100 years, from the initial preoccupation with production and sales, to increased appreciation of marketing as a more comprehensive concept, and to the current importance of relationship marketing. Marketing strategy has, thus, evolved from sellers's markets (with shortages of goods), to buyers's markets (with excesses of goods that buyers need or want), to, finally, relationship marketing, where the emphasis is on building lifetime relationships with customers.[2]

The marketing concept calls for

- a company-wide consumer orientation which focuses on needs and wants of target customers;
- a coordinated effort within the organizations; and,
- profit in the long run with sustained customer satisfaction.

The company-wide orientation means that everyone in your organization understands and recognizes that your company exists to satisfy your customers. Coordinated effort means that all departments, from your credit office (accounting), to engineering, to production—*all* play an important role in meeting the needs of your customers, as well as keeping your customers satisfied. Of course, ultimately, developing and maintaining a base of satisfied customers will lead to profits for your business over the long term.

The Marketing Mix

The modern marketing tool that you will need to use to achieve your marketing objectives is called the *Marketing Mix* or *Four P's***.** The four essential elements of the marketing mix are *product*, *price*, *promotion*, and *place* (distribution). A contemporary addition to this concept is the fifth *P*, or *people* (see Figure 4.2).

Addressing first the most recent of the P's, *People* refer to the customers of your business, and more specifically are called your *target market*. A target market is further understood to be a group of customers with similar characteristics, needs, and preferences. *Product* means goods (tangible) and services (intangible) or any combinations of these

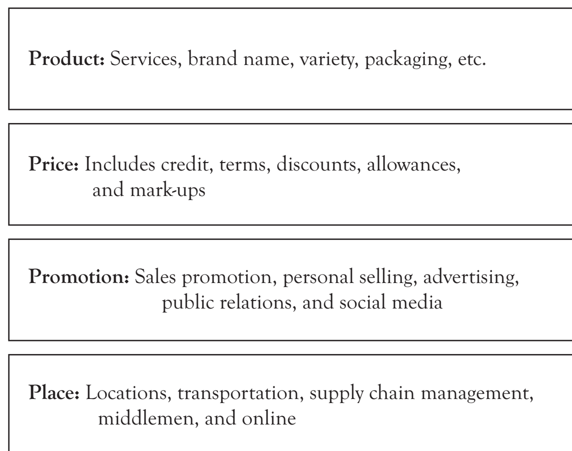

Figure 4.2 Four P's of the marketing mix

Source: Adapted from Armstrong and Kotler (2013).

that are offered to the target customers. An example would be a cable TV service. It comes with a cable box, DVR, remote control, and a promise or warranty to provide uninterruptible television programming service. It should be noted that, even though there is a tangible product being offered to customers, it is always combined with service; and, ultimately, all businesses are in the *service* business**.** *Price* means what your customers are prepared to pay in monetary terms for the product or service that you provide. This, in turn, represents the value that a customer receives. *Promotion* refers to the process that marketers use to communicate with your target customers about your offerings to persuade those customers to buy your product. For example, a small business selling food from a truck would be able to persuade customers through signs on the truck, display of different menus and pricing, and by parking the truck in a strategic location with maximum foot traffic. The business owner's task would then be to convert potential customers to paying customers. *Place* refers to where marketers make goods and services available to target customers. The place can be retail (e.g., Nordstrom), or cable service provided in your home, or, these days, it can be virtual or online (e.g., Amazon.com), or place can be at both brick-and-mortar locations and online, worldwide (e.g., many educational degree programs).

Marketing Process and Strategy

Strategy refers to the course of action you take in order to achieve your objectives. Effective marketing requires a coherent strategy. In addition to the marketing mix variables, you should take into consideration environmental variables, like the economy, laws, regulations (rules), competition, technology, and social or cultural factors and associated probable effects in designing a marketing strategy. Marketing strategy, therefore, involves anticipating future events and situations in order to design the best way to achieve your business goals and objectives within the context of the available opportunities in the marketplace. Thus, although the marketing mix variables were defined and briefly illustrated earlier, the focus will now shift to a more detailed exploration of how each variable can be applied in the context of strategy.

Product or service refers to both physical or tangible products and intangible services that an organization offers to the market or that the market selects. An example would be the iPhone 5 by Apple. It should be noted again that ultimately all offerings (tangible and intangible) are service-based. Almost all products are offered with a warranty or guarantee of performance, without which customers will be very hesitant to buy. A service warranty or guarantee is also used as a tool to create differentiation—a discernible difference compared with offerings of competitors. General Motors (GM) got back into the market with full force after its bailout by offering warranties of 10 years or 100,000 miles. Initially, GM offered cars with a provision that buyers could return cars within 60 days if the buyer was not satisfied. Both Hyundai and BMW reestablished footholds in the U.S. market by offering consumers warranties covering 10 years or 100,000 miles. BMW even offered to provide free oil changes for 10 years.

Besides having a strong branding strategy, it is worthwhile to consider cobranding, brand extension, and brand licensing. An example of cobranding would be the Eddie Bauer edition of the Ford Explorer; also, Subaru is an official car of L.L. Bean. Nike or Reebok logos on college campus jerseys or scoreboards represent forms of brand licensing.

Price refers to the amount that buyers are willing and able to pay for the products and services offered for sale. Price is also the yardstick of value that customers expect to receive from the product or service. The price, then, should be an indicator of value that customers are likely to get in exchange for goods or services. Therefore, price level can be adjusted (increased or reduced) depending on the actions of competitors and can be seasonally adjusted for market conditions like low or high demand, high or low unemployment, recessionary versus inflationary economic conditions, or new and innovative versus out-of-style products, and so forth.

Promotion refers to communication activities that you or your marketers use to inform and persuade targeted customers to buy your products and services. Promotion methods such as advertising, public relations, publicity, personal selling, sales promotions, direct marketing, and use of the Internet for e-mails and various social media (Facebook, YouTube, Twitter, etc.) are very effective tools to communicate with customers of the 21st century. Your promotional objective, like that of any and all

entrepreneurs, should have several goals. A major goal should be to provide information not only to currently targeted customers but also to the general public (or relevant others if you offer a specialized product or service), as these are the people who might eventually become your customers. A second goal should be to create a positive image of your company and its brand. Thirdly, you should be striving to accentuate value due to the differences or uniqueness of your offerings. Finally, your ultimate goal should be to increase or stabilize sales over the long term.

In seeking to accomplish your goals, you must make an attempt to blend various promotional mixes, such as advertising and personal selling, with sales promotions, like coupons, free samples, trinkets, displays, trade shows, premiums, and so forth. Any of these methods may be used to reach out to customers on a recurring or nonrecurring basis. Besides, you always have the option of using public relations and publicity to place your company's brand before readers of newspapers and magazines, and viewers of televisions (e.g., to note your contributions to the community or social causes). This type of nonpersonal presentation creates much more positive impact on the targeted audience than any commercial. The 2012 campaign of President Obama used these media most effectively and in very sophisticated ways to communicate with the voting public, not only to vote for brand "Obama," but also to urge the sharing of Obama campaign messages with family members, friends, and other known groups. Regardless of your political persuasion, the success of this strategy provides a glaring example of how social media can be used to reach a target audience—an example that can be very useful to you as you strive to promote your own business's products and services.

Place or distribution refers to the choices that you select to make your products or services available to customers based on the what, when, where, and how of customer needs. Place strategy provides time, ownership, convenience, possession, and utilities for customers. For example, marketers provide winter clothing during winter months, spring clothing during spring, and summer clothing during summertime. If you are in the clothing business, you will also offer services like returns or exchanges; while those in the home appliance industry will offer service warranties and home delivery. Thus, in the above campaign example, voters were given the opportunity to go and vote in polling places located within a

very reasonable distance from personal residences; and, in many cases were allowed to vote by mail, or even the Internet in New York and New Jersey, due to Hurricane Sandy. Integrating the four P's in designing marketing strategy, therefore, is critical for all business marketing efforts (i.e., for both small and large businesses).

Designing Your Marketing Strategy

In designing and implementing marketing strategy, the important first step is to answer the question, "What business are you in or what does your business do?" That is, you must define your business. This preliminary step is the same as defining the mission of your business, as discussed in Chapter 2. However, this step is very important here because it helps you to identify your target market, competition, and, above all, it helps you to effectively design the current and future direction of your business. For example, originally, railroad companies had defined the companies in the industry as railroad businesses (moving by railroad) rather than transportation businesses (which serve the purpose of moving people, products or goods from one place to another, regardless of the mode). Had railroad companies not focused only on the railroad business, obvious competitors (airlines, trucks, cars, barges, ships, etc.) would have been recognized as such. Look where the airline industry is today versus the railroad industry. When someone in New York makes plans to go to Los Angeles, it is automatically presumed that a flight will be booked.

Another way to define your business is to focus on what the customers are buying from you. Customers in the marketplace are not buying computers but *problem-solving and communication machines*. Hollywood studios are not in the business of making movies, but are in the *entertainment* business. Cosmetics manufacturers are not in the business of marketing cosmetics, but instead are marketing *hope* of fulfilling dreams of people who want to be seen as having a very good physical appearance or look.

It is now time to focus on putting into action what has been discussed, thus far. You should now set aside some time to develop your own marketing strategy. As can be seen in Figure 4.3, there are four steps in the process of designing your marketing strategy. Each of these steps will now be addressed.

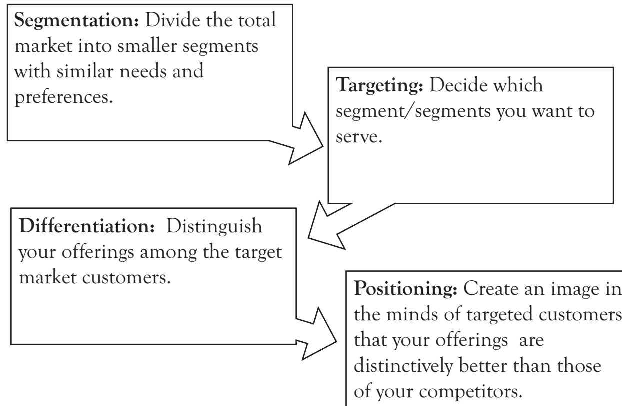

Figure 4.3 Steps in marketing strategy formulation

Source: Adapted from Boone and Kurtz (2013).

Step 1: Segmenting the Market

Since you cannot effectively serve *all* customers (mass marketing), it is a good strategy to segment the market. Segmentation involves dividing the total market into smaller parts (segments) based on homogeneous needs and preferences of customers. Additionally, customers in each segment have different resources, wants or needs, lifestyles, attitudes, buying habits, cultures, and neighborhoods. For example, the automobile market is divided into luxury, economy, family, sports, and trucks (to name a few).

Each segment has uniquely different needs and preferences. As an example, consider a food truck (otherwise referred to as a Grab & Go) lunch market. Assume that the total downtown Washington, DC luncheon market is $1 million per month. In this scenario, it is also reasonable to assume that many customers will eat lunch at restaurants, clubs, office cafeterias, and so forth, leaving only about $200,000 per month in purchases from customers who will buy directly from trucks. A truck owner will be very lucky to receive even 1% of this market initially, given that there are competitors, as well as considerations related to the location of the truck and volume of foot traffic. Therefore, as the truck owner, you should try to create initial demand by offering value: making it clear why customers should buy from you rather than your competitors. The initial offerings should not only be to *satisfy* customers, but to also *claim* each patron as a loyal customer who will sing the praises of your business,

spreading the word for you and bringing in other loyal customers. This process is called *viral marketing*, which is a very efficient and cost-effective way of marketing your business. Clearly, your segment here is economically focused, seeking value, and likely wanting a lunch that will be available within a matter of minutes and cost no more than $10. If you have a beneficial or well-liked product, the local newspaper and maybe even television station will sometimes do a story spotlighting your offerings and why people like or see your products or services as special. Depending upon the market and your position in it, this strategy alone can be worth several hundred thousand dollars of publicity.

Yet another example of segmentation would be categories of Hollywood movies such as family-oriented (G and PG), thriller, western, classics, romance, cartoons, action, and so forth—each designed to appeal to a different group or population.

Step 2: Targeting Your Market

Once a decision has been made as to what segments of the market you want to serve, those segments become your *target market*. This means that you perceive that the segments have significant enough attractiveness and potential to be profitable in the long run. As an example, Japanese auto manufacturers initially had targeted the economy segment of the market in the United States, with Toyota offering the Toyota Tercel and Honda offering the Honda Civic. However, with the passage of time, these companies have successfully transitioned to targeting all segments of the automobile market. By contrast, Volkswagen has yet to enter the luxury segment of the U.S. market, instead opting to focus on economy and mid-size (sedan) target markets. Thus, as a business owner, you can decide to enter and serve only one segment of the market or multiple segments of the market.

Step 3: Differentiating Your Products and Services

Once you have made your target market selection, you then need to distinguish your products from those of your competitors in that target market. This is known as differentiation. There are countless ways

that you can differentiate your offerings and provide great value to your customers, thereby creating and sustaining a competitive advantage in the market. Additionally, differentiation can be created by way of service, style, design, performance, price, delivery, and many other methods. For example, a gas station owner or attendant might get to know and greet each regular customer by name; or, in self-serve gas stations, the owner might decide that the female customers will not have to get out of cars and will be served by attendants at the same price as self-serve. This is the way to create customers's favorable or positive perceptions of your products or offerings. Differentiation is the strategy you use to create a specific mindset among your customers regarding your products.

Step 4: Positioning Your Offerings in the Market

Positioning refers to the creation of an image in the minds of customers. It is always in reference to competition and does not exist in a vacuum. For example, the name, Nordstrom, brings to mind a distinct image of prestige, quality, and a high level of customer service. Conversely, K-Mart or Wal-Mart stimulates different kinds of images such as inexpensive, not high-quality merchandise, and not very customer service-oriented stores. Customers would make an effort to be seen by neighbors if shopping at Nordstrom, but would try to hide or make sure not to be seen by neighbors, acquaintances, or friends while at K-Mart or Wal-Mart. Thus, positioning refers to creating an image in the minds of your targeted customers. Your strategy defines what kind of product image customers are likely to have; and, ultimately, through expression of tastes and preferences, customers are the ones who define the offerings of your company.

Remember that the marketing mix (product or service, price, promotion, and place or distribution) plays a very important role in creating the image of your offerings. You need to follow through on the promise of being really customer service-oriented or customer-focused and not make hollow promises. Thus, your sales staff and delivery people have to be trained well to deal with customers in a business where you are trying to create differentiation by promising high-level customer satisfaction.

Finally, strategy is nothing unless it is successfully implemented. In today's marketplace (both domestically and globally), you, as the chief

marketer of your business, need to be carefully watching and accurately keeping pace with the nature and speed of changes taking place in the market. This is critical in areas such as technology, innovation, population structure, and cultural changes; and, you must adjust your marketing strategy, accordingly, to retain your competitive advantage or else your business could become extinct. For example, remember the "Kodak moment," when everyone thought of Kodak as being synonymous with photography. Now Kodak is in bankruptcy. Yet another example of keeping up with the changes in the marketplace is the McDonald's hamburger. As the customers's preference for nutritional food increased, McDonald's began creating new menus with higher nutritional values, giving information on calories for each menu item and thereby keeping competitive advantage. Yet another good example is use of Blackberry cellular phones. At one time, Blackberry had a monopoly in the market, including the government market. Now the phones are struggling to be competitive in the market because of innovative phones by Apple and Samsung. These examples illustrate that you need to remain very vigilant as to what is happening in the marketplace. Also, in order to stay ahead of your competition, you need to invest in marketing research to gather information on a continuing basis about changing market conditions, competition, regulations, and the opening of opportunities to market abroad.

