MARITIME MANAGEMENT: MICRO AND SMALL BUSINESSES

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Maritime Management: Micro and Small Businesses (Pauley)

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CHAPTER OVERVIEW

1: Foundations of Business

1.1: Chapter 1- Foundations of Business

Learning Objectives

1. Describe the concept of stakeholders and identify the stakeholder groups relevant to an organization
2. Discuss and be able to apply the macro-business environment model to an industry or emerging technology
3. Explain other key terms related to this chapter including: entrepreneur; profit; revenue

Introduction

Today is an interesting time to study business. Advances in technology are bringing rapid changes in the ways we produce and deliver goods and services. The Internet and other improvements in communication (such as smartphones, video conferencing, and social networking) now affect the way we do business. Companies are expanding international operations, and the workforce is more diverse than ever. Corporations are being held responsible for the behavior of their executives, and more people share the opinion that companies should be good corporate citizens. Because of the role they played in the worst financial crisis since the Great Depression, businesses today face increasing scrutiny and negative public sentiment.[1]

Economic turmoil that began in the housing and mortgage industries as a result of troubled subprime mortgages quickly spread to the rest of the economy. In 2008, credit markets froze up and banks stopped making loans. Lawmakers tried to get money flowing again by passing a $700 billion Wall Street bailout, now-cautious banks became reluctant to extend credit. Without money or credit, consumer confidence in the economy dropped and consumers cut back on spending. Unemployment rose as troubled companies shed the most jobs in five years, and 760,000 Americans marched to the unemployment lines.[2] The stock market reacted to the financial crisis and its stock prices dropped by 44% while millions of Americans watched in shock as their savings and retirement accounts took a nose dive. In fall 2008, even Apple, a company that had enjoyed strong sales growth over the past five years, began to cut production of its popular iPhone. Without jobs or cash, consumers would no longer flock to Apple's fancy retail stores or buy a prized iPhone.[3] Since then, things have turned around for Apple, which continues to report blockbuster sales and profits. But not all companies or individuals are doing so well. The economy is still struggling, unemployment is high (particularly for those ages 16 to 24), and home prices have not fully rebounded from the crisis.

As you go through the course with the aid of this text, you'll explore the exciting world of business. We'll introduce you to the various activities in which business people engage— accounting, finance, information technology, management, marketing, and operations. We'll help you understand the roles that these activities play in an organization, and we'll show you how they work together. We hope that by exposing you to the things that business people do, we'll help you decide whether a business is right for you and, if so, what areas of business you'd like to study further.

Getting Down to Business

A business is any activity that provides goods or services to consumers for the purpose of making a profit. Be careful not to confuse the terms **revenue** and profit. Revenue represents the funds an enterprise receives in exchange for its goods or services. Profit is what's left (hopefully) after all the bills are paid. When Steve Jobs and Steve Wozniak launched the Apple I, they created Apple Computer in Jobs' family garage in the hope of making a profit. Before we go on, let's make a couple of important distinctions concerning the terms in our definitions.

First, whereas Apple produces and sells goods(Mac, iPhone, iPod, iPad, Apple Watch), many businesses provide services. Your bank is a service company, as is your Internet provider. Hotels, airlines, law firms, movie theaters, and hospitals are also service companies. Many companies provide both goods and services. For example, your local car dealership sells goods (cars) and also provides services (automobile repairs).

Second, some organizations are not set up to make profits. Many are established to provide social or educational services. Such not-for profit (or nonprofit), organizations include the United Way of America, Habitat for Humanity, the Boys and Girls Clubs, the Sierra Club, the American Red Cross, and many colleges and universities. Most of these organizations, however, function in much the same way as a business. They establish goals and work to meet them in an effective, efficient manner. Thus, most of the business principles introduced in this text also apply to nonprofits.

Business Participants and Activities

Let's begin our discussion of business by identifying the main participants of business and the functions that most businesses perform. Then we'll finish this section by discussing the external factors that influence a business' activities.

Participants

Every business must have one or more **owners** whose primary role is to invest money in the business. When a business is being started, it's generally the owners who polish the business idea and bring together the resources (money and people) needed to turn the idea into a business. The owners also hire **employees** to work for the company and help it reach its goals. Owners and employees depend on a third group of participants— customers. Ultimately, the goal of any business is to satisfy the needs of its customers in order to generate a profit for the owners.

Stakeholders

Consider your favorite restaurant. It may be an outlet or franchise of a national chain (more on franchises in a later chapter) or a local "mom and pop" without affiliation to a larger entity. Whether national or local, every business has **stakeholders**– those with a legitimate interest in the success or failure of the business and the policies it adopts. Stakeholders include customers, vendors, employees, landlords, bankers, and others (see Figure 1.2). All have a keen interest in how the business operates, in most cases for obvious reasons. If the business fails, employees will need new jobs, vendors will need new customers, and banks may have to write off loans they made to the business. Stakeholders do not always see things the same way – their interests sometimes conflict with each other. For example, lenders are more likely to appreciate high profit margins that ensure the loans they made will be repaid, while customers would probably appreciate the lowest possible prices. Pleasing stakeholders can be a real balancing act for any company.

Figure 1.2: Business Stakeholders

Functional Areas of Business

The activities needed to operate a business can be divided into a number of functional areas. Examples include: management, operations, marketing, accounting, and finance. Let's briefly explore each of these areas.

Management

Managers are responsible for the work performance of other people. **Management** involves planning for, organizing, leading, and controlling a company's resources so that it can achieve its goals. Managers plan by setting goals and developing strategies for achieving them. They organize activities and resources to ensure that company goals are met and staff the organization with qualified employees and managers lead them to accomplish organizational goals. Finally, managers design controls for assessing the success of plans and decisions and take corrective action when needed.

Operations

All companies must convert resources (labor, materials, money, information, and so forth) into goods or services. Some companies, such as Apple, convert resources into tangible products—Macs, iPhones, etc. Others, such as hospitals, convert resources into intangible products — e.g., health care. The person who designs and oversees the transformation of resources into goods or services is called an **operations manager**. This individual is also responsible for ensuring that products are of high quality.

Marketing

Marketing consists of everything that a company does to identify customers' needs (i.e. market research) and design products to meet those needs. Marketers develop the benefits and features of products, including price and quality. They also decide on the best method of delivering products and the best means of promoting them to attract and keep customers. They manage relationships with customers and make them aware of the organization's desire and ability to satisfy their needs.

Accounting

Managers need accurate, relevant and timely financial information, which is provided by accountants. Accountants measure, summarize, and communicate financial and managerial information and advise other managers on financial matters. There are two fields of accounting. Financial accountants prepare financial statements to help users, both inside and outside the organization, assess the financial strength of the company. Managerial accountants prepare information, such as reports on the cost of materials used in the production process, for internal use only.

Finance

Finance involves planning for, obtaining, and managing a company's funds. Financial managers address such questions as the following: How much money does the company need? How and where will it get the necessary money? How and when will it pay the money back? What investments should be made in plant and equipment? How much should be spent on research and development? Good financial management is particularly important when a company is first formed, because new business owners usually need to borrow money to get started.

External Forces that Influence Business Activities

Apple and other businesses don't operate in a vacuum: they're influenced by a number of external factors. These include the economy, government, consumer trends, technological developments, public pressure to act as good corporate citizens, and other factors. Collectively, these forces constitute what is known as the "macro environment" – essentially the big picture world outside over which the business exerts very little if any control. Figure 1.3 "Business and Its Environment" sums up the relationship between a business and the external forces that influence its activities. One industry that's clearly affected by all these factors is the fast-food industry. Companies such as Taco Bell, McDonald's, Cook-Out and others all compete in this industry. A strong economy means people have more money to eat out. Food standards are monitored by a government agency, the Food and Drug Administration. Preferences for certain types of foods are influenced by consumer trends (fast food companies are being pressured to make their menus healthier). Finally, a number of decisions made by the industry result from its desire to be a good corporate citizen. For example, several fast-food chains have responded to environmental concerns by eliminating Styrofoam containers.[4]

Of course, all industries are impacted by external factors, not just the food industry. As people have become more conscious of the environment, they have begun to choose new technologies, like all-electric cars to replace those that burn fossil fuels. Both established companies, like Nissan with its Nissan Leaf, and brand new companies like Tesla have entered the market for all-electric vehicles. While the market is still small, it is expected to grow at a compound annual growth rate of 19.2% between 2013 and 2019.[5]

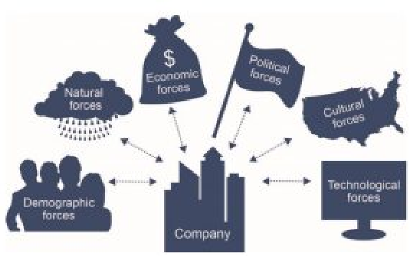

Figure 1.3: Business and its Environment

Key Takeaways

1. The main participants in a **business** are its **owners**, **employees**, and **customers**.
2. Every business must consider its **stakeholders**, and their sometimes conflicting interests, when making decisions.

3. The activities needed to run a business can be divided into functional areas. The business functions correspond fairly closely to many majors found within a typical college of business.
4. Businesses are influenced by such **external factors** as the **economy**, **government**, and other forces external to the business.

What Makes Shopify Successful? [6]

SOURCE: https://www.shopify.ca/

1. **The system is scalable**: An infinitely scalable SaaS platform. Even if you don't totally understand what that means, you can rest easy knowing it means your site will never crash. A fast and easy experience awaits every customer, any time.
2. **The system is secure**: Customers need to feel that their personal information, including credit cards, is safe when they shop online. Shopify is certified Level 1 PCI DSS compliant, meaning Shopify has been deemed compliant in six different categories set out by the Payment Card Industry Data Security Standard.
3. **An API makes integrations fast and easy**: Shopify is built for seamless integrations, which makes everyone happier. Their API lets you connect to your existing IT platform and the ERP, web app, CRM, accounting systems, a preferred CMS and other third party software.
4. **Healthy 3rd Party developer community lowers cost of adding plugins for specific features**: For the last six years Shopify Plus has been augmented by pre-approved apps that add features or customize things on the backend. The ecosystem that produces these add-ons and plugins is is regulated and overseen by Shopify, which helps ensure quality. For even the most complex logistics, there's likely an affordable solution already available.
5. **Marketing Automation Capabilities**: Shopify Plus offers built-in automation features such as Abandoned Checkout Recovery in the Professional or Unlimited plan. There are several apps available for the basic plan to add this feature.
6. **Advanced Reporting for SEO**: Shopify knows shoppers need to find you. Their advanced eCommerce CMS and shopping cart feature customizable H1, title and meta tags for SEO best practice, helping bring in traffic and getting you noticed by Google, Bing and Yahoo. Plus, new products and site changes show up fast on search engines through automatic sitemaps.xml file generation.
7. **24/7 support**: eCommerce means your store is open all the time. Shopify gets it and offers a support team available all day, every day. No filling out an online form and waiting for a reply for days. Email, live chat and phone are all available. When you're in business, so is Shopify.
8. **eCommerce University education series great for beginners and the experienced alike**: Shopify wants your business to thrive and offers a huge range of free tools and resources to build your store and your success. Free guides, a forum, online marketing advice, and in-depth case studies help you build, launch and grow your own online business.
9. **Easy to use**: All those options and features are great. But Shopify Plus is better than great because it's easy to use. User friendly to the max, Shopify has set itself apart as the ecommerce option focused on ease of use, allowing companies to focus on customer experience and marketing instead of building out, maintaining and working in expensive systems.
10. **Shopify Plus API**: For the enterprise customers that have Magento, SAP, SAGE, NetSuite or other ERP solutions. The ability to easily port over existing customers, make integrations easily at low cost, and transact at lower cost is very appealing. Shopify Plus is really helping enterprise take advantage of many tools thought to be for small business. Shopify Plus vs Magento Enterprise, we would pick Shopify Plus any day.

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1.2: Chapter 2- Success and Failure in Small Businesses

Learning Objectives

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

What Is a Successful Small Business?

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

Many people have studied whether there is any significant difference between the small business owner and the entrepreneur. Some entrepreneurs place more emphasis on growth in their definition of success.[1] However, it is clear that entrepreneurs and small business owners define much of their personal and their firm's success in the context of providing them with independence. For many small business owners, being in charge of their own life is the prime motivator: a "fervently guarded sense of independence," and money is seen as a beneficial byproduct.[2][3][4] Oftentimes, financial performance is seen as an important measure of success. However, small businesses are reluctant to report their financial information, so this will always be an imperfect and incomplete measure of success. [5] Three types of small business operators can be identified based on what they see as constituting success:

1. An artisan whose intrinsic satisfaction comes from performing the business activity
2. The entrepreneur who seeks growth
3. The owner who seeks independence[6]

When discussing failure rates in small business, there is only one appropriate word: confusion. There are wildly different values, from 90 percent to 1 percent, with a wide range of values in between.[7] Obviously, there is a problem with these results, or some factor is missing. One factor that would explain this discrepancy is the different definitions of the term failure. A second factor is that of timeline. When will a firm fail after it starts operation?

The term failure can have several meanings.[8] Small-business failure is often measured by the cessation of a firm's operation, but this can be brought about by several things:

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

Failure can therefore be thought of in terms of a cascading series of outcomes (see Figure 2.1 "Types of Business Failures"). There are even times when small business owners involved in a closure consider the firm successful at its closing.[9] Then there is the complication of considering the industry of the small business when examining failure and bankruptcy. The rates of failure can vary considerably across different industries; in the fourth quarter of 2009, the failure rates for service firms were half that of transportation firms.[10]

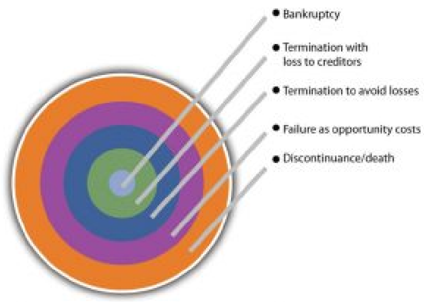

Figure 2.1 Types of Business Failures

The second issue associated with small business failure is a consideration of the time horizon. Again, there are wildly different viewpoints. The Dan River Small Business Development Center presented data that indicated that 95 percent of small businesses fail within five years.[11] Dun and Bradstreet reported that companies with fewer than twenty employees have only a 37 percent chance of surviving four years, but only 10 percent will go bankrupt.[12] The US Bureau of Labor Statistics indicated that 66 percent of new establishments survive for two years, and that number drops to 44 percent two years later.[13] It appears that the longer you survive, the higher the probability of your continued existence. This makes sense, but it is no guarantee. Any business can fail after many years of success.

Why Do Small Businesses Fail?

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

Three broad categories of causes of failure have been identified: managerial inadequacy, financial inadequacy, and external factors. The first cause,managerial inadequacy, is the most frequently mentioned reason for firm failure.[14] Unfortunately, it is an all-inclusive explanation, much like explaining that all plane crashes are due to pilot failure. Over thirty years ago, it was observed that "while everyone agrees that bad management is the prime cause of failure, no one agrees what 'bad management' means nor how it can be recognized except that the company has collapsed—then everyone agrees that how badly managed it was."[15] This observation remains true today.

The second most common explanation cites financial inadequacy, or a lack of financial strength in a firm. A third set of explanations center on environmental or external factors, such as a significant decline in the economy. Because it is important that small firms succeed, not fail, each factor will be discussed in detail. However, these factors are not independent elements distinct from each other. A declining economy will depress a firm's sales, which negatively affects a firm's cash flow. An owner who lacks the knowledge and experience to manage this cash flow problem will see his or her firm fail.

Managerial inadequacy is generally perceived as the major cause of small business failure. Unfortunately, this term encompasses a very broad set of issues. It has been estimated that two thirds of small business failures are due to the incompetence of the owner-manager.[16] The identified problems cover behavioral issues, a lack of business skills, a lack of specific technical skills, and marketing myopia. Specifying every limitation of these owners would be prohibitive. However, some limitations are mentioned with remarkable consistency. Having poor communication skills, with employees and/or customers, appears to be a marker for failure.[17] The inability to listen to criticism or divergent views is a marker for failure, as is the inability to be flexible in one's thinking.[18]

Ask many small business owners where their strategic plans exist, and they may point to their foreheads. The failure to conduct formal planning may be the most frequently mentioned item with respect to small business failure. Given the relative lack of resources, it is not surprising that small firms tend to opt for intuitive approaches to planning.[19][20] Formal approaches to planning are seen as a waste of time,[21] or they are seen as too theoretical.[22] The end result is that many small business owners fail to conduct formal strategic planning in a meaningful way.[23][24] In fact, many fail to conduct any planning;[25][26] others may fail to conduct operational planning, such as marketing strategies.[27] The evidence appears to clearly indicate that a small firm that wishes to be successful needs to not only develop an initial strategic plan but also conduct an ongoing process of strategic renewal through planning.

Many managers do not have the ability to correctly select staff or manage them.[28] Other managerial failings appear to be in limitations in the functional area of marketing. Failing firms tend to ignore the changing demands of their customers, something that can have devastating effects.[29] The failure to understand what customers value and being able to adapt to changing customer needs often leads to business failure.[30]

The second major cause of small business failure is finance. Financial problems fall into three categories: start-up, cash flow, and financial management. When a firm begins operation (startup), it will require capital. Unfortunately, many small business owners initially underestimate the amount of capital that should be available for operations.[31] This may explain why most small firms that fail do so within the first few years of their creation. The failure to start with sufficient capital can be attributed to the inability of the owner to acquire the needed capital. It can also be due to the owner's failure to sufficiently plan for his or her capital needs. Here we see the possible interactions among the major causes of firm failure. Cash-flow management has been identified as a prime cause for failure.[32][33] Good cash-flow management is essential for the survival of any firm, but small firms, in particular, must pay close attention to this process.

Small businesses must develop and maintain effective financial controls, such as credit controls.[34] For very small businesses, this translates into having an owner who has at least a fundamental familiarity with accounting and finance.[35] In addition, the small firm will need either an in-house or an outsourced accountant.[36] Unfortunately, many owners fail to fully use their accountants' advice to manage their businesses.[37]

The last major factor identified with the failure of small businesses is the external environment. There is a potentially infinite list of causes, but the economic environment tends to be most prominent. Here again, however, confusing appears to describe the list. Some argue that economic conditions contribute to between 30 percent and 50 percent of small business failures, in direct contradiction to the belief that managerial incompetence is the major cause.[38] Two economic measures appear to affect failure rates: interest rates, which appear to be tied to bankruptcies, and the unemployment rate, which appears to be tied to discontinuance.[39] The potential impact of these external economic variables might be that small business owners need to be either planners to cover potential contingencies or lucky.

Even given the confusing and sometimes conflicting results with respect to failure in small businesses, some common themes can be identified. The reasons for failure fall into three broad categories: managerial inadequacy, finance, and environmental. They, in turn, have some consistently mentioned factors (see Table 2.1 "Reasons for Small Business Failure"). These factors should be viewed as warning signs—danger areas that need to be avoided if you wish to survive. Although small business owners cannot directly affect environmental conditions, they can recognize the potential problems that they might bring. This text will provide guidance on how the small business owner can minimize these threats through proactive leadership.

Table 2.1 Reasons for Small Business Failure

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

Ultimately, business failure will be a company-specific combination of factors. Monitor101, a company that developed an Internet information monitoring product for institutional investors in 2005, failed badly. One of the cofounders identified the following seven mistakes that were made, most of which can be linked to managerial inadequacy:[40]

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

“Entrepreneurs Turn Business Failure into Success” Bloomberg Businessweek’s 2008 cover story highlights owners who turn business failure into success. [41]

Key Takeaways

- There is no universal definition for small business success. However, many small business owners see success as their own independence.
- The failure rates for small businesses are wide ranging. There is no consensus.
- Three broad categories of factors are thought to contribute to small business failure: managerial inadequacy, financial inadequacy, and external forces, most notably the economic environment.

Exercises

1. Starting a business can be a daunting task. It can be made even more daunting if the type of business you choose is particularly risky. Go to: www.forbes.com/2007/01/18/fairisaac-nordstromverizon-ent-fincx_mf_0118risky_slide.html?thisSpeed=undefined; where the ten riskiest businesses are identified. Select any two of these businesses and address why you think they are risky
2. Amy Knaup is the author of a 2005 study “Survival and Longevity in the Business Employment Dynamics Data” (seewww.bls.gov/opub/mlr/2005/05/ressum.pdf). The article points to different survival rates for ten different industries. Discuss why there are significant differences in the survival rates among these industries.