A Note on the Internet and Social Media Marketing

Today, all marketers (especially small business owners) need to work very closely with the Internet and social media, as there is no escape from these growing methods of communication. A small business with limited budget, a small staff, and so forth, might not see the relevance of using either the Internet or social media to reach customers; rather, such a business might simply resort to reliance on word-of-mouth. Yet, utilization of some of the Internet and social media as a tool to reach and communicate with customers is likely to reap a lot of benefits. An example of a small business start-up that should be cited here is 800razors.com. The company's business is generated strictly online and is designed to meet the needs of customers who are looking for inexpensive but performing razors or blades instead of well-known (more expensive) brands like Gillette. The

company did just under $1 million in business in less than six months.[3] An additional example of a successful small business is Morris Spanner's initiative to work with DICOM to transmit X-ray images of a person's body from one hospital to another, or one doctor to another, quickly via computers. The company has developed software that easily moves images among hospitals and doctors. To market the service, the company used marketing channels not traditionally used by the medical profession. These channels included Twitter, LinkedIn, Facebook, and use of other social networks, such as buying Google ad words to reach out to doctors and hospitals. The strategy finally landed a contract with the Mayo Clinic for an imaging project.[4]

In 2012 alone, each month some 191 million people conducted 17 to 18 billion searches using various Internet search engines. In addition, 184 million people spent an average of 22.25 hours watching videos online, and 72 million people read blogs.

In almost every corner of the globe today, the social networks are abundant (for example, Facebook, YouTube, Flickr, Twitter, LinkedIn, blogs), as are mobile phones (text messaging, e-mail, and so on). These are now very important marketing tools that all entrepreneurs—big and small—must accept and appropriately utilize in order to survive in today's highly competitive markets that increasingly have very well-informed consumers.[5] Think about the power of six billion consumers with cell phones worldwide who are in a position to keep up with events (and products) and spread information through, say, text messaging alone. In the United States, there are well over 200 million Internet users who visit different social networks for close to an hour every day. Similarly, nearly 60% of the customers of today are using mobile devices to access the Web and also are using mobile apps to conduct personal and business transactions. Furthermore, research results by eMarketer indicate that, during the second quarter of 2012, business-to-consumers (B2C) mobile sales accounted for about 15.1% of Internet sales.[6]

Since today's customers are everywhere, you are better off designing your marketing strategy to reach those customers through as many different types of media as you can afford, thus providing the maximum exposure of your offerings and resultant opportunities for the digital customers to buy. However, it is important for you to note that content marketing

remains a very effective tool for communication with your selected target audiences. This works because consumers are now sophisticated enough to detect or filter information that is valuable and enhances intelligence, and therefore contributes to development of better buyers. Eventually, the consumers, in turn, are likely to reward you with loyalty or business.

The different options described earlier are available, either alone or in combination, to all entrepreneurs. Small business owners with limited resources need to pay more attention to these avenues of communication to keep in touch with targeted customers. The initial investment of time and resources might be somewhat painful for you, but the ultimate rewards should make it worthwhile. For example, you can use LinkedIn for personal branding. You can also utilize Twitter.com or search to keep following conversations about your industry, company, brand, or generic or specific product, and then decide to open a Twitter account to communicate with the followers. Additionally, a company can arrange social media events, which can generate positive word-of-mouth conversations that could eventually result in long-term sales as well as building a brand, company image, or both. You can also sign up with Google Alerts to keep up with what population in general is talking about you, your brand, company, competitors, and so forth.

Among social media, Facebook deserves special mention: All entrepreneurs must become knowledgeable about the value of Facebook in making direct contact with customers. This is the most dominant of all social networking sites or services. Nearly 58% of the population uses Facebook to communicate among themselves and have also posted personal profiles. A large majority of Facebook users (62%) interact with different brands on their news feeds and not the brand's Facebook page. In a worldwide survey, nearly 60% of those who responded expressed expectations that brands provide responses to comments made in social media. You need to be mindful that both the comments made by social media users and responses provided by the company help to shape perceptions of the brand and company.[7] Clearly, this offers a great challenge to all marketers desiring to interact with customers. Nonetheless, with advantages to be gained by doing so, the effort is certainly worth expending.

Despite the popularity of Facebook, e-mail is likely the most recognized means of communicating through the Internet. Thus, e-mail

marketing has become more common. E-mail marketing is a low-cost, direct way to communicate with a large number of customers and it has a usually high response rate from people who have a desire to do business with the organization. Even among those who have not given permission to receive your e-mails, you can send e-mails with options to unsubscribe so that your e-mails do not become annoying and create negative comments among friends and neighbors. You can direct recipients to visit your website to place or review orders or review offers, request information, or you can invite comments.

The social media options that have been described provide some examples of the usefulness of these contemporary means of communicating with your customers or prospective customers. If you are interested in further details on any of these media, you are encouraged to research specific topics on the Internet or in books devoted to the topics.

The Federal Government Market

The federal government is one of the country's largest buyers of goods and services.[8] Its different departments, agencies, and commissions send out "requests for proposals" every year soliciting contractors to provide consulting services. The services include energy and defense consultation, environmental assessment, financial advisement, communication and information technology, and logistics. In one word, the government is omnivorous. Many government contracts, such as those offered by the Department of Defense (DOD), Homeland Security, and the Department of the Treasury are characteristically so broad and complex that some small businesses are unable to compete. By contrast, large companies like Lockheed-Martin, Boeing, Northrop Grumman, and General Dynamics dominate in such a competitive arena and are usually awarded government contracts—particularly the large ones.

Small businesses interested in competing for government contracts should understand the procedures and cultures of the government's procurement and contracting systems in order to be successful in the bidding process. The Small Business Act stipulates that small businesses must be afforded the maximum practicable opportunity to participate and to provide goods and services to the government.[9]

There are over 50 agencies and departments within the federal government. These organizational units have a statutory obligation to contract out to designated types of businesses at least 20% of everything purchased. The statutory goals include the following guidelines for involvement of various groups in government contracting:

- Small businesses—23% of prime contracts
- Small and disadvantaged businesses (SDB)—5% of prime contracts
- Women-owned small businesses (WOSB)—5% of prime and subcontracts
- HUBZones—3%
- Service-disabled veteran-owned small businesses (SDVOSB)—3% of prime and subcontracts

Government departments and agencies are required to submit annual reports indicating that these requirements have been fulfilled. Several programs have been designed to increase contracting opportunities for small businesses. For example, the Mentor-Protégé (MP) Program and Small Business Innovation Research (SBIR) Program are available to small businesses interested in participating in government contracts.[10] Furthermore, many contracts are set aside to attract the interest and participation of small businesses. Other programs designed for small business participation are identified as: Small & Disadvantaged Business, Certified Small Business, Small Women-Owned, Small Disabled Veteran-Owned, HUBZone, Alaska Native-, and American Indian-Owned Businesses.

However, you need to be aware that there are distinct differences between government and private-sector procurements. Unlike private procurements with limited regulations and vague transparency, governmental contracting and procurements are strictly regulated by Federal Acquisition Regulations (FAR). While this standardizes the contracting process and also makes it transparent and fair, it creates a process that is also cumbersome, slow, complicated, and subject to varied interpretations of rules (FAR sections). Furthermore, the process is characterized by longer decision times, longer payment

cycles, and budgetary allocation adjustments by Congress (which can often be difficult to predict). Nonetheless, resources have been put in place to help you navigate your way through what might initially appear to be a contracting process maze. A systematic approach to successfully marketing to the federal government is described in the sections that follow.

Identifying Available Marketing Assistance Resources

Before attempting to market to the federal government, it is, obviously, important for you to first learn what resources are available to assist you. With this knowledge, you can plan to utilize those resources to your advantage. Following are some of the resources.

1. Small Business Administration (SBA): www.sba.gov
   SBA provides
   - counseling services both in person and via e-mail;
   - training of various types (most are free or minimum cost);
   - financial assistance (loan guarantees and counseling); and,
   - small business certifications, such as 8(a).
2. Small Business Development Centers (SBDC's): www.sba.gov/sbdc
   SBDC's provide
   - counseling;
   - management assistance; and,
   - training (free or minimum cost).
3. Procurement Technical Assistance Centers (PTAC's): www.dia.mil/db/procurem.htm
   PTAC's provide
   - counseling (either in person or via e-mail);
   - training (free or minimum cost) in person or in classroom, some online; and,
   - registration and bid-matching assistance.
4. Small Business Program Offices are located in almost all government departments and agencies. These Office of Small and Disadvantaged Business Utilization offices are often referred to by the OSDBU (and

sometimes SADBU) acronym. The Department of Defense OSDBU is listed at www.acq.osd.mil/osbp[11]

Reexamining Your Business Definition

After having identified relevant resources, the next step is to take a fresh look at and redefine the nature of your business, if necessary. A narrow definition will limit your opportunities. For instance, recall the Railroad example in a previous section of this chapter, in which it was emphasized how beneficial it would have been had the company defined its business as Transportation and not Railroad. By providing a clear and appropriately expansive definition of the business, the company could have attracted the intended market (future travelers). Had the narrower Railroad definition been employed, someone traveling from Washington, DC to Los Angeles would never be thought of in the context of the train, but would automatically be assumed nowadays to be traveling by plane. Hence, the Railroad company would be summarily dismissed from consideration, because the company incorrectly defined its purpose. Similarly, when the federal government announces that it is buying computers, it is actually buying "problem-solving and communication." Thus, you must recognize that you are now in the problem-solving and communication business and not in the business of simply supplying computers.

Understanding Your Customer and Product Fit

Your job now is to understand how your customers (or prospective customers) can benefit from your products and services. Before going forward, take a moment to really think about your company's products and services. Get to know the agency and understand the context in which your product or service could be used. Think about whether existing products and services can meet those needs. Consider whether modifications would make your company more competitive and whether those modifications are feasible and potentially worth the effort. Obtain available information on past awards, quantities, and costs. Become known to potential purchasers. Take another close look at your company and

Table 4.1 Some qualifications for doing business with the federal government

Proof of Adequate Financial Resources
Compliance Delivery Requirements
Satisfactory Record of Performance
Satisfactory Record of Integrity and Business Ethics
Satisfactory Record of Experience in Accounting
Operational Controls, and Technology
Proof of Adequate Production, Construction and Technical Equipment and Facilities
Proof of Eligibility to Receive an Award Under Applicable Laws and Regulations
Certification of Competency

Source: Adapted from Federal Acquisition Regulations Website (FAR)9.104-1

consider what the government will look for when considering your company for a contract award. The FAR Part 9 clearly states the qualifications for organizations to do business with the federal government. Some of those qualifications are shown in Table 4.1.

Developing Your Strategic Marketing Plan

As a small business owner, the next step you can take to attract government contracts is to develop a strategic marketing plan. One popular approach that can deal with the vastness of big government is the segmentation, targeting, and positioning (STP) strategy, which was discussed in the earlier part of this chapter. The DOD offers a perfect opportunity to demonstrate how small businesses with limited resources can use the STP strategy to win government contracts (see Figure 4.4).

As shown in the following figure, the selection process for a small business requires that you first *segment* the market before identifying potential customers. Once you have identified the *target* market(s), study these prospective customers in detail, and get familiar with (*know*) the wants, desires, and habits of your future customers. While your goal is to develop business with sometimes very large government departments, it is important for you to remember that, ultimately, the face of these departments is a human one. Learn the names of and seek information from departmental personnel about key things that you need to know, such as:

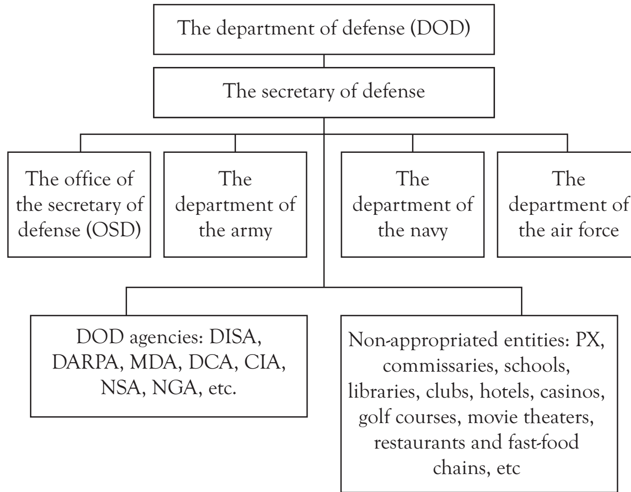

Figure 4.4 Example of segmentation strategy

Source: Adapted from DOD organization charts shown on DoD website (2013).

- Buying habits (centralized or decentralized, regional or headquarters, and so forth)
- Department or agency business procedures
- OSDBU influence
- Record of accomplishment of small business goals (%)
- Past practices or awards to small businesses
- Aggressiveness in achieving small business goals
- Friendliness toward small businesses
- Transparency

Remember that this list is not exhaustive. Add to it, as necessary to fulfill your own unique information needs.

Searching for Contracting Opportunities

As indicated earlier, the federal government is the largest purchaser in the country. Therefore, you can expect that virtually every department and agency can be viewed as a source of contracting opportunities. While the DOD is frequently mentioned in this chapter due to its extensive budget and purchasing needs, on a government-wide basis, the General Services Administration (GSA) deserves separate mention and is, thus, discussed briefly here.

General Services Administration

With 10 regional offices located throughout the United States, the General Services Administration (*GSA*) *is the main purchasing agent of the U.S. government*. The agency also is responsible for managing the Federal Supply Schedule (FSS) Program. Through the FSS and Indefinite Delivery Indefinite Quantity (IDIQ) contracts, different federal agencies can order commercial products and services from the *preapproved* list of vendors. Once on the list, departments and agencies can quickly make purchases from your company within certain dollar limits. For more information on the GSA Federal Supply Schedule, please visit www.fss.gsa.gov.

Subcontracting and Teaming Opportunities

The federal government, and DOD particularly, encourage setting aside a portion of procurements that would otherwise be too large for small business. The vehicle often employed is called subcontracting. Major contractors (e.g., Boeing, Lockheed-Martin, General Dynamics, Raytheon, and Northrop Grumman, etc.) with large federal government contracts are *required* to provide small businesses the opportunity to receive subcontracts. These large businesses serving as principal contract-holders (prime contractors) get credit for small business participation as well as *preference* in the evaluation of contract proposals and determination of subsequent awards. In fact, Section 8(d) of the Small Business Act and FAR 19.7 go so far as to require prime contractors having large prime contracts with the department or agency to provide maximum possible subcontracting plans indicating how minority-owned businesses (MBE's) will be utilized.

In addition, the subcontracting or teaming agreement is an opportunity for small businesses to both grow and have an opportunity to gain real-life experience from writing proposals to government agencies. This experience can later be translated into prime contracts and can be strategically used as a reference for you to show that your company has experience that differentiates it from other small business contractors.

The DOD's prime contractors and subcontracting reporting system, which is generated electronically, contains the names and addresses of companies, categories of products and services provided to DOD, subcontracting plans, and names and addresses of company officials who administer the

subcontracting plans. Additionally, the websites list more information about subcontracting, prime contracts, and the like, so that you can search for and market your offerings to prime contractors for subcontracting opportunities. Also see the discussion of the MP Program in a later section of this chapter.

Additional Important Electronic Searches

Review the Federal Procurement Data System (www.fpds.gov) for contract opportunities by the Simplified Acquisition Threshold (SAT), for awards in the $3K to $150K range. Also, regularly search www.fedbizopps.gov for active federal contracting opportunities. This website will also provide information on posted contracts during the last 90 to 365 days, by set-aside code, place of performance, type of contracts, and by agency. Also, look into the website of the Minority Business Development Agency—MBDA (www.mbda.gov) for both government as well as global business opportunities. Other important sources are also available.

Other Federal Programs

Three major programs that have been particularly helpful to some small businesses are the Mentor-Protégé (MP) Program, the Small Business Innovation Research (SBIR) Program, and the Small Business Technology Transfer (STTR) Program. You should spend the time to familiarize yourself with these programs and decide whether your company could benefit from participation in any of these programs. Following are brief descriptions of each program.

Mentor-Protégé Program

The MP Program affords small businesses the opportunity to pursue and secure procurements with the federal government as a joint venture with experienced and already established large or small businesses. This program was established in 1991 under Section 831 of Public Law 101-510. Under this arrangement, the established business (Mentor) provides developmental assistance (technical, managerial, financial, proposal preparation, etc.) to a small business (Protégé) to facilitate the Protégé's enhanced ability to successfully compete for prime contracts and subcontracts.