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Family Business: An Overview

Learning Objectives

1. Explain what a family business is.
2. Understand the role that family businesses play in the US economy.
3. Explain the advantages and disadvantages of family businesses.

"Family businesses are different."[1]

There is no agreed-on definition of a family business. The percentage of ownership, the strategic control, the involvement of multiple generations, and the intention for the business to remain in the family are among the many criteria that experts use to distinguish family businesses from other types of businesses. [2] For the purposes of this chapter, however, a ***family business*** is defined as a business that is actively owned and/or managed by more than one member of the same family.[3] A family business can also be defined as the result of someone's dream:

The story of every successful family business starts with someone who has the passion, confidence and courage to put his [or her] money where his [or her] mouth is…[These entrepreneurs] work incredibly hard, make things happen, are positive without being unrealistic and possess the resourcefulness to overcome all sorts of hurdles. They are also socially adept, capable of communicating effectively and good at inspiring others…[4]

Family business owners know that their roles are different from that of shareholders in companies owned by many public investors. In addition, "[E]mployees in family businesses know the difference that family control makes in their work lives, the company culture, and their career. Marketers appreciate the advantage that the image of a family business presents to customers, and families know that being in business together is a powerful part of their lives."[5]

Market and Employment Presence

Because of the private nature of most family businesses, it is difficult to obtain accurate information about them.[6] Complicating the situation is that most data sources do not distinguish between small family businesses, such as the local pizza parlor or deli, and large family businesses, such as Walmart, Mars, and Ford. "The reality is that family-based operations are represented across the full spectrum of American companies, from small businesses to large corporations."[7]. Within this context, the following has been observed[8][9]:

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

What this means is that family businesses continue to be a powerful economic force, no matter what their size and no matter how they are defined. "Family firms are the most common form of business structure; they employ many millions of people; and they generate a considerable amount of the world's wealth."[10]

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

Video Link 3.1: Mother and Daughter Partner in Family Business

A mother and daughter partner in a hair brush business.

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=36

Advantages and Disadvantages of the Family Business

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

Advantages

A family business offers the following advantages:

- One of the popular misconceptions about family businesses is that they are unable to adapt easily to increasing competitiveness and technological progress. The reality is that family businesses frequently have the advantage of entrepreneurial spirit, flexibility, and opportunism.[11]
- It is believed by some that family firms are "too soft" and rarely reach their potential. The reality is that family businesses actually outperform public companies. Oftentimes, the marketplace forces public companies to make short-term decisions, whereas a family business has the advantage of having more freedom to make its decisions. Family businesses can adapt to market fluctuations more easily because they can afford to be patient. They have common goals, shared values, and a commitment to brand building.[12]
- Family-owned businesses are often seen as ideal because family members form a "grounded and loyal foundation" for the company, and family members tend to exhibit more dedication to their common goals. "Having a certain level of intimacy among the owners of a business can help bring about familiarity with the company and having family members around provides a built-in support system that should ensure teamwork and solidarity."[13]
- The culture of a family business is very different from that of a company you will find on Wall Street. "Family businesses frequently take a very long-term point of view. They'll make investments that they don't expect to pay off for 5 or 15 or 25 years…Culture in a family business is more frequently based on very personal and emotional values. It's stronger because there are deeper roots and closer connections to the history of the company."[14]
- Family businesses are becoming more and more attractive to undergraduate business students who face a bleak job and salary outlook for new grads. These undergrads are choosing to return to their family businesses directly after graduation instead of trying to find a job in corporate America or on Wall Street.[15]
- There is a common misperception that family businesses are less professional and rigorous in their behavior because of the relational nature of the businesses.[16] However, like all other businesses, family businesses face global competition and rapidly changing markets. This creates more pressure on those who join to make sure that they produce. "This emphasis on professionalism has made family businesses both more daunting and more attractive—and has created new interest in them, from family members, outsiders, and business school students."[17]
- Many family-owned businesses tend to be stable and optimistic, even when economic times are uncertain. They seem to be better able to weather economic difficulties and stabilize the economy than their nonfamily counterparts.[18] However, this is a function of the industry and the size of the business.

- In general, family businesses feel that they are stronger because family members are involved in their activities. Family owners believe that their family members can be trusted, will work harder, and care more.[19]. This can help create competitive advantage in the marketplace.
- Family businesses may be more open to flexible or part-time schedules or choosing your hours. This presents a very attractive work environment for people who need to tend to children, parents, or other family members in need.[20]
- Family businesses tend to operate more ethically. In fact, many family businesses believe that their ethical standards are more stringent than those of their competitors. In addition, family businesses are often deeply embedded in their communities, and this proximity is seen as an important factor that increases the likelihood of ethical decision making and moral behavior.[21] As members of the local community, any ethical problems with a family business will be quickly visible.
- Family businesses also exhibit more social responsibility than their competitors. This has been attributed to their concern about image and local reputation[22] as well as their closeness to the community.
- Family businesses may incur lower costs because of the greater willingness of family members to make financial sacrifices for the sake of the business. Accepting lower pay than they would get elsewhere to help the business in the longer term or deferring wages in a cash-flow crisis are examples of family altruistic behavior.[23]
- Family businesses, in general, have greater independence of action because they have less (or no) pressure from the stock market and less (or no) takeover risk.[24]
- Family businesses tend to be more resilient in hard times because they are willing to plow profits back into the business. [25]
- Family businesses are less bureaucratic and less impersonal, which allows for greater flexibility and quicker decision making. [26]
- Family businesses offer the possibility of great financial success.[27] This can manifest itself in interesting ways. "As the family of a media conglomerate once mentioned, 'The name I have has certainly helped me to get access to top executives of companies, persons who under other circumstances would have kept their doors shut.'" [28]
- Family members have the chance to learn the business early. This extensive expertise can create an important competitive advantage.[29] "One executive recalled how as a child he would take long walks with his father, during which they would visit stores to look at competitor's products. Afterwards, his father would ask him which products he liked most, and this would lead to lengthy arguments about each product's quality. This man felt that the expertise he gained during those informal outings proved invaluable later in life."[30]

Video Link 3.2: Iron Horse Barbecue

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=36

A family-owned business that is helping other business fire up businesses of their own.

Why Family Businesses Are So Special

"If family businesses are so common, how can they also be special? When Freud was asked what he considered to be the secret of a full life, he gave a three-word answer: '*Lieben und arbeiten* [to love and to work].' For most people, the two most important things in their lives are their families and their work. It is easy to understand the compelling power of organizations that combine both. Being in a family firm affects all the participants. The role of chairman of the board is different when the company was founded by your father and when your mother and siblings sit around the table at board meetings, just as they sat around the dinner table. The job of a CEO is different when the vice president in the next office is also a younger sister. The role of partner is different when the other partner is a spouse or a child. The role of sales representative is different when you cover the same territory that your parent did twenty-five years earlier, and your grandparent twenty-five years before that. Even walking through the door on your first day of work on an assembly line or in a billing office is different if the name over the door is your own."[31]

Disadvantages

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

- Family businesses tend to be stable organizations. Although this is a good thing in many instances, stability can also make it difficult to change. A new, younger family member coming into the business will find tradition and structure. Changing that is not simple. The key to changing a family business lies in defining tradition in terms of the company's core values, not in specific ways of doing things. [32]
- Family closeness can lead to sibling rivalry or problems when both the parent and the child want control. By the third or fourth generation, with many cousins possibly sharing ownership, governance can become very complicated. [33]
- There may be times when the interests of a family member conflict with the interests of the business. One family member may want to expand the business, but other family members may not share this person's desire. The needs of the business are not in sync with the needs of the family.
- Family ties have a downside. Family members will frequently be expected to work harder, make more of a commitment, and get paid less than other employees in the business.[34]
- Family business owners may automatically promote someone from the family or give family members a job even if they do not have adequate skills for the job. A nonfamily employee may be better qualified.[35] This can cause dissension and resentment among other employees.
- Relationships between parents and children or among siblings have a tendency to deteriorate due to communication problems. "This dysfunctional behavior can result in judgments, criticism and lack of support."[36]
- The family business may be a breeding ground for jealousies, resentment, anger, and sabotage. Family problems may spill over into the workplace.[37]
- The business may be plagued with managerial incompetence, the lack of exposure to other businesses, and the inability to separate family and work.[38]
- Some family businesses may have difficulty attracting and keeping highly qualified managers. "Qualified managers may avoid family firms due to the exclusive **succession**, limited potential for professional growth, lack of perceived professionalism, and limitations on wealth transfer."[39] Succession refers to passing the business to the next generation.
- Family businesses have limited sources of external capital because they tend to avoid sharing equity with nonfamily members.[40] Having less access to capital markets may curtail growth.[41]
- Not all children of owner-managers may want to join the business. According to one study,[42] 80 percent of those who did not work in the family business did not intend to go into the business. This reluctance comes from several directions, such as the following:
  - My parents would not want me to join.
  - I could not work for my parents.
  - There are already too many family members in the business.
  - I am not interested in this particular business.
  - The business is too small for me.
  - The business would not allow me to use my talents.
  - The business would not allow me to use my training.
  - I can earn more elsewhere.
  - I am not interested in a business career.[43]

In Their Own Words

Why Some Children of Owner-Managers Do Not Want to Join the Business[44]:

I see the pressure my dad is under—this does put me off slightly. I want to enjoy my job as well as enjoying life outside work.

A larger factor when working under a relative is the problem of self-worth. It is hard to feel like you are worth something when your father is an MD.

A business relationship with your father makes your family relationship harder.

I do not look to go into the family business straight away, as I feel this is giving a commitment to work there for the rest of my life.

I would join only because I am genuinely qualified, not because I am the owner's daughter.

The difference in my father's education and mine is a factor affecting why I have decided not to go into the business. I have more choice over what I want to do as a career, and my personal interests would not be met by my father's company. I am sure it would not have been his choice had he had the same educational choices as me.

As much as the route into the family business is seen by outsiders as an "easy route to wealth and inheritance," in my case it was also a liability. At 17, was I to be the fourth generation after 100 years that could not keep the company going?