There are two types of MP Programs that are available for the DOD. The first is the SBA-sponsored MP program and the other is the

DOD-sponsored MP program. Under the SBA program, a certified small and disadvantaged business (Protégé) forms a joint venture with the Mentor firm to seek government contracts. On the other hand, the DOD offers two options for participation in the MP program: (1) the Direct Reimbursement Agreement, which reimburses the Mentor for all costs; and, (2) the Credit Agreement, which allows the Mentor firm to receive credit toward the subcontracting goals set forth in the Mentor's prime contract. DOD and its agencies are the only departments that offer direct reimbursement. All other departments and agencies within the federal government offer only credit agreements.

Small Business Innovation Research Program

The purpose of the SBIR program is to encourage scientific research and development (R&D) among small technology companies for development of new products, services, software, instruments, and robotics. The SBIR program was established in 1982 and is designed to assist in early-stage funding of the most attractive projects for small technology-oriented businesses, while removing the obstacles due to lack of funds for continued innovation. The small business science and engineering projects that are funded by this program are those that offer tremendous potential for not only giving some added advantage to government, but also having the eventual potential for commercialization in the private sector. With annual funding of nearly $2 billion, the SBIR program is administered by the SBA through 11 different federal agencies. However, more than 50% of this funding is used by the DOD SBIR Program.

The ultimate goal of the SBIR project is commercialization. *This is one of the most successful programs ever developed and implemented by the federal government to assist small businesses.* [Emphasis added]

Small Business Technology Transfer Program

The STTR Program was established by Congress in 1992. STTR is similar to SBIR, except that STTR encourages small technology companies to work on R&D projects. A comparison of the SBIR and STTR Programs is provided in Table 4.2.[12]

Table 4.2 Comparison of SBIR and STTR programs

Project phases	SBIR	STTR
Phase I. Project feasibility	6 months upto $150K	12 months up to $100K
Phase II. Project development	2 years and up to $1 Million	2 years and up to $750K
Phase III. Commercialization	Introduction of the technology in the commercial and government markets, but no funding from SBIR	Introduction of the technology in the commercial and government markets, but no funding from STTR

Source: DOD office of small business programs website

Final Steps

Please review and procure the NAICS code(s) that may be applicable or relevant to your offerings and register your company on SBA's Pro-Net database and all of the pertinent departments's or agencies's OSDBU databases. Also, look into the System for Award Management (SAM)—https://governmentcontractorregistration.org, which provides an avenue for: (1) registering to conduct business with government; (2) seeking federal business opportunities; and, (3) opportunity to self-certify as a small business.

Additionally, to locate DOD opportunities, refer to siadapp.dmdc.osd.mil/procurement/historical_reports/statistics/procstat.html, and scroll down to ST28. Every fiscal year, this site provides detailed reports on various products and services purchased by the DOD. It provides procurement classification codes, number of contracts, and dollars, including the names and locations of buying offices.

It Really Is Possible

By now, you might be wondering whether all of this effort will pay off for you. While no one can honestly promise that it will, what you are being told in this chapter is based on the best academic guidance combined with the author's practical experience in working with the federal

government. On that basis, the following testimonial is provided for your consideration.

A Closing Testimonial

Many times, people are inclined to view the preceding process and instructions in a negative light (as if what has been suggested is too methodical and overly academic). However, this author, who has worked with the federal agencies, would like to share a story with positive results.

"One day, late in the afternoon, a call came from an OSDBU director's office requesting the names and phone numbers of small businesses seeking contracts in the Convention Planning & Management Services Industry. Unfortunately, there was only one contractor on file for this type of service. Thus, the contract was awarded to that lone contractor on file. The point is that *it costs almost nothing* to add your name to these lists and the benefits can be vast. Another point to note is that different departments and agencies always call each other to get the names and addresses of companies conducting business with peer agencies. In addition, these kinds of interagency (or Intra-agency) or inter-departmental (Intra-departmental) calls are more frequent when one or more agencies work in tandem to achieve specific goals. In addition, many times, agencies are left with some *unencumbered funds*, which expire at the end of the fiscal year and it can often be rather easy to acquire contracts at this point, if your company is known by agencies seeking to spend (commit) those funds."

Key Tips

- Define what business you are in.
- Identify your market.
- Determine needs and wants of your target market.
- Build long-term customer relationships.
- Utilize a customer-centered approach.
- Anticipate customer reactions.
- Measure consumer expectations.
- Make required changes to fit customer needs and enhance customer satisfaction.

Chapter Summary Checklist

(X) Check all that apply		
☐	01.	I recognize and have successfully communicated the importance of marketing to all in my business.
☐	02.	Everyone in my business understands, appreciates, and practices our marketing philosophy.
☐	03.	Everyone in my business recognizes and understands the influence that factors in the marketing environment, such as laws and regulations, political, cultural, social, and economic conditions can have in designing and implementing our marketing strategy.
☐	04.	Everyone in my business has a thorough knowledge and understanding of the 4 P's of marketing.
☐	05.	I understand the differences between the nature and demands of the government and commercial markets.
☐	06.	I am clear about the various government programs, including set-aside programs, available from the federal government in support of small, small and disadvantaged, women-owned, service-disabled, veteran-owned, and other programs.
☐	07.	I am aware of the Small Business Administration's (SBA's) assistance programs for all small business owners.
☐	08.	I understand how to segment the commercial and government markets.
☐	09.	I have clear understanding of and know how to find various contracting and subcontracting opportunities in the federal government.
☐	10.	I understand other government programs such as the Mentor-Protégé (MP), Small Business Innovation Research (SBIR), and Small Business Technology Transfer (STTR) programs.

CHAPTER 5
Managing Cash Flow

A man had a dollar and spent a quarter and gave fifty cents to his daughter; he gave another quarter to his friend, and then had nothing left to spend.

—© 2013 Sage Sayings™

Introduction to Successfully Managing Your Cash

In business, as in life, learning how to manage your cash is essential for long-term survival. In fact, one of the most critical problems facing small businesses today is managing cash flow. Cash is king for the successful business! The reality is that cash is the critical fuel that allows the business to continue its operations and grow. Without this essential fuel, too many of today's small businesses experience great difficulty trying to keep afloat. Businesses that receive too little fuel will sputter and never have an opportunity to grow. Ironically, businesses that have too much of this fuel will also have problems maximizing development and growth. In a nutshell: cash management is extremely important to small business growth and success.

Conventional wisdom states that the biggest challenge for small businesses today is access to capital. However, the author's own surveys of small business owners have revealed a challenge to conventional wisdom. When asked "What is your greatest financial obstacle?" responses from a small group of business owners were as follows:

- Uneven cash flow (35%)
- Payroll (17%)
- Taxes (17%)
- Raising capital (12%)
- High rent (5%)
- Other (14%)

Thirty-five percent of the respondents cited "uneven cash flow" as the greatest financial obstacle, followed by payroll and taxes. At a distant fourth place, only 12% of the surveyed business owners cited "raising capital" as the greatest financial obstacle. Further review of these results suggests that the business owners's concerns regarding payroll and taxes are related to concerns about cash flow. When these results are combined, the implication is that uneven cash flow was the concern of 69% of the respondents. The survey results glaringly point to the importance of managing cash flow for the success of business growth and development.

This chapter explores the cash management strategy of projecting cash flow, understanding the importance of financial statements, and safeguarding your cash. Additional topics of discussion will be: cash flow and decision making, cash management and banking, and using technology in cash management strategies.

Cash Management Strategies and Systems

Effective cash management strategy can be succinctly described in two simple steps:

1. Get your cash as quickly as possible.
2. Hold onto your cash as long as you can.

Although this is a simple formula for effective cash management, it is very difficult to implement and typically requires a lot of attention from the small business owner, along with the devising and implementing of complementary or ancillary cash management strategies.

In the process of managing cash flow strategy, there are a number of roles that you must ensure are executed. These include the following:

1. Cash finder—investing and borrowing cash
2. Cash planner—deciding how cash will be used now and in the future
3. Cash distributor—determining how cash will be provided to the critical elements of the business

4. Cash collector—ensuring that cash is being collected in an effective manner
5. Cash guardian—monitoring, protecting, and safeguarding cash

These roles are very important and many times require you, the business owner, to be able to ensure simultaneous execution. Although business owners often delegate these roles to employees, the importance of each role requires that you never become detached but continue to be involved in these cash management roles.

In addition to the judicious demonstration of the earlier roles, an effective cash management system requires the implementation of six important strategies:

1. Accelerating cash receipts
2. Planning, managing, and controlling cash
3. Forecasting inflows and outflows of cash
4. Investing surplus cash
5. Monitoring cash flow
6. Understanding and effectively using financial statements

Cash Management Strategy 1—Accelerating Cash Receipts

In selling products or services, or both, many companies extend customer credit in the form of accounts receivable and later seek to collect on these receivables. Credit sales have become an important part of doing business in today's marketplace and these sales have increased significantly as a portion of the total sales of most businesses. The key element for business success is to reduce the amount of time that sales remain in accounts receivables. Therefore, you must employ tactics that will turn receivables into cash as quickly as possible.

Methods that may be used to accelerate cash receipts include the following:

- Collecting and depositing cash in your bank as soon as possible
- Using bank funds transfers
- Billing customers as soon as possible

- Using effective and appropriate customer credit terms
- Utilizing post office boxes and lockboxes
- Using your bank effectively
- Developing a system for monitoring cash management

Cash Management Strategy 2—Planning, Managing, and Controlling Cash

It is highly unlikely that any effort needs to be expended to convince you that planning, managing, and controlling cash—your most precious business resource—is extremely important. This strategy principally focuses on the second element of the simple cash management strategy: holding onto your cash as long as you can. To execute this strategy, you must implement processes that will allow you to hold onto cash as long as possible. In addition, you must effectively plan how the cash will be used now and into the future. This strategy requires that your business strategically delay payments without incurring late fees or damaging supplier and vendor relationships. The strategy requires a "just-in-time" approach to delaying payment of obligations so that you can hold onto cash. You must make sure that the business has the correct amount of cash available when needed—not only to address present needs but also future needs. Therefore, this strategy requires that the focus should not be on the bank balance or net profit but on the ability to predict cash flow in the future.

Planning cash requires that you never pay any bill or obligation a day sooner than necessary. It is also important to employ tactics to delay or extend the payment date to increase the amount of time the business holds onto its cash. Some planning or delaying tactics that could be employed include the following:

- Mailing payments on Friday
- Centralizing the accounts payable function and developing an overall strategy for evaluating creditors (all creditors are not equal in importance and credit terms)
- Employing a bill paying priority system

- Utilizing control distribution accounts with your bank
- Employing the use of credit cards in your bill paying strategy
- Scheduling cash disbursements only twice a month
- Negotiating and renegotiating with suppliers and vendors

Each one of these tactics will improve your ability to hold onto your cash. However, utilizing all of these tactics will allow you to pay as late as possible.

Cash Management Strategy 3—Forecasting Inflows and Outflows of Cash

Forecasting cash inflows and outflows is an extremely important function. This activity must be engaged in at least once a month and should be centered on predicting how much cash is expected to flow in for the month and how much cash will flow out during that same timeframe. This process is critical, because it allows you to effectively budget for cash inflows and outflows and plan for the cash necessary for growth and expansion. The use of a cash budget is a critical part of this strategy. Figure 5.1 shows an example of a cash budget for a small business.

The basic steps in preparing a cash budget include the following:

1. Determine the required minimum cash balance.
2. Forecast sales and other revenue items.
3. Forecast cash receipts.
4. Forecast cash disbursements.
5. Determine the end of the month cash balance needed for business operations.

Cash Management Strategy 4—Investing Surplus Cash

In effective utilization of a cash budget system, you will determine if the business will have surplus cash and the amount of idle cash that remains in the business on a monthly basis. It is important to find methods to reemploy idle cash or surplus cash to earn additional dollars. It is advised

ABC Company, Inc.
January, February, and March 20XX

	January	February	March
Beginning cash balance	$10,000	$10,000	$10,131
Cash receipts from customers	41,000	46,000	52,000
Total cash available	$ 51,000	$56,000	$62,131
Cash Disbursements:			
Cash Purchases for Merchandise	$29,100	$24,600	$40,200
Sales commissions	5,000	4,000	7,000
Sales Salaries	1,000	1,000	1,000
Administrative Salaries	2,250	2,250	2,250
Insurance	100	100	100
Utilities	150	150	150
Supplies	250	250	250
Income taxes Payable	10,000		
Dividends		1,500	
Interest on Line of Credit:			
January	50		
February		119	
Purchase of equipment			12,500
Total cash disbursements	47,900	$33.969	$63,450
Preliminary balance	$3,100	$22,031	$(1,319)
Additional funds from Line of Credit	6,900		11,319
Repayment of Line of Credit		(11,900)	
Ending Cash balance	$10,000	$10,131	$10,000

Figure 5.1 Cash budget

that you discuss the strategies for investing short-term cash balances with your banker, accountant, or investment advisor.

Cash Management Strategy 5—Monitoring Cash Flow

The monitoring of cash flow requires you, the business owner, to determine, on a daily basis, the amount of cash that is available and compare that with what is needed: (1) for reinvestment in your business; and, (2) for payment of pending obligations. Monitoring cash on a daily basis aids in determining if and when there is a shortage of cash and when to deploy your business's bank lines of credit. The monitoring process also aids in determining whether there is too much or excess cash on hand that needs to be invested.

Cash Management Strategy 6—Understanding and Effectively Using Financial Statements

Understanding and effectively using the information contained in your business's financial statements are critical to the effective management of cash flow. The three essential financial statements for any business include the *statement of financial position* or *balance sheet,* the *income statement* or *profit and loss statement*, and the *statement of cash flows*. Each of these will be discussed further.

Statement of Financial Position or Balance Sheet

This statement reveals the assets of your business and the claims against those assets (see Figure 5.2). Assets are defined as tangible and intangible valuable resources owned by the business. Assets include equipment, inventory, securities, receivables, property, land, patents, and of course, cash. Assets are on the left side of the statement of financial position or balance sheet.

The claims against assets are in two basic forms. The forms include liabilities (what the company owes to creditors), and the claims of the owners (referred to as owners' equity or stockholders' equity). Liabilities or the obligations of the business include accounts and notes payable, loans, tax liabilities, and mortgages and long-term debt. Liabilities are on the right side of the statement of financial position or balance sheet.

The claims of the owners of the assets of the business are known as owners' equity or stockholders' equity. There are two sources of equity—capital and retained earnings. Capital includes the direct investments of the owner(s) or stockholders in the business. Retained earnings are the amount of profits or earnings held by or reinvested in the business. The claims of the owners or stockholders are on the right side of the statement of financial position or balance sheet. The sum total of the liabilities and equity (right side) equals the total of the assets (left side).

The statement of financial position or balance sheet shows the financial health of a company or business at one point in time. This statement is typically prepared quarterly or annually.

XYZ Productions, INC.
December 31, 20X2 and 20X1

	20X2		20X1	
Assets				
Current Assets:				
Cash		$ 8,500		$ 6,000
Accounts Receivable		30,000		20,000
Merchandise inventory		42,000		35,000
Prepaid expenses		3,000		2,000
Total Current Assets		83,500		63,000
Long-term assets:				
Equipment:	$125,000		$105,000	
Less accumulated depreciation	30,000	95,000	24,000	81,000
Total Assets		178,500		144,000
Liabilities				
Current Liabilities:				
Accounts Payable		$17,500		$20,000
Interest Payable		1,500		2,000
Income taxes Payable		11,000		6,000
Total Current Liabilities		$30,000		$28,000
Long-term liabilities:				
Notes payable		45,000		32,000
Total Liabilities		75,000		60,000
Stockholders' Equity				
Contributed capital:				
Common stock, $5 par value	$47,500		$40,000	
Retained Earnings	56,000		44,000	
Total Stockholders' Equity		103,500		84,000
Total Liabilities and Stockholders' Equity		$178,500		$144,000

Figure 5.2 Balance sheet

Income Statement or Profit and Loss Statement

This statement provides information on the profitability of your firm or business. It explains how income is derived and how expenses are incurred in generating revenue. Figure 5.3 is an illustration of an income statement.