- The "spoiled kid syndrome" often occurs in a family business. The business owner may feel guilty because his devotion to the business takes away from the attention he should be giving to his children. Out of a sense of guilt, he or she starts to bribe the children, "a kind of pay-off for not being available emotionally or otherwise."[45]
- Financial strain emanating from "family members milking the business and a disequilibrium between contribution and compensation"[46] can have a significant negative impact on the business.
- Nepotism that results in the "tolerance of inept family members as managers, inequitable reward systems, [and] greater difficulties in attracting professional management"[47] can easily lead to low morale among nonfamily members of the business, and it can ultimately result in business failure.
- Family businesses frequently have a confusing organization, with "messy structure and no clear division of tasks." Authority and responsibility lines are unclear; jobs may overlap; executives may hold a number of different jobs; and the decision-making hierarchy may be completely ignored, existing only to be bypassed.[48] This can create a dysfunctional working environment.
- Family businesses frequently have paternalistic or autocratic rule that is characterized by a resistance to change, secrecy, and the attraction of dependent personalities.[49]

Key Takeaways

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

Exercises

1. Jaret Coulson has returned to the family business and is very enthusiastic about expanding the business. He has identified four options: (a) expanding the antique store either at its current site or elsewhere in Charlottetown; (b) opening several similar-sized antique shops in nearby towns; (c) using the Internet to expand sales; and (d) expanding the sales of refinished chairs in a local store to a regional furniture chain. Any one of these ideas would represent a change from his father's Mr. Coulson's business model. Given that he had not expressed any interest in the management of the business, how should he go about approaching his father with these ideas? If the company expands, should Jaret approach his sister and her husband about taking a more active role in the business? What should their roles be?

Family Business Issues

Learning Objectives

1. Explain why communication, employing family and non-family members, professional management, employment qualifications, salaries and compensation, succession, and ethics are important issues for all family businesses.

Looking at the vision and hard work of the founders, family businesses "take on their unique character as new members of the family enter the business. At best, the environment can be inspiring and motivating. At worst, it can result in routine business decisions becoming clouded by emotional issues."[50]

The owners and managers of family businesses face many unique challenges. These challenges stem from the overlap of family and business issues and include communication, employing family and non-family members, professional management, employment qualifications, salaries and compensation, and succession.

Communication

Communication is important in any business, but the complexities of communication in a family business are particularly problematic. Experts say that communication is one of the most difficult parts of running a family business.[51] The approach to communication needs to include commitment, the avoidance of secrecy, and an understanding of the risks of bad communication.

Commitment

In a family business, it is critical that there be a commitment to communicate effectively with family and non-family members of the business. "Business leaders should be open about their awareness of the potential for communication issues to evolve and their willingness to accept feedback and input from all employees about opportunities for improvement and areas of concern."[52]

One important issue is whether there should be a line drawn between family and business discussions. Some suggest that setting up strict guidelines from the start that draw a clear line between the different types of discussions is a good approach.[53] By contrast, the Praxity Family Business Survey[54] found that it is considered OK to talk about the business anywhere and at any time, whether at work or at home:

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

Secrecy

In family businesses, it is particularly important not to convey the impression that family members are more in the know than other employees. "…Even when this is not the case, the potential for the perception of exclusivity may exist. Steps should be taken to address any issues that may arise openly, honestly, and without preference for family members."[55]

Risks of Bad Communication

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

- "Family members assume they know what other family members feel or want."
- "Personal ties inhibit honest opinions being expressed."
- "The head of the family may automatically assume control of the business even if they don't have the best business skills."
- "One family member ends up dominating the business."
- "Family-member shareholders not active in the business fail to understand the objectives of those who are active and vice versa."
- "Personal resentments become business resentments and vice versa."[56]

These difficulties can be overcome if the family business makes a concerted effort to create and maintain an environment of open communication where people feel comfortable voicing opinions and concerns. It is important that family and non-family members have an equal opportunity to express their views.

Employing Family and Non-family Members

It is natural for a family business to employ family members, especially in management positions. Family members tend to be the first people hired when a small business gets started, and as the business grows, so do their roles.[57] There are both pros and cons to hiring family members. Both need to be considered carefully. Who to hire may well be the biggest management challenge that a family business owner faces.

Pros

On the positive side of things, several advantages can be identified for hiring family members:[58][59]

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

"A family whose members work well together can also give the business a welcoming and friendly feel. It can encourage employees who aren't in the immediate family to work harder to gain acceptance by those employees who are."[60]

Cons

There are also quite a few disadvantages to hiring family members:[61][62][63][64]

- Families are not perfect, so a dispute among family members can spill from home into the workplace.
  - There is always the possibility of managerial incompetence
  - It may not be possible to separate family and work
  - Patterns of conflict will be rooted in early family experiences
  - Communication may break down
  - Sibling rivalry may create problems
- Newly hired family members may feel that they do not have to earn their positions; their success will be seen as linked to their name instead of their abilities.
  - The company may be subject to charges of discriminatory hiring practices if job openings are not published.
  - Non-family members of the business may feel that family members get hiring preference.
  - Non-family members may feel that they will be automatically outvoted in decision making.
  - Hiring primarily family members for management positions may lead to hiring suboptimal people who cannot easily be dismissed. This could lead to greater conflict because of promotion criteria that are not based on merit.

Hiring Non-family Members

There will be times when the better decision may be to hire a non-family person for a particular job. Experience has shown that a family business is less likely to be successful if it employs only family members; bringing in the fresh thinking that comes with external expertise can be valuable at all levels of a business. [65] In addition, non-family members can offer stability to a family business by offering a fair and impartial perspective on business issues. The challenge is in attracting and retaining non-family employees because these employees "may find it difficult to deal with family conflicts on the job, limited opportunities for advancement, and the special treatment sometimes accorded family members. In addition, some family members may resent outsiders being brought into the firm and purposely make things unpleasant for non-family employees." [66]

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

Professional Management

The decision to hire a ***professional manager*** is likely one of the most important and difficult hiring decisions that a family business owner will have to make. "A typical argument…is that professional non-family managers should be brought in to provide 'objectivity' and 'rationality' to the family firm." There are several problems with this way of thinking. First, it perpetuates the outdated notion that family members are not professional, that the smartest thing for a family business to do is to bring in professional management—as quickly as possible. [67]

Second, professional managers are not always prepared to deal with the special nature of family-owned businesses. "The influence of families on businesses they own and manage is often invisible to management theorists and business schools. The core topics of management education—organizational behavior, strategy, finance, marketing, production, and accounting—are taught without differentiating between family and non-family businesses." [68] This does an injustice to the unique workings of a family-owned business.

Third, a professional manager from the outside is not always prepared, perhaps not even most of the time, to deal with the special nature of family companies. The dominant view on professional management downplays the importance of the social and the cultural context. "This is a problem in family firms where family relations, norms, and values are crucial to the workings and development of the business."[69] It is argued that the meaning business families attach to their businesses is guided by family values and expectations—so much so that "anything or anyone that interrupts this fragility could send the business into chaos."[70]

The hiring of an outside manager, therefore, should include an assessment of both ***formal competence***: formal education, training, and experience outside the family business and ***cultural competence***: an understanding of the culture of a specific firm. Although it is certainly helpful and appropriate, formal competence is not sufficient for managerial effectiveness. It needs to be supplemented with cultural competence, an understanding of the culture of a specific firm. Interestingly, most family businesses look only to formal competence when selecting a CEO. [71]

Culture and Non-family CEOs

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

As a non-family CEO, you have to have in-depth respect for the invisible forces among the employees in the family firm. You cannot escape the fact that there will always be special bonds between the family firm and the owner. Always (*The words of a non-family CEO in a family business*). [72]

One concern of family businesses may be that the hiring of a non-family manager will result in the loss of their "familiness." However, one study found that, even with non-family managers, bringing non-family management activities, styles, and characteristics, "[T]he special and unique aspects and forces of the system of the family, its individual family members, and the business itself provide a synergistic force that offsets the outside influences of the [non-family managers]." This same study acknowledged, however, that their research did not focus on understanding at what point, or percentage of non-family members, the feeling of "familiness" will begin to erode. [73]

Employment Qualifications

One of the more difficult challenges that a family business must face is determining employment qualifications for employees, both family and non-family. The lack of a clear employment policy and process can lead to major conflicts in the company. Unfortunately, it would appear that, despite their benefit, most family businesses have a family employment policy.[74]. As a result, many family businesses may end up with more employees from the family than the company needs, and some of these people may not even be qualified or suitable for the jobs they have been given. "Some family businesses even find themselves acquiring businesses that have no relationship with their original business or keeping some unprofitable business lines just to make sure that everybody in the family gets a job within the company."[75]. This kind of situation benefits no one.

A written family-business employment policy can solve a myriad of problems because it spells out the specific terms for family and non-family members with respect to recruiting, hiring, promoting, compensating, and terminating. One recommendation is that an ideal family employment policy should include the following:[76]

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

Others have recommended "that family members meet three qualifications before they are allowed to join the family business on a permanent basis: an appropriate educational background; three to five years' outside work experience; and an open, existing position in the firm that matches their background."[77]

There are no rules that dictate the content of a family business employment policy, so differences from one family business to another can be expected. However, it is very important "to set employment conditions that do not discriminate against or favor family members. This would help establish an atmosphere of fairness and motivation for all employees of the family business."[78]

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

Salaries and Compensation

As difficult as hiring decisions may be for the family business, decisions about salaries and compensation are probably even worse. No matter how well intentioned and well designed the company's compensation plan may be, there will still be jealousies, hard feelings, severed sibling relationships, and even lawsuits, particularly among those family members who feel they have been treated unfairly. [79] This presents a daunting challenge: how to develop a compensation plan that will be fair to family members and good for the business:

One of the greatest struggles of operating a family business is separating the family from the business. Oh yes, there are many great benefits to having family in the business and to being a family member in a family business, but the most difficult problems result when "family values" and issues take over, leaving business values and needs wanting. There is no greater source for family business problems—nor more fertile ground for their cure—than the family business compensation systems. [80]

Some of the Problems

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

- They consider fair compensation to be equal compensation for all family members, sometimes even for the owner. This creates a very sticky situation because all family members are not created equal. "It is sometimes difficult to assess and compare the talents of family members who are also employees. Nor do all family members contribute equally to the business. As a result of the stress that this causes, many family business owners ignore the problem and let compensation become a breeding ground for dissension in the family."[81]
- They do not compensate wives for the work they do. The reason often given? It saves on taxes. Not surprisingly, this approach leaves wives isolated from the business, invisible in the decision-making process, and unappreciated. This problem extends to the compensation of sons and daughters as well. A survey by Mass Mutual Insurance Company [82] reported a big discrepancy among the salaries of sons and daughters in family businesses across America. The average salary of the typical son in a family business was $115,000, while his sister earned only $19,000. This may be due to the tendency of sons being groomed for leadership, while daughters are groomed for the supportive roles that command lower salaries.
- The compensation for family members is higher than that for non-family members, but the differential is not tied to the actual job requirements or performance. This situation can lead to anger, reduced motivation, resentment, and eventual departure of the non-family member from the firm.
- The business overpays family members—for a variety of reasons:[83]
    - "Guilt, because mom & pop were so busy working when the kids were young."
    - "Fear of conflict, because someone's wife threatens not to come to the family picnic."
    - "Resistance to change, because 'That's the way we've always done it.'"
    - "Inability to confront family members who feel 'entitled' to inflated salaries."
    - "Determination to minimize estate taxes by transferring wealth through compensation."
- Emotional pressures are allowed to determine compensation policies. What this means is that compensation is not correctly determined by job requirements and performance in those jobs. When this happens, small problems develop centrifugal force:[84]
    - "Fighting between sibling/cousin partners increases."
    - "Hard-working family members and employees lose morale."
    - "Well-motivated competent employees leave the company."
    - "The company loses its competitive edge and growth potential."
    - "Family harmony decreases."
    - "The value of the company declines, or it is sold—for the wrong reasons."

Some of the Solutions

Developing a fair compensation plan for the family business is not easy. It requires good faith, trust, and good business sense. The dollar amounts offered to family members will be critical, but the more pressing issue is fairness. [85] Unfortunately, fairness is often construed as equality. This must be avoided.

There is no template for designing a compensation plan for family businesses, but there are several recommendations:[86]

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

Family members employed in the business will be paid according to the standards in our region, as reported by our trade association, for a specific position, in companies of our size. In order to retain good employees we will pay all employed family members and other managers within the top quartile of our industry's standards. Additional compensation will be based on success in reaching specific company goals, with bonuses shared among all members of the management team. Individual incentives will be determined according to measurable goals for job performance determined each year, and reviewed by the appropriate manager.[87]

- Gather information about the salaries of similar positions in the industry of the family business in the applicable region of the country. Look at companies that are similar in the number of employees, revenue, and product. If possible, obtain salary and benefit information.
- Have the base salary for each position be consistent with the salaries and wages paid for comparable positions at similarly sized businesses. Paying at this market value will have an excellent effect on non-family members because they will feel that they are on an even playing field. There will be a positive effect on business morale.
- The family business owner might consider seeking outside help in determining compensation levels for individual family members. However, this assistance must be seen as truly objective, with no reason to favor one viewpoint over another.

Oh, Those Sleepless Nights!

A recent family business survey reported that the following things keep family business owners awake at night. [88]

Table 3.1 Top Factors Business Owners Lose Sleep Over

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

Other urgent issues identified by a different family business survey included, in order of importance, the following:[89]

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

Succession

Another important issue that is particularly difficult for family businesses is **succession**. As mentioned earlier in this chapter, succession is about passing the business to the next generation. Decisions have to be made about who will take over the leadership and/or ownership of the company when the current generation dies or retires [90]. Interestingly, “only a third of all family businesses successfully make the transition to the second generation largely because succeeding generations either aren’t interested in running the business or make drastic changes when they take the helm.”[91]. There are family businesses that manage the transition across generations quite easily because the succession process chooses only the children willing and able to join and work with the prevailing family, business values, and goals. Unfortunately, there are also instances in which children have had to leave school as soon as legally allowed, not equipped to manage either the business, their lives, or their family. These children spend many resentful years in the business until it fails.[92]

Passing the family business to the next generation is a difficult thing to do, but succession is a matter of some urgency because 40 percent of US businesses are facing the issue of succession at any given point in time. [93]

This urgency notwithstanding, there are several forces that act against succession planning:[94]

1. Founder
    - Fear of death
    - Reluctance to let go of power and control
    - Personal loss of identity
    - Fear of losing work activity
    - Feelings of jealousy and rivalry toward successor
2. Family
    - Founder’s spouse’s reluctance to let go of role in firm
    - Norms against discussing family’s future beyond lifetime of parents
    - Norms against favoring siblings
    - Fear of parental death
3. Employees
    - Reluctance to let go of personal relationship with founder
    - Fears of differentiating among key managers
    - Reluctance to establish formal controls
    - Fear of change
4. Environmental
    - Founder’s colleagues and friends continue to work
    - Dependence of clients on founder
    - Cultural values that discourage succession planning

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

The Succession Plan

Voyageur Transportation, a company in London, calls its successful succession planning program, “If you got hit by a beer truck, what would happen to your department?”[95]. As a family business owner, you should pose this question in terms of yourself and your business. Hopefully, this will provide the impetus you need to develop a succession plan.

A good succession plan outlines how the succession will occur and what criteria will be used to judge when the successor is ready to take on the task. It eases the founder’s concerns about transferring the firm to someone else and provides time in which to prepare for a major change in lifestyle. It encourages the heirs to work in the business, rather than embarking on alternative careers, because they can see what roles they will be able to play. And it endeavors to provide what is best for the business; in other words, it recognizes that managerial ability is more important than birthright, and that appointing an outside candidate may be wiser than entrusting the company to a relative who has no aptitude for the work. [96]

A good succession plan will recognize and accept people's differences, not assume that the next generation wants the business; determine if heirs even have enough experience to run the business; consider fairness; and think and act like a business. The plan should also include a timetable of the transition stages, from the identification of a successor to the staged and then full transfer of responsibilities, and a contingency plan in case the unforeseen should happen, such as the departure or death of the intended successor or the intended successor declining the role.[97] It would also be helpful to get some good professional advice—from company advisors who have expertise in the industry as well as other family-run businesses.[98]

Although each succession plan will be different, the following components should be seen as necessary for a good succession plan:[99]

1. **Establish goals and objectives.** As the family business owner, you must establish your personal goals and vision for the business and your future role in its operation. You should include your retirement goals, family member goals, goals of other stakeholders (e.g., partners, shareholders, and employees), and goals relating to what should happen in the case of your illness, death, or disability.
2. **Family involvement in the decision-making process.** If the family and stakeholders who are involved in the decision-making process are kept informed of the decisions being made, many of the problems related to inheritance, management, and ownership issues will be alleviated. Communication, the process for handling family change and disputes, the family vision for the business, and the relationship between the family and the business should be addressed. The surest path to family discord is developing the succession plan on your own and then announcing it.[100]
3. **Identify successor(s).** This section of the plan will address the issue of who takes over ownership and management of the business. Identification of the potential successor(s), training of the successor(s), building support for the successor(s), and teaching the successor(s) to build vision for the business are included here. Working with your successor(s) for a year or two before you hand over the business will increase the chances for success.[101]
4. **Estate planning.** Estate planning is important if you are planning to retire or want to take precautionary measures regarding the future of the business in the event you are unable to continue operation of the family business due to illness, disability, or death. You should consult a lawyer, an accountant, a financial/estate planner, and a life insurance representative so that your benefits will be maximized. You will need to consider taxation, retirement income, provisions for other family members, and active/nonactive family members.
5. **Contingency planning.** Contingency planning is about unforeseen circumstances. It is about strategizing for the most likely "what if" scenarios (e.g., your death or disability). By thinking in terms of the unforeseen, you will be taking a proactive rather than reactive approach.
6. **Company structure and transfer methods.** This section of the succession plan involves the review and updating of the organizational and structural plan for the organization taking into account the strengths and weaknesses of the successor. The following needs to be identified: the roles and the responsibilities of the successor, the filling of key positions, structuring of the business to fit the successor, the potential roles for the retiring owner, any legal complications, and financial issues.
7. **Business valuation.** This section is relevant only if the business is being sold. Passing the business to a family member would not involve a business valuation.
8. **Exit strategy.** With any succession, ownership will be transferred, and you will remove yourself from the day-to-day operations of the business. Alternatives will be compared, and a framework for making your final choices will be developed. The transfer method and the timelines are decided. The exit plan should then be published and distributed to everyone who is involved in the succession process.
9. **Implementation and follow-up.** The succession plan should be reviewed regularly and revised as situations change. It should be a dynamic and a flexible document.

As difficult as the planning process can be, the goal should be a succession plan that will be in the best interests of all—or most—of the parties involved. Business interests should be put ahead of family interests, and merit should be emphasized over family position.[102]

The Family Business and Technology

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

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

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

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

The resistance to new technology quieted, however, after Johnson was able to point to market share growth of 35 percent at the $200 million business in the past year. "The numbers are starting to resonate," he says. "Five years ago, I couldn't even say what our market share was because we didn't have the technology to figure it."[103]

Key Takeaways

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

Exercises

1. Select a family business in your area. Make arrangements to speak with three members of the family who work in the business. Develop a list of ten questions that cover a broad range of issues, such as the approach to compensation (but do not ask for specific salary or wage numbers), the process for hiring family and non-family members, and the plans for passing the business to the next generation. Ask each member of the business the same questions. Pull the answers together and compare them. Where did you find similarities? Where did you find differences? Did everyone know the answer to each question? Where were people reluctant to answer? Prepare a three- to five-page report on your findings.
2. The family business is looking to expand, and some members of the family, but not all, feel that it might be worth bringing in someone from the outside to fill one of the new management positions because the family talent has been pretty much exhausted. Design a process for hiring an external manager. What things should be considered? How might you get buy-in from all family members?

Conflict

Learning Objectives

1. Explain what conflict is.
2. Explain why positive or constructive conflict can be helpful to a family business.
3. Explain why negative or destructive conflict can damage a family business.
4. Identify sources of negative conflict in a family business.
5. Identify some ways in which negative conflict can be avoided.