The basic income statement equation is revenues or sales or services minus expenses equal net income or net profit. Revenues or sales are the

XYZ Productions
For Year Ended December 31, 20XX

Sales		$295,000
Cost of goods sold	$150,000	
Expenses		
Wages and other operating expenses	108,000	
Interest expense	3,500	
Income tax expense	7,500	
Depreciation expense	12,000	(281,000)
Loss on sale of Equipment		(3,000)
Gain on retirement of debt		8,000
Net income		**$ 19,000**

Figure 5.3 Income statement

amount of products, goods, or services sold or delivered to customers during a certain period of time. Gross profit or gross margin is generally derived by taking total revenue or sales and subtracting the cost of sales or the cost of inventory items sold.

The second major item on the income statement or profit and loss statement is expenses, generally operating expenses. These are the costs that are incurred during the period to generate the sales or revenues that have been recorded. Operating expenses would include salaries, rent, insurance, supplies, and other expenses that are necessary for the enterprise to continue to operate and generate revenue.

The third major item on the income statement is net income, net profit, or net loss. This is the indicator of whether your business's revenues or sales are greater than expenses or vice versa. It is important to know that the net income or net loss reflected on the income statement does not, by itself, indicate cash inflows or cash outflows.

Statement of Cash Flows

The statement of cash flows is perhaps the most important financial statement for operating a small business or enterprise. It outlines the sources and uses of cash for a specific period of time. This critical information is vital to you in managing your small business and managing cash flow. You must know your business's sources of cash, how it is being used, and the additional cash needs or surplus of cash that your business has. Profit or net income is not cash and cash is not profit or net income.

XYZ Productions, Inc.
For Year Ended December 31, 20XX

Cash flows from operating activities:		
Cash received from customers	$285,000	
Cash paid for merchandise	(158,500)	
Cash paid for wages and other operating expenses	(109,000)	
Cash paid for interest	(4,000)	
Cash paid for taxes	(2,500)	
Net cash provided by operating activities		**10,000**
Cash flows from investing activities:		
Cash received from sale of Equipment	$ 6,000	
Cash paid for purchase of Equipment	(5,000)	
Net cash provided by investing activities		**1,000**
Cash flows from financing activities:		
Cash received from issuing stock	$ 7,500	
Cash paid to retire notes	(9,000)	
Cash paid for dividends	(7,000)	
Net cash used in financing activities		(8,500)
Net increase in cash		$ 2,500
Cash balance at beginning of 20XX		6,000
Cash balance at end of 20XX		$ 8,500

Figure 5.4 Statement of cash flows (direct method)

The statement of cash flows is organized into three categories for the sources and uses of cash. These are: operating activities, investing activities, and financing activities (see Figure 5.4 for an example of a statement of cash flows).

Operating activities are all transactions associated with cash from the normal operations of the business (the central function of the business). Cash inflows from operating activities include sales or service revenue, and cash outflows from operating activities include payment of salaries and wages, payments to suppliers, interest, rent, and taxes. Changes in accounts receivable and inventory are also included in operating activities.

Cash outflows from investing activities include purchase of long-life assets, such as land, plant, equipment, and purchase of nonmarketable securities. Cash inflows from investing activities include the opposite of those types of transactions: sale of land, plant, equipment, and nonmarketable securities. Investing activities also include the collection of noncurrent loans.

Cash inflows from financing activities include borrowing of cash and issuance of common or preferred stock. Cash outflows from financing activities include repayment of loans, repurchase of stock, and dividend payments to stockholders or investors.

Preparing the Statement of Cash Flows

To prepare a statement of cash flows, you will need the current year's income statement and the current and immediately past year's balance sheets, along with a worksheet to record your calculations. See Figure 5.5 for an example of such a worksheet. Adjustments to net income are necessary because most businesses use a method of accounting (accrual accounting) that records revenues at the time of sale, without regard to whether the sales are for cash or are made on credit. Adjustments to account for this must be made when converting income statement information to the statement of cash flows.

Operating Activities

As stated, the statement of cash flows begins with the operating activities section. There are two methods of calculating cash flow from operations: the direct method and the indirect method. The direct method[1] identifies the operating activities that generate cash inflows and outflows. The indirect method[2] adjusts net income for accruals, deferrals, and noncash expenditures. The two methods yield the same cash flow result. Compare the final results in Figure 5.4, which was prepared using the direct method, with those shown in Figure 5.6, which employed the indirect method.

Next, the cash increase or decrease for the period is determined by comparing the beginning cash balance with the ending cash balance. Refer again to Figure 5.2, which shows balance sheets of XYZ Productions, Inc. for years 20X1 and 20X2. The income statement of XYZ Productions, Inc. is shown in Figure 5.3, and Figure 5.4 is the corresponding cash flow worksheet, which shows the changes in the balance sheet accounts from one year to the next.

After determining each account's increase or decrease for the year, it must be further determined if the changes resulted in cash inflows or

XYZ Productions, Inc.
For Year Ended December 31, 20X2

	December 31, 20X1	Analysis of Changes Debit	Analysis of Changes Credit	December 31, 20X2
Balance sheet—debits:				
Cash	6,000			8,500
Accounts receivable	20,000	10,000		30,000
Merchandise inventory	35,000	7,000		42,000
Prepaid expenses	2,000	1,000		3,000
Equipment	105,000	35,000	15,000	125,000
	168,000			208,500
Balance Sheet—credits:				
Accumulated depreciation, Equipment	24,000	6,000	12,000	30,000
Accounts payable	20,000	2,500		17,500
Interest payable	2,000	500		
Income taxes payable	6,000			1,500
Notes payable	32,000	17,000	5,000	11,000
Common stock, $5 par value	40,000		30,000	45,000
Retained earnings	44,000	7,000	7,500	47,500
			19,000	56,000
	168,000			208,500
Statement of Cash Flows:				
Operating activities:				
Net Income		19,000		
Increase in account receivable			10,000	
Increase in merchandise inventory			7,000	
Increase in prepaid expenses			1,000	
Decrease in accounts payable			2,500	
Decrease in interest payable			500	
Increase in income taxes payable		5,000		
Depreciation expense		12,000		
Loss on sale of Equipment		3,000		
Gain on retirement of Notes			8,000	
Investing Activities:				
Receipt from sale of Equipment		6,000		
Payment for purchase of Equipment			5,000	
Financing Activities:				
Payment to retire Notes			9,000	
Receipts from issuing stock		7,500		
Payments of dividends			7,000	
Non-cash Investing and Financing Activities:				
Purchase of Equipment financed by		30,00	30,000	
Notes		168,500	168,500	

Figure 5.5 Worksheet for statement of cash flows (indirect method)

outflows. Beginning with the operating activities section of the statement of cash flows (Figure 5.4), the information on the worksheet aids in adjusting the net income amount to a cash basis. The chart shows the impact of increases and decreases in certain accounts on cash flows from operations. Changes in accounts receivable, inventory, and prepaid expenses impact cash flows from operations. The accounts receivable balance relates to credit extended to customers in selling goods and services. The accounts payable balance reflects the amount that has been used to

XYZ Productions, Inc.
For Year Ended December 31, 20XX

Cash flows from operating activities:	
Net Income	19,000
Adjustments to reconcile net income to net cash provided by operating activities	
Increase in accounts receivable	(10,000)
Increase in merchandise inventory	(7,000)
Increase in prepaid expenses	(1,000)
Decrease in accounts payable	(2,500)
Decrease in interest payable	(500)
Increase in income taxes payable	5,000
Depreciation Expense	12,000
Loss on sale of plant assets	3,000
Gain on retirement of bonds	(8,000)
Net Cash provided by operating activities	10,000
Cash flows from investing activities:	
Cash received from sale of plant assets	6,000
Cash paid for purchase of plant assets	(5,000)
Net cash provided by investing activities	1,000
Cash flows from financing activities:	
Cash received from issuing stock	7,500
Cash paid to retire bonds	(9,000)
Cash paid for dividends	(7,000)
Net cash used in financing activities	(8,500)
Net increase in cash	2,500
Cash balance at beginning of 20X2	6,000
Cash balance at end of 20X2	8,500

Figure 5.6 Statement of cash flows (indirect method)

buy inventory to sell; and, changes in the inventory balance are related to the main operation of the business—selling goods.

Investing Activities

This section of the statement of cash flows records the increases and decreases in noncurrent assets, such as equipment, buildings, land, and investments. The sale of equipment, for example, will generate cash inflows, while the acquisition of additional equipment will result in cash outflows. Thus, cash inflows and outflows from investing activities are, respectively, determined by adding the proceeds from the sale of noncurrent assets and subtracting the purchases of noncurrent assets during the period.

Financing Activities

The third and final section of the statement of cash flows focuses on financing activities. This section records the increases and decreases in the two areas of investing—noncurrent liabilities and owners' or stockholders' equity. Increases in noncurrent liabilities such as long-term debt result in increased cash, while decreases in noncurrent liabilities will decrease cash because liabilities are being paid with cash. Furthermore, the financing section is impacted by increases and decreases—not from operations (i.e., net income or net loss), but in owners' or stockholders' equity. An increase in the capital account is an additional investment in the business and will provide additional cash to finance business activities, while a decrease (e.g., owners' or stockholders' withdrawal) will reduce cash available for financing operations and result in cash outflows.

The following information is a guide to preparing the financing section of the statement of cash flows: *Cash inflows or outflows from financing activities; + increases in noncurrent liabilities – repayment of noncurrent debt – dividends paid + increases in capital stock or – decrease in capital stock.*

Following the guidance provided earlier for each section will facilitate completion of a credible statement of cash flows. Refer again to Figure 5.4, which shows such a statement.

Analyzing the Statement of Cash Flows

The statement of cash flows shows the business owner(s), stockholders, decision makers, or all, where cash was generated and how it was utilized. In analyzing the statement of cash flows, you will need to review all three sections: the operating activities section, the investing section, and the financing section.

Operating Activities Section

You should begin your analysis with the operating activities section. This section reveals the amount of cash generated or lost from the business's main activity. In reviewing this section, you will discover whether sales and expenses met or exceeded plans. Collection of customer accounts

and increases or decreases in short-term debt (accounts payable) are also shown. Increases in accounts receivable may require a review of customer credit terms or the collection process. Increases in accounts payable may require a review of inventory for nonmoving items and purchase prices and quantities. If cash flow from operations met or exceeded plans, there might be no need for adjusting the business plan or business operations. If, on the other hand, cash flow from operations did not meet plans, a readjustment of the business plan or review of sales and expenses could be warranted. In the long term, the cash flow from operations should sustain the business. Over the long term, insufficient positive cash flow will result in your business being unable to pay its employees, creditors, taxes, and owners or stockholders—that is, business failure.

Investing Activities Section

The investing section of the statement of cash flows reveals (during the period of operations) whether the business reinvested in its assets and operations or sold its assets to fund current operations. A lack of reinvestment in noncurrent assets might reveal lack of growth or serious cash flow problems.

Financing Activities Section

The financing section of the statement of cash flows reveals the payments of or increases in long-term debt, capital infusion, or withdrawals of capital, and payment of dividends to stockholders. This will reveal the business's methods of financing long-term operations as well as payments of obligations and payments to investors.

The overall analysis of the statement of cash flows shows where cash is being generated in the business and allows you to analyze whether operations are going according to plans. The analysis also provides information for making changes to meet plans. Looking at past cash flow statements will provide trends upon which important decisions can be made, such as whether to increase long-term investments or to increase the investment returns to business owners or stockholders. Long-term positive cash flow indicates a growing business, while negative or sporadic cash flow can indicate serious

problems and need for business adjustments. The statement of cash flows provides the critical information needed for making important decisions about the long-range success and viability of your business.

Banking Relationships

It is important that you have a dependable relationship with your banker. A good banking relationship can make the difference between a business's survival and its failure. You should strive to develop a relationship with a supportive and reliable bank that will address the needs of your business as it grows over the next three to five years. In order to determine banking needs, your task as the business owner is to assess and evaluate the current and future financial needs of your business. Will those needs include a checking account, overdraft protection, lines of credit, small business loans, short-term or long-term investing, and so forth?

After effectively assessing and evaluating your financial needs, you should shop around and find the right bank: one that can aid and assist the growing needs of your business. When attempting to choose the right bank, many people find that size does matter. Generally, small businesses develop a better relationship and receive better services (including small business loans, overdraft protection, and lines of credit) from small community or regional banks. It is important, on at least an annual basis, that you review your relationship with your bank and consider the products and services of your bank's competitors.

Finally, the bank plays a crucial role in managing your cash flows, from the way receipts are recorded to access to lines of credit, and the like. It is essential for you to understand your relationship with your bank and use it effectively to manage your cash flows. Chapter 3 of this book provides some helpful information that you can use to better prepare yourself to meet the expectations of banks as you attempt to carve out the best relationship for your business.

Safeguarding Your Cash

Cash management and managing your cash flows are major challenges for any small business and business owner. The necessity to safeguard and

protect cash and resources adds another formidable challenge to your list of key owner or manager responsibilities. If you have not yet experienced it, you need to be aware that fraud should be one of your key concerns. Fraud continues to be a growing menace to the health and viability of all businesses—including small businesses. Your job is to know how to counteract it (preferably, before it happens).

There are several conditions that allow fraud to occur, including: poor internal controls; collusion on the part of employees and third parties; management override of internal controls; and, having high cash transactions and activities. Accompanying these conditions are several preconditions that must be present for fraud to occur. These preconditions include the following:

1. *Need*—which exists when a person, such as an employee, has a perceived urgent financial requirement such as overdue bills, mounting debt, or personal desires not supported by personal financial means.
2. *Access*—which is possible when a person has a position working with cash or desirable business assets.
3. *Opportunity*—which arises when a business with poor or a lack of internal controls provides great potential for fraud to occur.
4. *Rationalization*—which can easily occur when, for a variety of possible reasons, a person is convinced that committing fraud is justified (e.g., a person holding a grudge over additional pay or other compensation believed to be due—even if this source of dissatisfaction is not known to you).

Following is a list of the means of discovery of fraud, in order of discovery frequency:

1. Internal controls
2. Notification by an employee
3. Internal audit review
4. Management investigation
5. Notification by customer
6. By accident
7. External auditor review

Please pay special attention to the fact that fraud discovery by external auditor review has the lowest discovery frequency. Therefore, seeing to it that your business maintains good internal controls is essential for discouraging and detecting fraudulent activities. For some very helpful examples of specific methods of internal control that can help you in this regard, see the theft and fraud section of Chapter 6 of this book.

Using Technology in Managing Cash Flows

Effectively managing cash flows requires the use and regular review of cash flow reports, and technology can play a significant role in that regard. The reports that show entire inflows and outflows of cash in your business can be created in a number of ways. Begin with your accounting software programs, which are designed to: (1) assist in managing small business accounting functions; and, (2) have built-in report generation functions. For example, QuickBooks accounting software has an excellent cash flow management tool that is straightforward and effective. You should also look to your accountant to develop the kinds of reports that are needed, including keeping track of the critical timing of the reports needed to effectively manage cash flows. There are also free templates that are available to generate cash flow reports. Many of these are available at local small business development centers (SBDC's), and the U.S. Small Business Administration. Also, in today's environment, what would you do without cellphone applications (apps)? Yes, cash flow apps are available, many of which are free; although, some may require a monthly subscription. Pulse is a great app and it costs a nominal amount each month. Another popular app for small business is Enloop, which is free and assists in creating financial forecasts, as well as in writing a business plan.

Summary

Managing cash flows is *vital* to the success of your small business. You play critical roles in managing the cash of your business. Implementing cash management strategies ensures effective use of your business's most important asset. Use of a cash budget further assists you in forecasting and predicting cash inflows and outflows. Finally, understanding and analyzing the statement of cash flows and its components will give you information for the critical decision making that is required for small business growth and profitability.

Chapter Summary Checklist

(X) Check all that apply		
☐	01.	I understand the importance and implications of cash in business growth and development.
☐	02.	I understand the business owner's five roles in cash management and why each is important in an effective cash management strategy.
☐	03.	I understand the simple formula for effective cash management but also understand why it will require constant attention and lots of hard work.
☐	04.	I know what the first step is in an effective cash management system and how to accomplish it.
☐	05.	I understand the role of a "just-in-time" perspective in an effective cash management system.
☐	06.	I understand the importance of forecasting of cash inflows and outflows and the frequency with which this should be done.
☐	07.	I understand why a cash budget is important and how it aids in the cash forecasting process.
☐	08.	I fully appreciate why an understanding of financial statements is important in managing a business and managing cash flows.
☐	09.	I have sufficient understanding to explain to my employees or counterparts why the statement of cash flows is the most important financial statement for small business owners to understand and monitor.
☐	10.	I understand the preconditions that can lead to theft and fraud in my business.

CHAPTER 6

Managing Costs

That night, she made just enough filling for 10 pies—not a morsel could she waste; but, by sunrise, to her surprise, no pies: an empty bowl followed her last taste.

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Introduction to Understanding Costs and Cost Control Strategies

Although the overriding purpose of any business is to make a profit, no business does so without incurring some costs. The challenge is to minimize those costs so that your profit can be maximized. Properly using resources to accomplish your business's objectives is dependent upon an appreciation of cost and its various forms. Thus, knowing how much goods and services cost is vital to the long-range strategy of a successful business—and, perhaps, especially any small business.

Throughout the organization, it is critical to be able to define various costs and trace those costs to benefits or a revenue stream. It is also essential that, in managing your business operations, you establish and implement an effective cost management strategy. Yes, cost-cutting and cost containment techniques are employed by all organizations every day. However, such practices are not to be construed as evidence of having an *effective* cost management strategy. An effective cost management strategy incorporates methods of identifying, evaluating, and controlling costs as a function of: (1) benefits to various activities in the business; and, (2) impact on efficiency. Of course, effective cost management strategies differ from business to business based on the industry, size, location, and so forth.

In today's ever-changing and highly complex business environment, entrepreneurs and managers have to be aware of the different types of

costs and cost behaviors in order to make effective operating decisions. The different types of costs may be broken down into categories as simple as fixed versus variable, or product costs versus period costs, or direct costs versus indirect costs, and so forth. Additionally, costs are affected by different activities and it is also important that you understand the various cost drivers, such as professional hours, direct labor costs, machine hours, the number of orders placed, checks processed, units manufactured, and the like. Furthermore, to enhance the success of your business, you must also understand cost behavior—that is, how costs change as a function of various activities. This information becomes extremely important in analyzing, understanding, and ultimately managing costs.

Good strategizing requires that cost management be applied, not only to the normal operations of your business, but also to special projects and special activities. When integrated into the total operations of an enterprise, cost management strategies will result in reduced costs of products and services as well as increased value of the products and services that you deliver to your customers or clients. With these aims in mind, you will first obtain from this chapter a comprehensive description of cost types, followed by a discussion of budgeting, cost-cutting strategies, and associated methods or systems for managing and controlling costs. You will also be shown ways of avoiding theft and fraud, as well as means for sustaining effective cost-cutting strategies in your company.

A Detailed Look at Costs

Understanding the various types of costs and the relationships between costs is important to understanding and creating an effective cost management strategy. It is very important for you to recognize that some costs are more manageable than others and some costs yield more benefits than others. Therefore, defining the various types of costs will provide a better understanding of how to manage your costs.

General Types of Costs

Costs can be defined in a variety of ways but mainly as a function of the associated behavior. There are variable costs, fixed costs, mixed costs,

product costs, period costs, direct costs, and indirect costs. These costs are defined as follows:

- *Variable costs* are costs that change with changes in activity, although the unit cost remains constant. Examples would be direct materials, wages, and commissions.
- *Fixed costs* are costs that remain constant even when activities change. Examples are office rent, insurance, and depreciation.
- *Mixed costs* are costs that have both a fixed and a variable component. Examples are telephone service costs and utility costs.
- *Product costs* are costs to manufacture a product. Examples would be labor, materials, and manufacturing overhead used to produce a product. Companies that provide only service to customers would not have product costs.
- *Period costs* are costs that are matched against revenue for a specific period of time. An example is advertising cost.
- *Direct costs* are costs that can be linked directly to a single cost objective. An example would be the costs of maintaining a fleet of cars.
- *Indirect costs* are costs associated with multiple cost objectives. An example would be administrative salaries.

Controllable Versus Uncontrollable Costs

Knowing the types of costs is very important to you because this knowledge will provide you with information on which costs are controllable. Variable costs are more controllable than fixed costs in the short term because variable costs are tied directly to an activity. Conversely, fixed costs are not a function of a specific activity and remain constant in the short term. The control aspect of variable costs is in your analyzing whether or not the current costs incurred can be reduced. This reduction in costs can be a function of better use of materials, better use of direct labor, or other items used in the production of a product or a service.

As suggested earlier, fixed costs are usually not controllable in the short term and are not as controllable as variable costs. However, as the business owner or manager, you must investigate your fixed costs as well because

some fixed costs can be converted into variable costs and therefore have a controllable aspect. An example would be changing salaries that are paid to sales personnel from a fixed component to straight commission based on the number of units sold.

Understanding the various types of costs and cost behavior will assist in predicting certain costs, as well as, in controlling the costs in the future. Based on various activities like sales or production or the number of customers, cost management can yield greater profitability for your business.

Budgeting

A budget is an excellent financial planning tool, and is an effective tool in cost management, as well. Budgeting requires gathering as much information as possible to predict revenues and expenses over a period of time. The process may also entail gathering information from key employees and relying on historical data in preparing the most accurate budget possible.

A budget assists you in your efforts to ensure effective financial forecasting. It also assists you in controlling costs, and ultimately aids in making important decisions. Therefore, your budget provides a blueprint for your business to grow and prosper. It requires that information regarding anticipated revenues and related costs be outlined so that your business can

- manage cash and cash flow more effectively;
- accomplish business and management objectives;
- identify problems in advance of occurrence;
- develop a plan for profitability and increasing market share;
- be proficient in critical decision-making situations;
- monitor performance and financial targets; and,
- rely on it as a vital tool in developing your cost management strategies.

In developing a business plan, you outline how your business will grow and make a profit. A proposed budget and financial plan are integral to the business planning process. Unfortunately, however, many small business owners and entrepreneurs do not plan very effectively or do not utilize an effective budgeting process. You will not follow that pattern, if you

embrace the fact that it is important that you develop a one-year, three-year, or five-year plan to guide your business. The accompanying budget will let you know what your largest expenditures and costs are going to be and will also provide you with a roadmap for effective cost management. The budget will assist you in important decision-making situations, such as when to hire additional employees, when to increase your advertising budget and costs, and conversely, when to reduce certain levels of expenditures and costs. Therefore, understanding the budgeting process is an excellent (and essential) cost management tool.

The budgeting process includes several steps:

1. *Outlining goals and objectives for the budgeting period*: This step requires that you outline the goals and objectives of the business for the next planning period. This information will be based on your anticipated profit as well as the planned market share of your business.
2. *Reviewing past financial performance:* A business's past performance often is a great predictor of its future performance and activities. Therefore, analyzing past performance and financial data assists in developing an effective and generally rather accurate budget. This means that you should review your income statement, balance sheet, financial obligations, tax return, and cash flow statements. This information is vital in preparing an accurate budget.
3. *Projecting anticipated revenue for the business*: This step requires the business to look at past revenue data, anticipate new competition, and outline realistic revenue for the planning period. Obviously, the accuracy of this information is also vital to developing an effective budget.
4. *Identifying costs*: Based on the goals of the business, you will need to outline the specific anticipated costs associated with each goal and objective. As stated earlier, using past data on business performance will assist you in this process. To better plan your costs, you will also need to conduct research regarding anticipated increases in expenses, competition, as well as changes in the health of the economy.
5. *Developing the budget*: Using information from the previous steps in the budgeting process, you will develop a *pro forma* (projected) income

statement which will serve as an effective budget. It will include projected revenues and anticipated expenditures or costs for the budgeting period. Preparation of the budget is a critical step but effectiveness of the budget is also critical in cost management. The budget should be a living document that will be used in making decisions and monitoring revenues and costs. In order to remain relevant as a cost management tool, the budget must also be updated and adjusted as additional information becomes available. Over time, as you continue to use your budget for cost management purposes, you will become better able to anticipate cost behavior and the activities that drive your costs.

Cost-Cutting Strategies

During the recent economic downturn, the theme for most businesses was cutting costs. Today, perhaps more than ever, you must employ sound management techniques, including developing cost-cutting strategies. However, in doing so, it is important to implement cost-cutting strategies that do not compromise product or service quality. Reasoned judgment is needed because cost-cutting strategies, also known as cost savings strategies, are necessary for maintaining an effective and profitable business. The following five-step process will aid you in developing the correct cost-cutting strategies for your small business:

Step 1. Review and classify your costs.
Step 2. Audit your largest category of costs.
Step 3. Identify areas of waste and losses.
Step 4. Deploy cost-cutting strategies designed to increase savings and maintain quality.
Step 5. Monitor and analyze cost savings and impact.

Step 1: Review and Classify Costs

As stated earlier, knowing and being able to categorize your costs is important so that you know which costs are controllable and which are not. In analyzing costs, it is important to determine which costs can be modified to save the company money and which are virtually uncontrollable.

Step 2: Audit Your Largest Costs

You should get in the habit of auditing your business's top five largest categories of expenditures. This practice will help you to identify the areas of greatest potential cost savings. Generally, one of the major large category cost areas will be employee expenses. Other major cost categories include utilities, health insurance and employee benefits, facility cost, routine maintenance, purchases, administrative salaries, telecommunications, technology, and company vehicles.

Categorizing your five biggest cost areas will assist in breaking the costs down into smaller areas for analysis. In auditing the large cost areas, the consistent question that you need to ask is: How can these costs be reduced? You also need to make a practice of asking employees closely associated with the cost categories for cost-cutting and cost-saving recommendations. Employee suggestions, along with the overall objectives of the business, will result in effective cost-cutting strategies and cost savings.

Step 3: Identify Waste and Losses

You should expect that consistently searching for areas of waste and losses within the business as a cost-cutting strategy will yield cost savings. Waste can take many forms, from overusing materials or products to continuing to purchase products or services that are no longer needed. Errors are another area of unnecessary costs for the business. Errors take many forms, as well, including mistakes in the handling of materials, or shipping the wrong products to customers, or damaging products in the shipping area, just to name a few examples. You need to be diligent about investigating frequent or recurring errors and implementing methods to reduce or eliminate any problems.

Step 4: Implement Cost-Cutting Strategies

The specific cost-cutting strategies will differ from business to business. However, there are some suggested areas that could be universal for

small-and medium-sized businesses. The following cost-cutting strategies have been implemented in the past and have proven to be effective.

1. *Use cheaper labor*: Use part-time workers and college interns who will work for low or no wages. Part-time workers do not receive benefits and college interns often will work for free to build a record of work experience.
2. *Use free equipment, furniture, and fixtures*: There are several methods of finding free equipment, furniture, and fixtures. Doing so typically requires that you be aware of businesses that are expanding or going out of business. Making an offer to pick up unneeded or discarded items often can lead to your receiving these items for free.
3. *Reduce the number of suppliers*: Reducing the number of suppliers can result in larger discounts when you make purchases from a small number of suppliers.
4. *Buy supplies in bulk*: Larger purchases of supplies can decrease the price per unit and reduce employee time devoted to procuring supplies, as well.
5. *Sublease office space*: Subleasing often can result in a reduced lease fee when another business has more space than needed. This also works if the other business has vacant space and can reduce its costs by subletting the space.
6. *Outsource*: Consider outsourcing activities such as accounting, payroll, information technology (IT), and so forth.
7. *Seek lower rates for credit cards*: Credit card rates can be highly negotiable, so you should periodically review and renegotiate credit card and bank rates.
8. *Look for slow inventory items*: You should consider returning slow or nonmoving inventory to suppliers.
9. *Reduce paper and ink costs*: Consider using cloud computing to implement a paperless strategy that will reduce the cost of paper and printer ink.
10. *Reduce utility costs*: Experiment to find ways to increase or reduce thermostat settings to reduce heating and air-conditioning costs.

Step 5: Monitor and Analyze Cost Savings and Impact

The previous examples of cost-cutting techniques are designed to stimulate additional cost-cutting strategies for your business. You will need to keep a watchful eye on the areas where you employed cost-cutting strategies to ensure that the implementation is proceeding according to your plan and that the desired results are being achieved.

Analyzing Financial Statements

An important cost management strategy to employ is a review of your financial statements. The financial statements (the balance sheet, income statement, and statement of cash flows) can yield a lot of information regarding items for cost reduction and cost elimination. Begin with the statement of cash flows. Figure 6.1 shows a statement of cash flows that is categorized into the major areas of operating activities, investing activities, and financing activities, along with the associated increase or decrease in cash.

XYZ Productions, Inc.
For Year Ended December 31, 20XX

Cash flows from operating activities:		
Cash received from customers	$285,000	
Cash paid for merchandise	(158,500)	
Cash paid for wages and other operating expenses	(109,000)	
Cash paid for interest	(4,000)	
Cash paid for taxes	(2,500)	
Net cash provided by operating activities		**10,000**
Cash flows from investing activities:		
Cash received from sale of Equipment	$ 6,000	
Cash paid for purchase of Equipment	(5,000)	
Net cash provided by investing activities		**1,000**
Cash flows from financing activities:		
Cash received from issuing stock	$ 7,500	
Cash paid to retire notes	(9,000)	
Cash paid for dividends	(7,000)	
Net cash used in financing activities		**(8,500)**
Net increase in cash		**$ 2,500**
Cash balance at beginning of 20XX		6,000
Cash balance at end of 20XX		**$ 8,500**

Figure 6.1 Statement of cash flows

In identifying areas that could be candidates for cost reduction, it is recommended that you look at the operating activities first. Items such as cash payments for wages, merchandise, interest, taxes, and the like, should be analyzed, followed by the items in the investing activities and the financing activities. Identify the largest items consuming cash in each of the three categories and analyze each one as a candidate for cost reduction.[1]

Your next move is to conduct a review of the income statement in the area of expenses. The income statement shows the costs that are incurred and the revenue that is generated. Review of those costs can identify candidates for cost reduction. On the income statement, it is recommended that you identify and analyze the three to five largest expense items. Figure 6.2 shows a sample income statement with a variety of different expenses. You should scan it to identify the largest expense items that you would highlight as candidates for possible cost reduction.[2]

The balance sheet is categorized into three major areas: assets, liabilities, and owners' equity or capital. In reviewing the balance sheet, it is important for you to analyze whether or not there are excess assets or unused assets in the business. Figure 6.3 illustrates a sample small business balance sheet. You should attempt to determine which items should be highlighted as candidates for cost reduction.[3]

Using the Activity-Based Costing Approach

Activity-based costing (ABC) generally is a system that is used in manufacturing. It breaks down everything into activities. The activity describes what the business does, and the costs associated with those activities are shown. For small businesses that are in manufacturing, ABC is a very effective system to implement. For small businesses that are service-based, ABC also provides a better way to analyze and manage costs than alternative approaches. The simplest form of ABC has a number of steps, which include the following:

Step 1. Determine the major activities of your small business.
Step 2. Associate cost and performance with each activity.
Step 3. Determine a result or an outcome measure of each activity.

Step 4. Trace each activity to the cost objectives of your small business.
Step 5. Determine short-term and long-term goals.
Step 6. Evaluate each activity relative to the critical business processes of your business.

XYZ Productions, INC.

Year Ended December 31, 20XX

Sales			2,150,450
Returns and allowances			3563
	Net Sales		2,146,887
Cost of Sales			
Beginning Inventory			42,000
Purchases			722,145
Production Labor			510,216
Ending Inventory			40,000
	Total Cost of Sales		1,276,561
		Gross Profit	870,326
Selling Expense			
Wages			82,000
Commissions			30,000
Marketing			20,000
	Total Selling Expenses		132,000
Operating Expense			
Salaries			350,000
Payroll Taxes			45,500
Benefits			40,000
Office Supplies			500
Postage			25
Professional Fees			1,500
Telephone			750
Utilities			1,000
Training & Education			350
Miscellaneous			100
	Total Operating Expenses		439,725
Total Selling and Operating Expenses			**571,725**
Net Income			**298,601**

Figure 6.2 Income statement

XYZ Productions, INC.