All businesses have conflict. It can be a good thing or it can be a bad thing. ***Positive conflict*** or ***constructive conflict*** can be beneficial to a family business when it increases opportunity recognition, produces high-quality decisions, encourages growth, strengthens groups and individuals, increases the learning necessary for entrepreneurial behavior, and increases the levels of commitment to the decisions being made.[104][105][106] An example of positive conflict is a disagreement between family members on the strategic direction of the family business, the result being a much-needed rethinking of the business plan and a new agreed-on vision for the company.[107]

By contrast, negative or destructive conflict can hurt a business by damaging the harmony and relationships of family members in the family business, discouraging learning, causing ongoing harm to groups and individuals in the business, frustrating adequate planning and rational decision making, and resulting in poor quality decisions.[108][109] "The absence of good conflict makes it that much harder to accurately evaluate business ideas and make important decisions…But conflict does not mean browbeating."[110] An example of a negative conflict would be arguments over the successor to the business. Ultimately, the failure to adequately control negative conflict may contribute to the high mortality rate of family-owned businesses.[111]

Because of the clash between business and emotional concerns in a family business, the potential for negative conflict can be greater than for other businesses.[112]. The tension that exists among the personal lives and career pursuits of family members creates an interrole conflict. A situation when a family member has simultaneous roles with conflicting expectations (occurring when a family member has simultaneous roles with conflicting expectations) in which the role pressures from work and home are incompatible.[113] This conflict is difficult—if not impossible in some instances—to resolve. "Due to the interconnection and frequent contact among family members working in the business with those who are not but may still have an ownership stake, recurring conflict is highly probable in family firms."[114]

Sources of Conflict

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

The PricewaterhouseCoopers Family Business Survey[115] identified a core group of issues that are likely to cause tension.

Table 3.2 Factors Causing Tension in Family Businesses

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

Add to this the fact that "[F]amily firms are prone to psychodynamic effects like sibling rivalry, children's desire to differentiate themselves from their parents, marital discord, identity conflict, and succession and inheritance problems that non-family businesses do not suffer from,"[116] and it's easy to see how the family business is a fertile field for negative conflict.[117]

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

- **Rivalry.** Harry Levinson from the Harvard Business School maintains that, "the fundamental psychological conflict in family businesses is rivalry, compounded by feelings of guilt, when more than one family member is involved."[118]. This rivalry can occur between father and son, siblings, husband and wife, father and daughter, and in-laws with members of the family that own the business.
- **Differing vision.** Family members will often disagree with the founder and with each other about the vision and strategy for the business. These differences "can create fear, anger, and destructive attempts to control decisions that are divisive and counter-productive to making and implementing sound decisions."[119]. Rivalries that spill into the workplace can get nasty, leading to destructive behaviors.
- **Jealousy.** There is always the potential for jealousy in the family business. It can arise from feelings of unfairness in such things as compensation, job responsibilities, promotions, "having the ear" of the business founder, and stock distributions. It can also arise with respect to the planned successor when there is a difference of opinion about who it should be. If it is not resolved, jealousy has the potential to divide the family and destroy the business.[120]
- **Succession.** Succession is always a big obstacle for a family business. In some cases, the founder may feel that his or her children are not capable of running the business. This will cause obvious tension between the parent and the child/children, such that the child or children may leave the business in frustration[121]. This, in turn, becomes problematic for succession. "Who gets what type of equity, benefit, title, or role can be major sources of explicit conflict or implicit but destructive behaviors."[122]. It is also true that while the founder of the business wants to continue family ownership and leadership of the business, this may not be true of his or her immediate family or later-generation family members[123]. This can create substantive conflict during succession planning.
- **Playing by different rules.** This cause of negative conflict "often presents itself as a form of elitism or entitlement that exists simply by virtue of being in a family that owns a business. Examples show up in allowing one or more family members to exhibit deficient standards of conduct or performance that violate sound business practices or important requirements that all other employees are expected to follow. Such behaviors can be divisive and demoralizing to all employees and customers as well as harmful to the reputation of the business."[124]
- **Decision making.** If roles and responsibilities are not clearly defined, conflict will arise over who can make decisions and how decisions should be made. This will lead to confusion, uncertainty, and haphazard decisions that will put the company at risk.
- **Compensation and benefits.** "This is one of the most frequent sources of conflict, especially among members of the younger generation." A person's compensation is inextricably linked to his or her feelings of importance and self-worth. Compound that with the emotions associated with being a member of the family that owns the business, and you have the potential for explosive negative conflict. Clearly, this is not in the best interests of the business.[125]

Avoiding Conflict

Some measure of family squabbling is expected in a family business. Some of the arguments will be logical and necessary. However, "it's important that they remain professional and not personal, because squabbling among family members in a work environment can make the employees and customers feel extremely uncomfortable, and can give them grounds for legal claims against the business."[126]. The negative effects of family squabbling are as follows:[127]

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

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

Second, emotional reactions should be differentiated from problem-solving reactions. Family members need to take a professional perspective rather than that of an irritated sibling, parent, son, or daughter.[128]. It will probably be difficult to do this, but it is important that it be done.

Third, focus on the professional role instead of the family role. "Make sure it's clear what the expectations and attitudes of all your employees are…Because you're a small business, you might not have as strict a policy as a large corporation, but it would still be helpful to put it in writing, such as in an employee handbook, which carries legal responsibilities to both family and outside employees."[129]

Fourth, encourage honesty from the beginning. When first starting to work together, it is important that family members sit down together to talk about potential conflicts that might arise. Acknowledging that it will be more difficult to work together because of being family is a good beginning. Treating family members and the professional environment with respect and expecting honesty when someone steps over the line should make for a smoother process.[130]

Last, the founder should try to keep the conflict constructive. This means stimulating task-oriented disagreement and debate while trying to minimize interpersonal conflicts[131]. This will require a fair decision-making process. For people to believe that a process is fair, it means that they must:[132]

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

Key Takeaways

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

Exercises

1. The founder of Carson's Dairy Farm in Springfield, PEI has decided to retire. He wants one of three children to take over leadership of the business—and he knows exactly who it should be. Other members of the family have their ideas as well. One segment of the family wants the oldest son, Michael, to take over, but the founder thinks Michael is a melon head. The second son, Christopher, is a well-meaning and hard-working part of the business, but he just does not have what it takes to be a leader. Nonetheless, he is favored by another group of family members. Samantha, the youngest child, is as sharp as a tack, with solid experience and accomplishments under her belt. On an objective basis, Samantha would be the best choice for the business. She is the founder's choice to take over the company and has other family supporters as well, although not as many as for Michael or Christopher. This is a situation tailor-made for conflict. How does the founder finesse the selection of Samantha and minimize the conflict that is bound to occur? Can he win?

Westbrook Lobster

Source: Used with permission, Michael Larivere, manager, Westbrook Lobster, Wallingford, CT.

In 1957, Westbrook Lobster opened in Westbrook, Connecticut, as a specialized lobster and fish market. As time went on, the company expanded to offer a comprehensive range of fish, shrimp, and prepared foods. In 1989, Larry Larivere, who grew up near the docks of New Bedford, Massachusetts, bought the business and had a dream of expanding the business with a seafood restaurant.

Fast forward to 2004. Larry and his two sons, Michael (an environmental science major) and Matthew (a business major), opened up their second restaurant in Wallingford, Connecticut. It overlooks the Quinnipiac River in the historic Yale Brother's Mill built in the late 1670s. Originally a grain mill, later converted to a German and Britannia silver spoon factory, and finally converted into a restaurant, the building was rich with history.

Michael speaks easily about the value that Westbrook Lobster offers its customers: high quality food, great service…and visiting the tables while people are dining. He sees these visits as an important part of the relationships that he has built with his customers over the years. Westbrook customers eagerly await the monthly postcards that are sent out that feature dining specials, discounts, and coupons. He tries to get the postcards out early and actually receives phone calls if they are not received early. Many people have come to depend on them. Michael says that these postcards definitely give the restaurant its greatest return. The restaurant has a presence on Facebook, but that is geared to the bar crowd—a younger crowd.

Technology plays an important but mixed part in the restaurant's operations. Michael says that it is tough to run a restaurant these days without technology tools like POS (point of service) systems. These systems include touch screens for placing orders and paying for food items. Interestingly, however, most food vendors still do their business face to face (or telephone to telephone), choosing to stick with personal relationships. Only a few suppliers, such as liquor vendors, accept orders online.

The current Westbrook Lobster website was created by Michael and Matthew using services from intuit.com. They built the site themselves and are proud to note that restaurant gift cards can now be purchased directly from the site. This is a perfect example of Web 2.0 capabilities.

As far as running the business, currently fifty employees strong, Larry Larivere (Dad) is brought in on the big decisions. Otherwise, Michael and Mathew run the restaurants on their own. There are currently no other family members in the business.

Westbrook Lobster continues to provide the freshest seafood available at competitive prices. The daily selection includes everything from locally harvested shellfish to fresh fish from waters up and down the East Coast. They also offer several "healthy" options that are made without butter or bread crumbs. These menu items are very popular and are especially attractive for people with food allergies or people who just want to eat a bit lighter. All their efforts continue to pay off. Westbrook Lobster was voted "Best Seafood Restaurant Statewide" in *Connecticut Magazine* 2009 and "Best Seafood in New Haven County" in *Connecticut Magazine* 2009 and 2010.

Larry, Michael, and Matthew invite you to Westbrook Lobster when you are in the area. Once you are there, you are family.

Source: [133] and [134]

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CHAPTER OVERVIEW

2: Day-to-day Operations

Cheshire Package Store Used with permission from Robert Brown.

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

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

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

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

Defining the Customer’s Concept of Value

Learning Objectives

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

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

Marcus Aurelius Antoninus

In the previous chapter, Peter Drucker and W. Edward Deming placed the customer at the center of their definitions of the purpose of a business. They used the customer as being at the core of that purpose rather than focusing on financial measures such as profit, return on investment (ROI), or shareholders’ wealth. Drucker’s logic was that if a business did not create a sufficient number of customers, there never would be a profit with the business. Deming argued that delighting customers would become the basis for them to consistently return, and loyalty would ensure that the business would have a higher probability of surviving in the long term. The clearest way of doing that is by focusing on providing your customers with a clear sense of value. This emphasis on value will produce economic benefits. Gale Consulting explains the notion of value this way, “If customers don’t get good value from you, they will shop around to find a better deal.” [1]

A recent study put it this way, “These firms have been successful…by consistently creating superior ***customer value***, and profiting handsomely from that customer value.”[2]

Strong evidence indicates that this focus on making the customer central to defining the business translates into economic success. It has been estimated that the cost of gaining a new customer over retaining a current customer is a multiple of five. The costs of regaining a dissatisfied customer over the cost of retaining a customer are ten times as much.[3] So a key question for any business then becomes, “How does one then go about making the customer the center of one’s business?”

What Is Value?