For Year Ending December 31, 20XX

Assets	
Current Assets	
Cash	12,000
Accounts Receivable	25,000
Inventory	40,000
Prepaid Expenses	6,835
Total Current Assets	83,835
Fixed Assets	
Property- net of depreciation	225,500
Equipment- net of depreciation	70,000
Vehicles- net of depreciation	6,000
Total Fixed Assets	301,500
Total Assets	**385,335**
Liabilities	
Current Liabilities	
Lines of credit	25,000
Accounts Payable	8,000
Current Portion of Long-term Debt	15,000
Total Current Liabilities	48,000
Long-term Liabilities	
Long-term debt and capital leases	52,000
Loans payable to stockholders	60,000
Total Long-term Liabilities	112,000
Total Liabilities	**160,000**
Stockholder's Equity	
Common Stock	1,000
Additional Paid-in Capital	30,000
Retained Earnings (Cum from prior years)	50,000
Retained Earnings (From current P&L)	144,335
Total Stockholder's Equity	225,335
Total Liabilities and Stockholder's Equity	**385,335**

Figure 6.3 Balance sheet

Although ABC can be a little costly for some small businesses, it can yield outstanding results. When a business looks at the major activities that drive its processes and then associates costs with those processes, the resultant insights provide an excellent foundation for analyzing costs, and for identifying and implementing a cost reduction strategy.

Using a Spend Analysis

Spend analysis is the process of gathering information regarding expenditures of a company. Spend analysis is used in supply-chain management activities to categorize, analyze, and evaluate how a company spends its procurement dollars. The approach would require a quarterly or yearly categorization and analysis. The strategy is designed to help to protect your business from waste. Thus, spend analysis can be an effective tool for both large and small businesses. This analysis may be conducted by your accounting or finance staff or it could be assigned to the departments where the cost or expenditure was incurred. Using the spend analysis method, a small business can track how the business spends its money, with the goal of eliminating wasteful and nonproductive expenditures and purchases. This analysis can be conducted by hand for some small businesses or there is software available to conduct this process. However, in order for the analysis to be effective, all aspects of the company's expenditures must be reviewed. This would also necessitate gathering data on vendors and service providers and using those data to compare where the company is getting its best value and return on its expenditure dollars. It is important to note that an analysis also affords you the opportunity to compare vendors and suppliers to determine which of those are giving you the best return for your procurement or service dollars. Very importantly, the information gained from the spend analysis can be used to eliminate certain vendors, service providers, or suppliers; and, it also can be used as a basis for negotiating future expenditures with those entities.

There are five steps in conducting a spend analysis in a small business, with a sixth step added here to emphasize the importance of ensuring that relevant decision makers are kept abreast of the results of the analysis. The process is described as follows:

Step 1. Identify the sources of information regarding company purchases and expenditures.

Step 2. Gather all of the data related to expenditures and purchases from the various departments and units within your small business.

Step 3. Ensure that the data are free of errors and check whether or not there is consistency in the information provided.

Step 4. Categorize the spend information according to the various departments and major purchases and expenditures that are needed by your business.

Step 5. Analyze the data to ensure that there is consistency in the purchased items and consistency with respect to suppliers. The analysis should also compare suppliers and service providers to ensure that expenditures are yielding optimal value.

Step 6. Share the information with appropriate decision makers within your business.

There are several benefits associated with conducting a spend analysis. These include the following:

- The ability to analyze the company's overall spending and spending habits
- The fact that the analysis of the spend candidate yields errors and outliers in the overall spend strategy
- The ability to provide information to share with decision makers as a foundation for planning for the next period
- Increased awareness of all employees about the importance of spending and expenditures
- The ability to allow for and provide a foundation to compare vendors
- The ability to allow for and provide information for negotiating future purchase and service provider contracts

Cost–Benefit Analysis

The most simplistic alternative to the spend analysis for a small business is a cost–benefit analysis. The cost–benefit analysis is a simple process that allows the business to periodically list its major service cost items and rate the benefit derived in the context of the overall objectives of the business. The process focuses on looking for the weak expense items as candidates for reduction or elimination. Figure 6.4 illustrates a simple cost–benefit chart for expenses. You should make an effort to use the cost–benefit

XYZ Productions

For the year ended Dec 31 20XX

Expense	Cost amount	Benefit/implicit value (Rate 5–1)
Wages	82,000	
Commissions	30,000	
Marketing	20,000	
Salaries	350,000	
Payroll taxes	45,500	
Benefits	40,000	
Office supplies	500	
Postage	25	
Professional fees	1,500	
Telephone	750	
Utilities	1,000	
Training & education	350	
Miscellaneous	100	
Total costs/values	571,725	

Figure 6.4 Cost–benefit chart

chart, inserting your own cost numbers and employing a rating system of 1 to 5 (see second column of Figure 6.4), with 5 representing the cost item that provides the greatest benefit in the form of contribution to achievement of your business objectives, and 1 representing the item that makes the least contribution. From this, you should have made at least a preliminary identification of potential candidates for cost reduction in your business.

Using Technology

Today, there are a number of software packages for small businesses seeking to move from manual accounting to software that allows the business to conduct far more planning activities while producing a number of informative reports and charts. The software packages not only will help your business in preparing financial statements and recording financial transactions, but can also provide budgeting tools that will assist you in cost management.

Some software packages also provide you with a dashboard of financial information that is readily available on the desktop of your computer. The accounting and financial software packages can provide cloud-based solutions for the recording of financial information as well. In addition, there are online providers of information to which your business can pay a monthly fee to receive financial updates, planning software, projected reports, and so forth. The type of software or software package that should be used by your business will depend on the nature of the business, such as its size and anticipated accounting and financial information needs. Almost all of the software packages will assist in the budgeting process and provide tools for managing costs and expenditures.

The features of the accounting software available to small businesses are fairly uniform and include general accounting, inventory management, customer management, purchasing and vendor management, time and job billing, banking, and payroll. However, contained in many accounting software packages are a number of different features that assist in cost management and provide data and reports for critical decision making.

Examples of popular software packages are QuickBooks Pro, Sage 50, and Dac Easy Small Business. There is also free (open source) accounting software available, including TurboCASH 5, TAS Basics, and GnuCash, to name just a few. Some software programs are comprehensive and provide the business with effective tools for financial decision making, budgeting, and cost management.

Theft and Fraud

All too often, small businesses are the target of theft and fraud that is perpetrated by employees. The impact of employee theft and fraud can be devastating for a small business. The impact not only reduces the resources of the business as it attempts to continue operations, but, typically, it also negatively affects employee morale. Furthermore, in identifying and seeking to rectify employee theft and fraud, your business can incur legal fees and devote numerous hours to prosecuting the guilty

parties. Although business insurance can provide for some recovery of the lost resources, most of the time the business will find that the insurance is not enough to fully compensate for the total loss of funds and other resources. Therefore, it is important for you to focus on reducing opportunities for theft and fraud by putting proper controls and measures in place.

The major disadvantage of small business is that, by definition, the ventures are small and often employees will handle an entire function, such as the bookkeeping or purchasing function. It is common for an individual in a small business to be responsible for opening the mail, reconciling bank statements, matching invoices with reports, signing checks, and generally managing the entire accounting function. Unfortunately, this can be a recipe for disaster, as it increases the opportunity for theft and fraud. Also, there is increased exposure for small businesses with employees who are responsible for supplies, materials, and products. This is particularly the case when one individual is responsible for the recent recording, the receiving report, conducting the inventory counts, and shipping the products or documenting use of materials.

In addition, small businesses are often targeted by outside thieves because of limited safeguards against theft. It is important for you to recognize that, although a small business might engage an outside certified public accountant (CPA) to prepare financial statements, to conduct audits, and to prepare tax returns annually, CPA's are not considered a significant safeguard against theft and fraud. The engagement letter of the outside CPA will stipulate that services to be rendered are not designed to necessarily detect fraud but will inform the client of any observed fraudulent activity. However, the outside CPA can be a resource in recommending to you how to improve your internal controls to deter employee fraud and theft.

Therefore, you must make an effort to eliminate or reduce as many opportunities for fraud and theft as possible. These efforts would include hiring ethical employees, having employees commit to ethical behaviors, and implementing internal controls that reduce the opportunities for significant losses.

Basic internal control techniques for small businesses would include the following:

1. Separate the accounting functions between employees.
2. Allow only limited access to financial assets and information as well as accounting computer systems and software.
3. Have employees rotate duties regularly.
4. Ensure that bank statements and credit card statements are reviewed first by you or the check or credit card signer.
5. Require that bank accounts be regularly reconciled primarily by an employee not responsible for issuing or sending out checks.
6. Ensure that checks are maintained under lock and key.
7. Periodically review all company vendors to ensure that fraudulent vendors are not being used.
8. Ensure that checks are signed only after receipt of proper documentation.
9. Hire honest employees by doing background checks and checking references thoroughly.
10. Perform random internal audits.
11. Investigate thoroughly all suspected acts of theft and fraud.

Sustainable Strategies

In today's economic climate, all companies including small businesses are seeking ways to reduce costs. Often, these cost-cutting techniques that are put in place are not sustainable. Typically, these measures also have a short-term impact but long-term negative effects on the company, employees, and client base. These non sustainable cost reduction techniques are popular but sometimes are arbitrary, lack identification of cost drivers, are based on historical data that might not be relevant today, and generally reflect poor financial information and data.

Whenever small businesses under economic pressure make inevitable short-term decisions or use a short-term approach to cost-cutting, it must be remembered that these approaches are not effective in long-term cost management. The approaches could include any single or a combination of the following approach(es):

- Hiring freezes
- Eliminating overtime and increases in salary
- Freezing travel
- Offering early out or early retirement packages
- Cutting back on important services
- Abandoning growth and expansion plans
- Layoffs and downsizing

These approaches have immediate and short-term benefits but in the end hurt the organization's performance, have a negative impact on customer service, and drive the company's best employees away. Successful small businesses should avoid these short-term fixes and employ a sustainable long-term strategy.

Sustainable cost reduction strategies are based directly on clear business goals and objectives, where employees are provided information as to the need for cost-cutting strategies and cost management. Strategies are based on continuous improvement; and, more importantly, strategies are based on employee buy-in. Sustainable cost management strategies include: reducing all nonessential spending; clarifying the overall cost management approach and strategy; creating a culture of cost reduction and cost savings; and, conveying to each employee an individual responsibility in the process. In addition, in important company meetings it is essential to provide information to employees regarding progress toward cost reduction goals and to solicit employee recommendations for continued successful implementation of cost management strategies. You should also consider a reward system for particularly effective cost savings recommendations submitted by your employees.

Chapter Summary Checklist

(X) Check all that apply		
☐	01.	I understand why cost-cutting and cost containment are sometimes not effective cost management strategies.
☐	02.	I understand the various types of costs and how to use the information to determine which costs are controllable.
☐	03.	I can explain to my employees how to use a budget as an effective financial planning and cost management tool.
☐	04.	I understand and have ensured that appropriate employees know the five-step process for implementing cost-cutting strategies.
☐	05.	I understand how reviewing financial statements can help to identify items for cost reduction.
☐	06.	I understand how using activity-based costing and spend analysis will assist my business in the area of cost management.
☐	07.	I can identify some of the accounting software that will provide my business with budgeting and reports that are helpful in cost-cutting.
☐	08.	I am aware of some useful techniques for targeting theft and fraud activity that can significantly reduce unnecessary cost in my business.
☐	09.	I can identify some of the short-term cost-cutting strategies that can have a negative impact on customers and employee relations.
☐	10.	I am aware of the four preconditions that typically set the stage for employee theft and fraud.

APPENDIX A

Break-even Analysis

The break-even point (BEP) is the point at which total revenue equals total cost. Before break-even, the company is losing money. After break-even, profit is being realized. Therefore, it is critical to project the volume of sales needed to reach break-even and the point in time when this volume will be achieved.

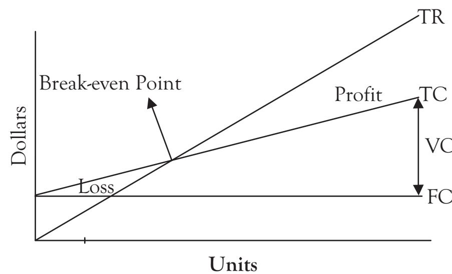
As shown in Figure A.1, calculation of the BEP in units (#) is based on the simple formula: BEP# = FC/P-VC,

where,

FC = the fixed costs of the operation

P = the unit price of the product to be sold

VC = the variable cost (cost associated with the sale of each unit of product)



Break-even Point (BEP): Point at which
Total Revenue (TR) = Total Cost (TC)
where,
BEP# = FC/(P – VC) and BEP$ = BEP# × P
and,
TR = Units Sold (#) × Price (P)/unit
TC = Fixed Cost (FC) + Variable Cost (VC)
CM = Contribution Margin = (P – VC)

Figure A.1 Graphic depiction of break-even analysis

Calculating the BEP: An Example

Karen Jenkins opens a dress shop. Her fixed costs equal $40,000. This means that Karen knows she will have to pay $40,000 over the course of the year, regardless of whether she sells 10,000 dresses or none at all. Karen knows that her variable costs (those she will incur for each dress sold) will be $60. She sets the price of her dresses at $100. What will her BEP be in units?

Unit Calculation:

BEP# = FC/(P – VC)

BEP# = $40,000/($100/unit – $60/unit)

BEP# = $40,000/$40/unit

(notice that the $'s will cancel out and the units will move to the numerator)

BEP# = 1,000 units

Once you know the number of units you must sell to reach break-even, it is very easy to convert that to dollars. The simple formula is:

BEP$ = BEP# × P

= 1,000 dresses × $100/dress

= $100,000

For Karen, this means that, if all conditions remain as stated here, she must sell 1,000 dresses, for a total of $100,000 in sales before she reaches the BEP for her one-product (dress) business.

Determining the BEP in Time

Suppose Karen had made the following monthly projections of units of product to be sold by her business:

Jan 55	Jul 200
Feb 80	Aug 250
Mar 120	Sep 100
Apr 250	Oct 60
May 60	Nov 120
Jun 300	Dec 400

According to these projections, Karen will achieve break-even in July, the month during which cumulative sales are expected to reach 1,000 units.

Calculating Multi-Product Break-even

Assume now that Karen had the same fixed costs ($40,000), but decided to sell shoes and accessories, in addition to dresses.

With the prices and variable costs for dresses, shoes, and accessories being as shown in Table A.1, and with the estimate that 60% of sales will come from dresses, 30% from shoes, and 10% from accessories, what will Karen's BEP be in units? In dollars?

Calculations for Karen's Expanded Product Line

Recall that BEP# = FC/(P – VC). However, since there is a product mix, the respective contributions to the sales mix are incorporated into the calculation, as follows:

BEP# = $40,000/[(0.6[$100/unit – $60/unit]) + (0.3[$65/unit – $25/unit]) + (0.1[$25/unit – $10/unit])]

Table A.1 Karen Jenkins Boutique projections of product sales and contribution margins

	Dresses	Shoes	Accessories
Percentage of sales	60	30	10
P	100	65	25
VC	60	25	10
CM	40	40	15

In the formula above, 0.6 represents the 60% of sales projected to come from dress sales; 0.3 represents the 30% projected to come from shoe sales; and, 0.1 represents the 10% expected to come from the sale of accessories. Thus, continuing the calculation,

BEP# = $40,000/[(0.6[$40/unit]) + (0.3[$40/unit]) + (0.1[$15/unit])]

BEP# = $40,000/($24/unit + $12/unit + $1.50/unit)

BEP# = $40,000/$37.50/unit

BEP# = 1,067 units

Since dresses represent 60% of projected sales and the other two products represent only 40% of projected sales, combined, notice that this product mix does not lead to a smaller number of units to reach break-even. This is so because the contribution margin (P – VC) for dresses ($40/unit) is not enough to compensate for the combined contribution margins of the other two product lines ($40 + $15 = $55).

Moving from the combined number of units to the units of individual products that Karen must sell in order to achieve break-even is now relatively simple:

With BEP# at 1,067 units, the product mix at break-even is as follows:

1,067 × 0.6 = 640 dresses

1,067 × 0.3 = 320 shoes (pairs)

1,067 × 0.1 = 107 accessories

Again, BEP$ = BEP# × P

640 dresses × $100/dress = $64,000

320 pairs of shoes × $65/pair = $20,800

107 accessories × $25/accessory = $2,675

BEP$ = $87,475

The mix reduces the total dollar amount needed to reach break-even, as compared with dress sales only.

Some Final Tips on Break-even Estimates

- When you are using product lines with many different items varying in price, you may use an average or base the price and variable cost on a single item if it represents the preponderance of sales (e.g., 90% or more of the sales of that product line).
- Understand that you may use the break-even calculations to test various scenarios such as how changes in price or variable cost might change your BEP projections. This means that you would be able to see whether various scenarios can lead you to profitability sooner, for example. You are also able to see how various fixed cost scenarios (e.g., leasing rather than buying a building or expensive capital equipment) could affect your profitability.
- Investors are very interested in these estimates. After all, your reason for going into business is to make a profit and this analysis tells you under what circumstances this will occur.

APPENDIX B

Legal Business Structures

This appendix is intended as a brief description of the three major forms of legal business structures available to business (sole proprietorship, partnership, and corporation), along with a description of the most recent legal structure (the limited liability company or LLC). You are encouraged to consult the U.S. Small Business Administration (SBA) website for more detailed descriptions of the various structures and legal requirements (including taxation).[1] Although descriptions are provided and comparisons of structures are made, the materials presented here are for your preliminary consideration only, as the author is not a legal professional. You are encouraged to consult your legal advisor for a more thorough discussion before your adoption of a particular legal structure for your business.

The Sole Proprietorship

A single person starting a business by simply opening the doors of a business is the example of a sole proprietorship. This is the most common form of legal structure found in the United States today. The reasons for this are very simple: the sole proprietorship makes it easy and inexpensive to start a business and there are no extra tax filing requirements (aside from adding a Schedule C form to your personal tax returns).

Although easy to enter, this type of business structure is fraught with problems for the business owner. For one thing, it leaves the owner very vulnerable to liability lawsuits. In the instance that someone falls in your store or accuses you of having sold tainted food, or any other cause for action, a judgment against you puts your personal assets at risk. Therefore, no matter how successful you might have been up to the point of that judgment, anything and everything of value that you had been able to amass would be subject to seizure to satisfy the judgment against you.

In addition, when you open a business and operate it alone, you have only your own business and managerial knowledge and skills to draw upon. Unless you succeed in getting capable people to invest time advising or mentoring you, the business is left to what you can do on your own.

Furthermore, and perhaps of more concern to some, as a sole proprietor, you are less attractive as an investment risk. You will find it more difficult to attract funding (whether equity or debt). Again, unless your own network has a very broad reach and you are extremely highly regarded, you are unlikely to have access to the financial resources that you will need to start your business or fund its growth.

Due to the disadvantages associated with operating a sole proprietorship, it is recommended here that you not opt for this structure. Even if you do not expect your business to grow substantially, you need not subject yourself and your future (and that of your family) to the possibility of one day having to vacate your home or relinquish other valuable assets in order to pay off a debt incurred while operating this type of business.

The Partnership

A partnership is a noncorporate legal structure entered into by two or more persons who share ownership and control of a business with the intent of making a profit.[2] The partnership can take on a number of forms (e.g., limited partnership, limited liability partnership, R&D limited partnership, etc.); however, the discussion here will be kept at a general level (except for a brief reference to the limited liability partnership).

There are several things that you should know and consider before entering into a partnership. Perhaps, the most important thing to know is that, in every partnership except limited liability partnerships,[3] all partners are jointly and severally liable for the debts and obligations of the partnership. Therefore, friendship and familial emotions and loyalties aside, questions that you should ask yourself before going into partnership with someone else minimally include the following:

- *Length and nature of relationship*: How well do I really know this person?
- *Trustworthiness:* What evidence do I have that I can trust this person? Have I conducted a background check?

- *Character:* Does this person's character reflect an innate sense of honesty, fairness, and the desire to do what is right and legal?
- *Financial status and responsibility:* Is the person financially stable? What is the person's track record with respect to managing money (e.g., have I seen a credit report)?
- *Competence:* What are the person's strengths, particularly in professional areas that are important to the business?
- *Reliability:* Can I count on the person to be a steady high-performer, particularly when it comes to conducting business?
- *Flaws and idiosyncrasies:* Are there major weaknesses or quirks that I recognize in this person that could make it difficult for us to work together over the long term?
- *Significant others:* How do I get along with this person's wife or family? How do our families interact? Could these relationships threaten the partnership down the road?

In many ways, going into business with another person is like getting married. You are actually likely to spend more waking hours with that person than with your spouse. Therefore, you need to know as much as you possibly can about the individual *before* entering into a business arrangement. Key issues of concern to you should be discussed, and how these should be handled should be formally documented. In business, "formal" means in writing; therefore, you need to establish a partnership agreement that is signed by the partners before operations begin. This is important because it is often much harder to come to agreement over a matter after it has raised its head during day-to-day operations. Some of the issues that you should try to work through and document include the following:

- *Ownership shares:* What percentage of the partnership and its profits will be owned by each partner?
- *Financial commitments:* Who can financially obligate the partnership? Will one signature suffice or will more than one signature be required at all times or for certain dollar thresholds?

- *Bank accounts:* Who can sign checks and handle financial statements of the partnership? Will one signature suffice or will more than one signature be required at all times or for certain dollar thresholds?
- *Areas of responsibility:* For example, which one of you will be responsible for day-to-day management issues and who will be responsible for marketing?
- *Sale of partnership interest:* Can a partner desiring to sell all or a part of partnership interest do so? If so, will the other partner have first right of refusal to purchase the interest? Will the partner desiring to sell have to obtain the existing partner's prior approval of the proposed new partner?
- *Dissolution of partnership:* If, at some time in the future, the partners mutually decide to dissolve the partnership, what terms will govern how the assets and liabilities of the partnership are handled? If one partner wants to buy out the interest of the other partner, what terms will govern this transaction?
- *Death or incapacitation of a partner:* If a partner dies or is incapacitated to the extent of being incapable of fulfilling the duties and responsibilities set forth in the partnership agreement, what will happen to that partner's interest in the business? In the event of death, will heirs inherit partnership interest with all the rights and responsibilities of the deceased partner? Will the terms prescribed for sale of partnership interest or dissolution of the partnership govern, or will other specific terms apply?
- *Dispute resolution:* How will you settle major disputes (e.g., mediation, arbitration, etc.)?

The Uniform Partnership Act has been adopted by every state. You should review it to familiarize yourself with the requirements for your state.[4]

The Corporation

A corporation is an artificial entity which has an identity that is separate and distinct from its owners and exists only in contemplation of the state. The corporation has an indefinite life and, thus, can outlive its owners.

The regular corporation has a number of advantages. The most notable advantage of adopting a corporate structure is the limited liability that it provides. Unless you are found liable in the case of fraud or a breach of fiduciary duty, you are not personally responsible for legal judgments that result from actions of the corporation. Therefore, even though the corporation might have to pay out sizable amounts to claimants, those payments are drawn from the assets of the corporation and not your own personal resources. The corporation is also typically viewed as a more sophisticated structure, with more management depth than other structures, and the ability to attract investors and financing. Most of the largest businesses in the country are corporations.

However, there are also disadvantages associated with operating under the corporate structure. The most notable disadvantage is double taxation. This means that the corporation is taxed and any dividend distributions to shareholders are also taxed. Yet another disadvantage of operating a corporation is the paperwork that is required. Annual tax filings of corporations can be expensive, and preparation and forwarding of tax statements to sometimes hundreds or thousands of shareholders can be costly and time-consuming.

S Corporation

The S corporation (also referred to as the S Corp and formerly known as Subchapter S corporation) is a special type of corporation that must be applied for and approved by the Internal Revenue Service (IRS). The structure offers the limited protection of the corporation without double taxation. Instead, the S Corp is allowed to pass through gains and losses to shareholders.

Several provisions govern your ability to qualify for this status, including, minimally:

- All members have equal voting rights
- The entity must be a domestic corporation (i.e., it must maintain its headquarters or conduct operations within the state in which it is incorporated)

- No members of affiliated companies may be a shareholder of the S Corp
- Maximum of 100 shareholders[5]

In addition, once you obtain S Corp status, you are restricted for a five-year period from reelecting it if you decide to relinquish it and elect another legal structure.

The Limited Liability Company

The limited liability company (LLC) is the most recent form of legal structure and it is recognized in every state; although, provisions such as the permitted lifespan of the LLC may vary from state to state and you should learn what you can about the provisions that pertain to your state.[6]

What makes the LLC so attractive is that it allows the flexibility or relative freedom of a sole proprietorship (single-person LLC) or partnership (two or more-persons LLC), including the pass-through of profits and losses to members that is allowed with the S Corp. LLC's also offer limited liability protection, just the same as a corporation. As such, owners of an LLC may function with the knowledge that, unless found liable for improper conduct such as fraud or breach of fiduciary duty, personal assets may not be seized to satisfy any judgments granted to creditors.

Unlike more longstanding structures, there is currently no uniform set of standards governing limited liability companies across the 50 states. In some states (e.g., Maryland), owners of LLC's for some time did not have to pay fees on the enterprise, except for the initial fee to establish the business structure. However, over time, as the popularity of the structure increased, tax filing fees were imposed in Maryland (moving fees from $0 to $300 annually). On the other hand, the federal government does not tax LLC's, but persons operating LLC's are regarded as self-employed and must, therefore, pay self-employment taxes such as Medicare and Social Security (see SBA website).[7]

In sum, there are several options from which you can choose when legally structuring your business. Table B.1 briefly chronicles some of the major distinctions among the various legal business structures.

Table B.1 Comparisons among legal business structures

	Sole proprietorship	Partnership	Corporation	LLC
Flexibility	High	High	Low	High
Liability	Unlimited	Unlimited (except in limited liability partnership)	Limited	Limited
Level of management depth	Low	Low to moderate	High	Varies
Taxes	Individual (self-employment	Pass-through to partners	Double (S corporation pass-through to shareholders)	Pass-through to members
Maximum duration	Lifespan of owner	Varies	Indefinite (outlives owners)	Varies
Number of owners	One	Two or more	Unlimited (S corporation limited to 100 shareholders)	One or more
Paperwork	Little	Little	Considerable (less for S corporation)	Little

APPENDIX C

Intellectual Property Protection

As the name implies, intellectual property includes those things that can be viewed as creations of your mind that you believe to be valuable enough to protect. The major forms of intellectual property protection include: copyrights, patents, trademarks (for products) or service marks (for services), and trade secrets. Each will be discussed in this brief appendix.

All forms of intellectual property protection grant the holder a virtual monopoly with respect to the property, with some conditions and term limitations. Nonetheless, you should be aware that the intellectual property protection is of no use to you if you cannot afford to take the legal action to enforce your rights to the property.[1] Certainly, for many, the mere fact that the copyright or patent or other seal is shown provides a deterrent to infringement. However, intellectual property infringement is all-too-common, so you need to be prepared to take action to protect your property, if needed.

Copyrights

Original works of authorship such as books, articles, poetry, software, and the like, are eligible for consideration for copyright protection. There are some who are of the opinion that it is not necessary to actually seek a formal copyright because the copyright law provides that material is copyrighted when you create it. However, why subject yourself to a potential challenge by someone who somehow obtained a copy of your work and decided to claim it as his or her own? Registering a copyright within five years of publication is regarded by courts as legally sufficient evidence of authorship.

The copyright process is far more user-friendly today than it was several years ago. Today, for example, you can provide a CD rather than the sheet music to register your work. However, copyright fees have increased markedly over the years—growing from $5, thirty years ago, to $35 for electronic filing of a basic copyright claim today. The fee structure for copyrights varies based upon the type of material that is being copyrighted. Your document and associated fees should be paid to the U.S. Copyright Office.[2]

Copyrights are granted to authors of original work for the life of the author plus 70 years. That is why the famous *I Have a Dream* speech of Dr. Martin Luther King will move into the public domain in the year 2038 (he died in 1968). Up until that time, the managers of his estate (presumably his family) will maintain legal control of the speech and determine by whom and how it is used, as well as at what price, if desired. That is how a copyright works.

There are some limitations associated with a copyright, however. One of the most important of these limitations is the fair use doctrine, which allows copyrighted work to be used for certain purposes, such as criticism, teaching, research or scholarship, and news reporting. Since it is not totally clear what the limits are for knowing when someone is properly using portions of a copyrighted work under the fair use doctrine and when someone is actually infringing on a copyright, court decisions over time have provided the current level of understanding of what the lines are. As government documents may not be copyrighted, following is a list of four criteria, taken directly from the website of the U.S. Copyright Office, that you should use to make an informed decision about whether an intended use of copyrighted work might result in violating the intent of the copyright:[3]

1. The purpose and character of the use, including whether such use is of commercial nature or is for nonprofit educational purposes
2. The nature of the copyrighted work
3. The amount and substantiality of the portion used in relation to the copyrighted work as a whole
4. The effect of the use upon the potential market for, or value of, the copyrighted work

A Few Words About Innovations

Before addressing the types of patents, a brief discussion of forms of innovation should prove informative for you, as some of these can easily serve as the basis for seeking patent (or other intellectual property) protection.

There are four types of innovation: invention, extension, duplication, and synthesis.[4] Following is a brief discussion of each.

Inventions

An invention is the creation of something new. If you are not an inventor, do not become concerned. Most entrepreneurs do not get started by using inventions. However, inventions can sometimes be very profitable if commercial potential is great and resources are available to move the product from prototype to the marketplace. Alexander Graham Bell invented the telephone and developed and controlled Bell Laboratories. Ma Bell, as it (and AT& T) came to be known in U.S. vernacular, held a monopoly over the telephone industry until it was broken up in 1984 by the U.S. District Court for the District of Columbia, led by Judge Harold H. Greene. This case illustrates the point that a patent on an invention (the premier form of innovation) does afford considerable protection that can allow an inventor to amass great power and wealth. Yet, when that owner's control of the invention interferes, unacceptably, with competition, the monopolistic enterprise is likely to run risks similar to those experienced by AT&T.

Extensions

Extensions are innovations to an existing product or service that move that product or service along to a new level. For example, in the department store business, James Cash Penney produced an extension by establishing the first nationwide chain of department stores. The point is that department stores existed before Penney established the JC Penney chain. He simply moved the concept to a nationwide chain level. A similar example would be Ray Kroc, who established McDonald's as the nation's first fast-food restaurant chain. Kemmons Wilson is yet another example, as Wilson took the existing concept of a motel and used it to establish Holiday Inns as the first nationwide motel chain.

Duplication

A typical way of identifying duplication is to look for the owner's name on the company or the owner's presence in advertising. This signifies the owner's high level of involvement in the business and willingness to stand behind the products and services provided by that business. Examples include the late Dave Thomas of Wendy's (Dave was prominently featured in Wendy's commercials, and instead of using his own name, he named the company after his daughter).

Synthesis

Synthesis is found when a number of separate products or services are combined into a single product or service offering. Examples include watches that also have calculating functions, take blood pressure readings, and the like. The individual products are not new; but, the combination of product functions can sometimes make for new and highly desirable products for consumers.

There are several other innovation models and typologies.[5] You are encouraged to review these as sources that can be helpful to you by inspiring ideas for your business's products and services.

Patents

A patent is a form of intellectual property protection that covers product or service inventions and innovations. There are three conventional types of patents: utility, design, and plant patents. An overview of each will be provided here (along with a brief description of a more recent patent type, the business method patent). All initial descriptions of patent types were drawn directly from the website of the U.S. Patent and Trademark Office (USPTO)[6] and are shown in italics.

Utility Patents

Utility *patents may be granted to anyone who invents or discovers any new and useful process, machine, article of manufacture, or compositions of matters, or any new useful improvement thereof.* For example, for years, Kodak worked to find a method of producing instant photographs that could

compete with but not infringe upon the patent of Polaroid. After some effort, the Kodak Instamatic camera was introduced to the market and began competing quite favorably with Polaroid. However, Polaroid sued, claiming patent infringement. While the case remained in the courts for several years, ultimately, Polaroid prevailed. The result was that Kodak was forced to recall all of its Instamatic cameras and remove the product from the market. The financial penalty that Kodak paid to Polaroid was just under $1 billion.