It is essential to recognize that value is not just price. Value is a much richer concept. Fundamentally, the notion of customer value is fairly basic and relatively simple to understand; however, implementing this concept can prove to be tremendously challenging. It is a challenge because customer value is highly dynamic and can change for a variety of reasons, including the following: the business may change elements that are important to the customer value calculation, customers’ preferences and perceptions may change over time, and competitors may change what they offer to customers. One author states that the challenge is to “understand the ever changing customer needs and innovate to gratify those needs.” [4]

The simple version of the concept of customer value is that individuals evaluate the perceived benefits of some product or service and then compare that with their perceived cost of acquiring that product or service. If the benefits outweigh the cost, the product or the service is then seen as attractive (see Figure 4.1 “Perceived Cost versus Perceived Benefits”). This concept is often expressed as a straightforward equation that measures the difference between these two values:

customer value = perceived benefits − perceived cost.

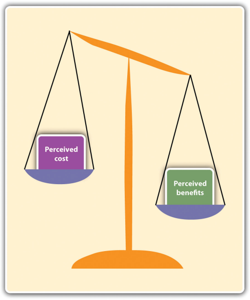


Figure 4.1 Perceived Cost versus Perceived Benefits

Some researchers express this idea of customer value not as a difference but as a ratio of these two factors. [5] Either way, it needs to be understood that customers do not evaluate these factors in isolation. They evaluate them with respect to their expectations and the competition.

Firms that provide greater customer value relative to their competitors should expect to see higher revenues and superior returns. Robert Buzzell and Bradley Gale, reporting on one finding in the Profit Impact through Marketing Strategy study, a massive research project involving 2,800 businesses, showed that firms with superior customer value outperform their competitors on ROI and market share gains.[6]

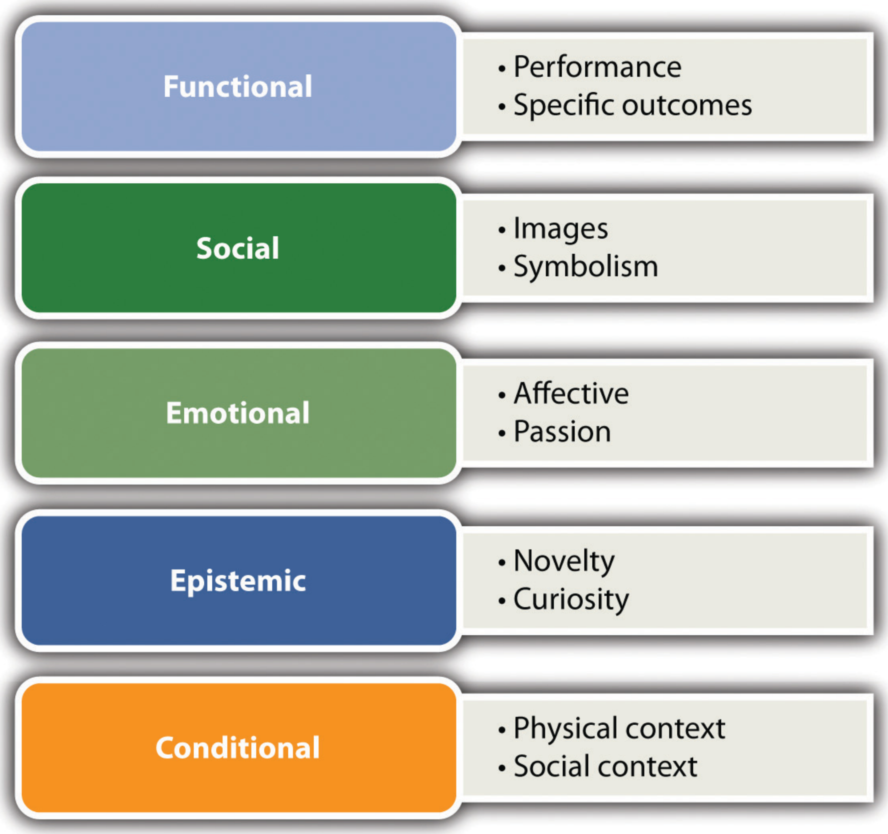
Given this importance, it is critical to understand what makes up the perceived benefits and the perceived costs in the eyes of the consumer. These critical issues have produced a considerable body of research. Some of the major themes in customer value are evolving, and there is no universal consensus or agreement on all aspects of defining these two components. First, there are approaches that provide richly detailed and academically flavored definitions; others provide simpler and more practical definitions. These latter definitions tend to be ones that are closer to the aforementioned equation approach, where customers evaluate the benefits they gain from the purchase versus what it costs them to purchase.

However, one is still left with the issue of identifying the specific components of these benefits and costs. In looking at the benefits portion of the value equation, most researchers find that customer needs define the benefits component of value. But there still is no consensus as to what specific needs should be considered. Park, Jaworski, and McGinnis (1986) specified three broad types of needs of consumers that determine or impact value provided five types of value[7][8]; as did Woodall (2003), although he did not identify the same five values.[9]

To add to the confusion, Heard (1993–94)[10]identified three factors, while Ulaga (2003)[11] specified eight categories of value; and Gentile, Spiller, and Noci (2007) mentioned six components of value.[12] Smith and Colgate (2007) attempted to place the discussion of customer value in a pragmatic context that might aid practitioners. They identified four types of values and five sources of value. Their purpose was to provide "a foundation for measuring or assessing value creation strategies."[13] In some of these works, the components or dimensions of value singularly consider the benefits side of the equation, while others incorporate cost dimensions as part of value.

From the standpoint of small businesses, what sense can be made of all this confusion? First, the components of the benefits portion of customer value need to be identified in a way that has significance for small businesses. Second, cost components also need to be identified. Seth, Newman, and Gross's five types of value provide a solid basis for considering perceived benefits (see Figure 4.2 "Five Types of Value"). Before specifying the five types of value, it is critical to emphasize that a business should not intend to compete on only one type of value. It must consider the mix of values that it will offer its customers. (In discussing these five values, it is important to provide the reader with examples. Most of our examples will relate to small business, but in some cases, good examples will have to be drawn from larger firms because they are better known.)

Figure 4.2 Five Types of Value



The five types of value are as follows:

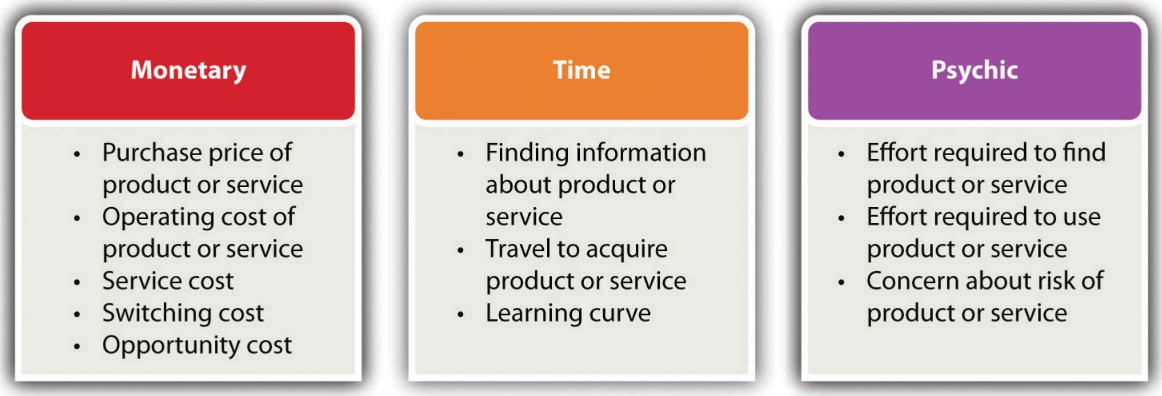
1. ***Functional value*** relates to the product's or the service's ability to perform its utilitarian purpose. Woodruff (1997) identified that functional value can have several dimensions.[14] One dimension would be performance related. This relates to characteristics that would have some degree of measurability, such as appropriate performance, speed of service, quality, or reliability. A car may be judged on its miles per gallon or the time to go from zero to sixty miles per hour. These concepts can also be seen when evaluating a garage that is performing auto repairs. Customers have an expectation that the repairs will be done correctly, that the car will not have to be brought back for additional work on the same problem, and that the repairs will be done in a reasonable amount of time. Another dimension of functional value might consider the extent to which the product or the service has the correct features or characteristics. In considering the purchase of a laptop computer, customers may compare different models on the basis of weight, battery lifetime, or speed. The notion of features or characteristics can be, at times, quite broad. Features might include aesthetics or an innovation component. Some restaurants will be judged on their ambiance; others may be judged on the creativity of their cuisine. Another dimension of functional value may be related to the final outcomes produced by a business. A hospital might be evaluated by its number of successes in carrying out a particular surgical procedure.
2. ***Social value*** involves a sense of relationship with other groups by using images or symbols. This may appear to be a rather abstract concept, but it is used by many businesses in many ways. Boutique clothing stores often try to convey a chic or trendy environment so that customers feel that they are on the cutting edge of fashion. Rolex watches try to convey the sense that their owners are members of an economic elite. Restaurants may alter their menus and decorations to reflect a particular ethnic cuisine. Some businesses may wish to be identified with particular causes. Local businesses may support local Little League teams. They may promote fundraising for a particular charity that they support. A business, such as Ben & Jerry's Ice Cream, may emphasize a commitment to the environment or sustainability.
3. ***Emotional value*** is derived from the ability to evoke an emotional or an affective response. This can cover a wide range of emotional responses. Insurance companies and security alarm businesses are able to tap into both fear and the need for security to provide value. Some theme parks emphasize the excitement that customers will experience with a range of rides. A restaurant may seek to create a romantic environment for diners. This might entail the presence of music or candlelight. Some businesses try to remind customers of a particular emotional state. Food companies and restaurants may wish to stimulate childhood memories or the comfort associated with a home-cooked meal. Häagen-Dazs is currently producing a line of all-natural ice cream with a limited number of natural flavors. It is designed to appeal to consumers' sense of nostalgia.[15]
4. ***Epistemic value*** is generated by a sense of novelty or simple fun, which can be derived by inducing curiosity or a desire to learn more about a product or a service. Stew Leonard's began in the 1920s as a small dairy in Norwalk, Connecticut. Today, it is a $300 million per year enterprise of consisting of four grocery stores. It has been discussed in major management textbooks. These accomplishments are due to the desire to turn grocery shopping into a "fun" experience. Stew Leonard's uses a petting zoo, animatronic figures, and costumed characters to create a unique shopping environment. They use a different form of layout from other grocery stores. Customers are required to follow a fixed path that takes them through the entire store. Thus customers are exposed to all items in the store. In 1992, they were awarded a Guinness Book world record for generating more sales per square foot than any food store in the United States. [16] Another example of a business that employs epistemic value is Rosetta Stone, a company that sells language-learning software. Rosetta Stone emphasizes the ease of learning and the importance of acquiring fluency in another language through its innovative approach.
5. ***Conditional value*** is derived from a particular context or a sociocultural setting. Many businesses learn to draw on shared traditions, such as holidays. For the vast majority of Americans, Thanksgiving means eating turkey with the family. Supermarkets and grocery stores recognize this and increase their inventory of turkeys and other foods associated with this period of the year. Holidays become a basis for many retail businesses to tap into conditional value.