Duration: Up to 20 years from the date of filing of the patent application, subject to payment of maintenance fees. Utility patents represent about 90% of recent patents.[7]

Design Patents

Design patents may be granted to anyone who invents a new, original, and ornamental design for an article of manufacture. For example, the incandescent light bulb developed by Edison—or the turbo direct injection engine developed by Volkswagen— would qualify for this type of patent (i.e., if Volkswagen was a U.S. company). Design patents also make it possible for clothing designers to protect unique (nontrademark) features that make their products distinctive, such as signature buttons on expensive jackets or custom wheels for luxury automobiles.

Duration: Design patents last for a period of 14 years from the date the patent is granted (soon subject to change). There is no requirement to pay maintenance fees.

Plant Patents

Plant patents may be granted to anyone who invents or discovers and asexually reproduces any distinct and new variety of plant. Efforts to cross-breed plants have resulted in new plant varieties "(e.g., a longstanding myth is that the ancestors of Albert Broccoli, an Italian American born in Queens, crossed cauliflower and pea seeds and produced broccoli,[8] which is now an American staple [and, just as an interesting aside, Albert Broccoli also produced the 16 James Bond movies, which probably has contributed to perpetuation of the myth]).However, a number of other plants have been produced by cross-breeding (e.g., tea roses, clementines, etc.) and

such new plant varieties may be candidates for patent protection, given the ability to meet specific requirements imposed by the U.S. Patent and Trademark Office.

Duration: Up to 20 years from the date of filing of the patent application. There is no requirement to pay maintenance fees.

Business Method Patents

A fourth classification of patent is also listed on the USPTO website: the business method patent. However, this form of patent is not treated as a separate category up to this point but as a process patent to be handled under conventional patent forms. The growth in this type of patent application is associated with the rapid increase in e-commerce and use of the Internet.[9] As an example, Amazon.com received a patent for its one-click process that allows customers to be able to place an order simply by clicking a button. Efforts to give a company like yours a competitive advantage in its marketplace might well meet with similar success. Information on this type of patent may be found on the USPTO website.[10] You can also find the guidelines for filing a patent on the USPTO website,[11] along with relevant forms and fee information.

Trademarks and Service Marks

A trademark is used to identify the products, or services in the case of a service mark of an organization, for purposes of commerce. The trademark is a word, slogan, symbol, or sound that is unique to the organization owning it and exists for the purpose of distinguishing its products from those of others. Most PC's open with the colorful Windows symbol and familiar sound, for instance.

A trademark search is necessary to ensure that you are not planning to use a trademark that is already owned by another entity. The USPTO website makes this process rather easy—at least at the federal level. You should also check with the state in which you do business in order to find out about trademarks in that state.

While the process for applying for a trademark is not difficult, you must use your trademark in order to keep it. Once you have received

authorization to begin using the trademark (a trademark "allowance"–not the actual registration), you must use it within six months or request an extension that will allow you an additional six months to begin use. Otherwise, your application will be considered as having been abandoned and you will have to take action to revive it. However, after you receive the actual trademark registration, you must still be vigilant in order to maintain it. Trademarks can be cancelled or invalidated for the following reasons:

- Failure to file required documents and pay fees in a timely manner
- Lack of use for three consecutive years (abandonment)
- Allowing the trademark to develop generic use (e.g., people commonly referring to a Jacuzzi rather than a jetted tub, or asking for a Kleenex rather than a facial tissue, or a Xerox copy rather than a photocopy)[12]
- Failure to challenge others's use of the trademark
- Significant modification of the trademark such that the original trademark and the modified version may be viewed by consumers as distinguishable.[13]

The UJSPTO has a very user-friendly step-by-step explanation of the electronic filing process for trademark regisration.[14] You are also encouraged to view the 42-minute video that gives you a very good understanding of trademarks and why these are important to you as a business owner.[15]

For more detailed information on intellectual property, you are encouraged to read a recent book on the subject by Scott Shane.[16]

Trade Secrets

Although there is no separate category for trade secrets among federal intellectual property protections (as is the case for patents, copyrights, and trademarks), you can protect your products by legally keeping some secrets. For example, if you make a product that requires divulging ingredients (e.g., a food item), you can still preserve the unique quality of your product by not disclosing how you combine and cook the ingredients.

The same can be done for other products. In this way, you will be in compliance with regulations requiring you to show what ingredients were used while still ensuring that your competition cannot duplicate your product.

Notes

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1. U.S. Small Business Administration (SBA) website (2013).
2. Welsh and White (1981).
3. U.S. Bureau of the Census (2013).
4. Gaskill, Van Auken, and Manning (1993); Hisrich and Brush (1986); Hisrich and Brush (1984); Roberson-Saunders (1991).
5. Kuratko and Hodgetts (2004), pp. 523–524.
6. Kuratko and Hodgetts (2004), pp. 524–526; Table 15.2.
7. Levitt (1960).
8. Elston and Audretsch (2011).
9. Baker and Sinkula (2008).
10. Web.com and National Association of Women Business Owners (2013).
11. Web.com and National Association of Women Business Owners (2013).
12. Coyne, Singh, and Smith (2008).
13. Ebben and Johnson (2011).
14. Boudreaux, Rao, Underwood, and Rumore (2011).
15. Warshawsky and Cahill (1996).
16. Timmons (1998).

Chapter 2

1. Kreitner (2007), p. 159.
2. Dessler and Phillips (2008), pp. 189–191.
3. Bateman and Snell (2009), pp. 75–77.
4. Kiechel (2010).
5. Schermerhorn (2011), pp. 208–209.
6. Thankur and Calingo (1992).
7. Thankur and Calingo (1992).
8. Dessler and Phillips (2008).
9. Lewis, Goodman, and Fandt (1995), p. 124.
10. Hambrick and Fredrickson (2005).
11. Zimmerer and Scarborough (2005), pp. 72–73.
12. Stoner, Freeman, and Gilbert (1998), pp. 261–306.
13. American Society for Training and Development—ASTD (1997).
14. Hamel (2000), pp. 72–73.

15. Pearce (1992).
16. Patagonia mission found in Schermerhorn (2011), p. 212.
17. Certo (1994).
18. Ireland and Hitt (1992).
19. Hellriegel and Slocum (1996), p. 142.
20. Quigley (1994).
21. Kreitner (2007), p. 159.
22. Zimmerer and Scarborough (2005), p. 74.
23. Under Armour website (2013).
24. ASTD (1997).
25. Robbins (1991), p. 221.
26. Griffin (2006), p. 38.
27. Williams (2007), p. 85.
28. Schermerhorn (2011), pp. 80–98.
29. Robbins (1991), pp. 215–243.
30. Daft (2012).
31. Hellriegel and Slocum (1996), p. 79.
32. Katz (1985).
33. Pew Research Center (2009).
34. Enez and Early (1993).
35. Twenge, Campbell, Hoffman, and Lance (2010).
36. Toossi (2006).
37. Mitchell (2010).
38. Bies and Tyler (1993).
39. Griffin (2006), p. 39.
40. Forelle (2008), p. B2.
41. Lewis et al. (1995), pp. 152–153.
42. McGregor (2010).
43. Giles (2010).
44. White (2008, March), pp. B1–B3.
45. Giles (2010).
46. Bateman and Snell (2009), pp. 28–29.
47. Green and Capell (2008).
48. Lessons (2010), pp. 49–53.
49. Marcus and Fremeth (2009).
50. Hellreigel and Slocum (1996), pp.80–81.
51. Pereira (2004), p. R4.
52. Smart and Martin (1992), p. 104.
53. Zahra and Chaples (1993).
54. Johnston and Mehra (2002).
55. Parker and Axtell (2001).

56. Dudley (2002).
57. Robbins (1991), pp. 82–83.
58. Donaldson and Preston (1995).
59. Donaldson and Preston (1995).
60. Jones and George (2009), p. 273.
61. Williams (2007), p. 173.
62. Prahalad and Hamel (1990).
63. Stalk, Evans, and Shulman (1992).
64. Mahoney and Pandian (1992).
65. Hamel (2000), pp. 72–73.
66. Griffin (2006), p. 81.
67. Porter (1996).
68. Collis and Rukstad (2008).
69. Mintzberg (1990).
70. Hamel and Prahalad (1989).
71. Mankins (2004).
72. Schermerhorn (2011), p. 210.
73. Schermerhorn (2011), p. 210.
74. Hellriegel and Slocum (1996), p. 151.
75. Beer and Eisenstat (2004).
76. Lewis et al. (1995), p. 58.
77. Williams (2007), p. 184.
78. Kinicki and Williams (2011), pp. 182–183.
79. Pearce (1994).
80. McKinley, Sanchez, and Schick (1995).
81. Porter (1985).
82. Dessler and Phillips (2008), p. 193.
83. Jones and George (2009), pp. 277–278.
84. Kinicki and Williams (2011), p. 181.
85. Hellriegel and Slocum (1996), p. 163.
86. Beer and Eisentat (2000).
87. Bossidy and Charan (2002).
88. Eisentat (1993).
89. Bateman and Snell (2009), p. 168.
90. Lewis et al. (1995), p. 168.
91. Gupta, Boyd, and Sussman (2004).

Chapter 3

1. A good website to view is sba.gov. This site provides a tremendous amount of information on financing your firm and would be the best place to begin.

2. Recourse regarding mortgages means that if you sell the loan at a loss the lender has a right to collect the difference from you. For example, if your current mortgage balance on the home was $500,000, and you were forced to sell the home for $400,000 and paid that amount to the lender, the lender would still maintain the right to collect the remaining $100,000 from you. All home equity loans are recourse loans. Whether or not your first mortgage is a recourse loan depends upon the law in your state.
3. Floating interest rates have two components: a reference rate (such as LIBOR or a prime rate), which "floats" or changes, and a fixed premium (that does not automatically change), which is added to the reference rate. LIBOR refers to the London Interbank Offer Rate (the interest rate at which banks in London borrow from each other), and Prime generally refers to the U.S. prime rate (the rate that commercial banks reserve for their best customers). In the United States, the most popular prime rate is the Wall Street Journal (WSJ) prime or rate, which is the rate charged by 75% of the 30 largest commercial banks. Again, each of these rates (LIBOR and WSJ) is referred to as a reference rate. Thus, one of these reference rates will be attached to a floating interest rate, which will also have a second interest component that is fixed interest and is typically referred to as a spread or premium.
4. *See* note 3.
5. *See* note 3.
6. A Duns PAYDEX number is a Dun and Bradstreet (D&B) measure of payment performance that ranges from 100 to 1, with 100 indicating the highest performance. Generally a PAYDEX score of 80–100 implies that your company has low risk of not paying; 50–79 implies medium risk; and, 0–49 implies high risk. These numbers are viewed by suppliers. The Duns code represents the classification used by D&B for your specific business. D&B reports may be accessed by any of your creditors, suppliers, or potential lenders, creditors or suppliers. The D&B report provides a complete, detailed history of your credit, including your payment practices, on time payments, late payments, defaults, etc. The D&B report (particularly the PAYDEX) provides a rating of your firm's credit quality.
7. RMA refers to Robert Morris Associates ratios. The data RMA uses to calculate these ratios are obtained by member commercial banks and come from specific firm financial reports that are submitted by businesses that apply for commercial bank loans. The businesses are classified by industry using the NAICS code number. The ratios are categorized by both the sales level of the businesses as well as the asset size of the businesses. In deciding whether or not to lend to your business, commercial lenders use the ratios in the RMA reports and compare these to your business's ratios.
8. Portfeld (2011, December), contributor.

9. Qualified or accredited investors are defined by the SEC as individuals who have a net worth of at least $1,000,000 or have earned an average income of $200,000 or more in the last two years.
10. *See* note 9.

Chapter 4

1. American Marketing Association (2011).
2. Boone and Kurtz (2004), p. 11.
3. The Washington Post (2013a), p. A16.
4. The Washington Post (2013b), p. A17.
5. Hausman (2013), p. 3.
6. Redsicker (2013).
7. Mickens (2012).
8. SBA Program Office (2010), p. 1.
9. Small Business Act, Section 8(d) and Small Business Act–15 (g)1.
10. Small Business Administration website (2013).
11. DOD Office of Small Business Programs (2012), p. 1.
12. DOD Office of Small Business Programs website (n.d.).

Chapter 5

1. In using the direct method in calculating cash flows from operating activities, the following is a helpful guide:

   Cash from sales = Sales – increase in accounts receivable or + decrease in accounts payable – bad debt expense.
   Cash paid to suppliers for inventory = Cost of goods sold + increase in inventory or – decrease in inventory + decrease in accounts payable or – increase in accounts payable.
   Cash paid for operating expenses = Total operating expense – bad debt expense – depreciation – amortization + decrease in accrued liabilities or increase in accrued liabilities.
   Cash paid for interest expense = interest expense + decrease in interest payable or – increase in interest payable.
   Cash paid for dividends = dividends + decrease in dividends payable or – increase in dividends payable.
   Cash paid for taxes = tax expense + decrease in taxes payable or – increase in taxes payable.

2. In using the indirect method in adjusting net income for cash flows from operating activities, the following is also a helpful guide (Note: a + or – sign

within the parentheses indicates the direction in which net income will move with the change in the account):

(+) Decrease in Accounts Receivable (add to net income)
(–) Increase in accounts receivable – subtract from net income
(+) Decrease in inventory
(–) Increase in inventory
(–) Decrease in accounts payable
(+) Increase in accounts payable
(–) Decrease in accrued expenses
(+) Increase in accrued expenses
(+) Decrease in prepaid expenses
(–) Increase in prepaid expenses
(–) Decrease in taxes payable
(+) Increase in taxes payable
(+) Depreciation
(–) Amortization of bond premium
(+) Amortization of bond discount
(–) Gain on sale of equipment
(+) Loss on sale of equipment

Suggestions for Further Reading

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Larson, K., Spoede, C., & Miller, P. (1994). *Fundamentals of financial & managerial accounting.* New York, NY: Richard D. Irwin.

Reider, R., & Heyler, P. (2002). *Managing cash flow*. New York, NY: John Wiley & Sons.

Weaver, S., & Weston, J. (2001). *Finance & accounting for nonfinancial managers.* New York, NY: McGraw-Hill.

Wild, J., Shaw, K., & Chiappeta, B. (2012). *Financial and managerial accounting* (5th ed.). New York, NY: McGraw-Hill

Chapter 6

1. In reviewing Figure 6.1, you can see in the operating activities area that $167,500 was spent for merchandise and wages and other operating expenses in a company with $285,000 in revenues from sales. You would need to spend some time determining whether any reductions could be

made in either area. In the investing area, you would, of course, examine the $5,000 spent for equipment to determine whether it was necessary, as well as whether it would have been more prudent to lease equipment, for example. Finally, you would review your financing activities, particularly the $5,000 paid out to retire notes. You should also determine whether payment of $7,000 in dividends was appropriately timed.

2. While you can certainly pick out the largest expense items in Figure 6.2, you also need to examine it from the standpoint of how your company compares with those of your counterparts. For example, calculate the profit margin (net income divided by sales) and then compare it with that of similarly sized companies in your industry. Whether your expense level is allowing you to achieve an appropriate profit margin (given your level of sales) is something that should be weighed against industry median ratios (see Chapter 3 for a discussion of financial ratios). For information on financial ratios for your industry, you should consult Robert Morris Associates (RMA), which provides median financial ratios for various industries and sizes of firms within those industries (see Chapter 3 – note 5 for more information about RMA).
3. In addition to the cost information provided in Figure 6.3, a number of financial ratios can be calculated from the balance sheet (e.g., liquidity ratios, debt ratios, etc.), or the balance sheet in conjunction with the income statement (e.g., profitability ratios). See RMA for appropriate industry comparisons.

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Enhancing the Managerial DNA of Your Small Business

Pat Roberson-Saunders • Barron H. Harvey • Philip Fanara, Jr. • Gwynette P. Lacy • Pravat Choudhury

Most people who start businesses do so with little or no experience and no formal education in business or management training. If this sounds familiar, this book has been written expressly for you and anyone who aspires to create a business.

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