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

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

   As previously pointed out, the notion of perceived customer value has two components—perceived value benefits and perceived value costs. When examining the cost component, customers need to recognize that it is more than just the cost of purchasing a product or a service. Perceived cost should also be seen having multiple dimensions (see Figure 4.3 "Components of Customer Value").

Figure 4.3 Components of Customer Value



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

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

The ***psychic component*** of cost can be associated with those factors that might induce stress on the customer. There can be stress associated with finding or evaluating products and services. In addition, products or services that are difficult to use or require a long time to learn how to use properly can cause stress on customers. Campbell's soup introduced a meal product called Souper Combos, which consisted of a sandwich and a cup of soup. At face value, one would think that this would be a successful product. Unfortunately, there were problems with the demands that this product placed on the customer in terms of preparing the meal. The frozen soup took twice as long to microwave as anticipated, and the consumer had to repeatedly insert and remove both the soup and the sandwich from the microwave.[17]

In summary, business owners need to constantly consider how they can enhance the benefits component while reducing the cost components of the value equation. Table 4.1 "Components of Perceived Benefit and Perceived Cost" summarizes the subcomponents of perceived value, the types of firms that emphasize those components, and the activities that might be necessary to either enhance benefits or reduce costs.

Table 4.1 Components of Perceived Benefit and Perceived Cost

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

Video Clip 4.1- Customer Value

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What creates a customer experience of value?

Video Clip 4.2- Creating Customer Value

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

Video Clip 4.3- Simple Rules: Three Logics of Value Creation

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Three core logics of the value proposition.

Video Clip 4.4- Articulating Your Value Proposition

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

Different Customers—Different Definitions

It is a cliché to say that people are different; nonetheless, it is true to a certain extent. If all people were totally distinct individuals, the notion of customer value might be an interesting intellectual exercise, but it would be absolutely useless from the standpoint of business because it would be impossible to identify a very unique definition of value for every individual. Fortunately, although people are individuals, they often operate as members of groups that share similar traits, insights, and interests. This notion of customers being members of some type of group becomes the basis of the concept known as market segmentation. It involves recognizing that the market at large is not homogeneous. This involves dividing the market into several portions that are different from each other. [18] It simply involves recognizing that the market at large is not homogeneous. There can be several dimensions along which a market may be segmented: geography, demographics, psychographics, or purchasing behavior. Geographic segmentation can be done by global or national region, population size or density, or even climate. Demographic segmentation divides a market on factors such as gender, age, income, ethnicity, or occupation. Psychographic segmentation is carried out on dimensions that reflect differences in personality, opinions, values, or lifestyle. Purchasing behavior can be another basis for segmentation. Differences among customers are determined based on a customer's usage of the product or the service, the frequency of purchases, the average value of purchases, and the status as a customer—major purchaser, first-time user, or infrequent customer. In the business-to-business (B2B) environment, one might want to segment customers on the basis of the type of company.

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

Video Clip 4.5- Tom Peters: The Biggest Underserved Markets

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

Key Takeaways

- Essential to the success of any business is the need to correctly identify customer value.
- Customer value can be seen as the difference between a customer's perceived benefits and the perceived costs.
- Perceived benefits can be derived from five value sources: functional, social, emotional, epistemic, and conditional.
- Perceived costs can be seen as having three elements: monetary, time, and psychic.
- To better provide value to customers, it may be necessary to segment the market.
- Market segmentation can be done on the basis of demographics, psychographics, or purchasing behavior.

Exercises

Frank's All-American BarBeQue

Robert Rainsford is a twenty-eight-year-old facing a major turning point in his life. He has found himself unemployed for the first time since he was fifteen years old. Robert holds a BS degree in marketing from the University of Rhode Island. After graduation, a firm that specialized in developing web presences for other companies hired him. He worked for that firm for the last seven years in New York City. Robert rose rapidly through the company's ranks, eventually becoming one of the firm's vice presidents. Unfortunately, during the last recession, the firm suffered significant losses and engaged in extensive downsizing, so Robert lost his job. He spent months looking for a comparable position, yet even with an excellent résumé, nothing seemed to be on the horizon. Not wanting to exhaust his savings and finding it impossible to maintain a low-cost residence in New York City, he returned to his hometown in Fairfield, Connecticut, a suburban community not too far from the New York state border.

He found a small apartment near his parents. As a stopgap measure, he went back to work with his father, who is the owner of a restaurant—Frank's All-American BarBeQue. His father, Frank, started the restaurant in 1972. It is a midsize restaurant—with about eighty seats—that Frank has built up into a relatively successful and locally well-known enterprise. The restaurant has been at its present location since the early 1980s. It shares a parking lot with several other stores in the small mall where it is located. The restaurant places an emphasis on featuring the food and had a highly simplified décor, where tables are covered with butcher paper rather than linen tablecloths. Robert's father has won many awards at regional and national barbecue cook-offs, which is unusual for a business in New England. He has won for both his barbecue food and his sauces. The restaurant has been repeatedly written up in the local and New York papers for the quality of its food and the four special Frank's All-American BarBeQue sauces. The four sauces correspond to America's four styles of barbecue—Texan, Memphis, Kansas City, and Carolina. In the last few years, Frank had sold small lots of these sauces in the local supermarket.

As a teenager, Robert, along with his older sister Susan, worked in his father's restaurant. During summer vacations while attending college, he continued to work in the restaurant. Robert had never anticipated working full-time in the family business, even though he knew his father had hoped that he would do so. By the time he returned to his hometown, his father had accepted that neither Robert nor Susan would be interested in taking over the family business. In fact, Frank had started to think about selling the business and retiring. However, Robert concluded that his situation called for what he saw as desperate measures.

Initially, Robert thought his employment at his father's business was a temporary measure while he continued his job search. Interestingly, within the first few weeks he returned to the business, he felt that he could bring his expertise in marketing—particularly his web marketing focus—to his father's business. Robert became very enthusiastic about the possibility of fully participating in the family business. He thought about either expanding the size of the restaurant, adding a takeout option, or creating other locations outside his hometown. Robert looked at the possibility of securing a much larger site within his hometown to expand the restaurant's operations. He began to scout surrounding communities for possible locations. He also began to map out a program to effectively use the web to market Frank's All-American BarBeQue sauce and, in fact, to build it up to a whole new level of operational sophistication in marketing.

Robert recognized that the restaurant was as much of a child to his father as he and his sister were. He knew that if he were to approach his father with his ideas concerning expanding Frank's All-American BarBeQue, he would have to think very carefully about the options and proposals he would present to his father. Frank's All-American BarBeQue was one of many restaurants in Fairfield, but it is the only one that specializes in barbecue. Given the turnover in restaurants, it was amazing that Frank had been able to not only survive but also prosper. Robert recognized that his father was obviously doing something right. As a teenager, he would always hear his father saying the restaurant's success was based on "giving people great simple food at a reasonable price in a place where they feel comfortable." He wanted to make sure that the proposals he would present to his father would not destroy Frank's recipe for success.

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

Knowing Your Customers

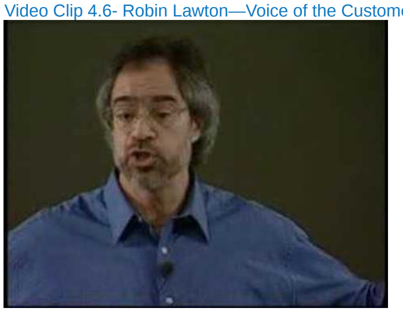
Learning Objectives

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

The perceived value proposition offers a significant challenge to any business. It requires that a business have a fairly complete understanding of the customer's perception of benefits and costs. Although market segmentation may help a business better understand some segments of the market, the challenge is still getting to understand the customer. In many cases, customers themselves may have difficulty in clearly understanding what they perceive as the benefits and costs of any offer. How then is a business, particularly a small business, to identify this vital requirement? The simple answer is that a business must be open to every opportunity to listen to the **voice of the customer (VOC)**. This may involve actively talking to your customers on a one-to-one basis, as illustrated by

Robert Brown, the small business owner highlighted at the beginning of this chapter. It may involve other methods of soliciting feedback from your customers, such as satisfaction surveys or using the company's website. Businesses may engage in market research projects to better understand their customers or evaluate proposed new products and services. Regardless of what mechanism is used, it should serve one purpose—to better understand the needs and wants of your customers.

Video Clip 4.6- Robin Lawton—Voice of the Customer—What Do Customers Value?



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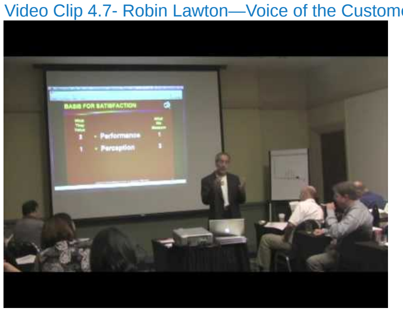
International Management Technologies introduces Robin Lawton on the topic of "What Do Customers Value?"

Video Clip 4.7- Robin Lawton—Voice of the Customer—Basis for Satisfaction Keynote



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

Research

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

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

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

Who Your Customer Is—and Is Not

At the beginning of this chapter, it was argued that your central focus must be the customer. One critical way that this might be achieved is by providing a customer with superior value. However, creating this value must be done in a way that assures that the business makes money. One way of doing this is by identifying and selecting those customers who will be profitable. Some have put forth the concept of **customer lifetime value**, a measure of the revenue generated by a customer, the cost generated for that particular customer, and the projected retention rate of that customer over his or her lifetime. [19],[20]

This concept is popular enough that there are lifetime value calculator templates available on the web. The Harvard Business School created the calculator used in Exercise 2.1. It looks at the cost of acquiring a customer and then computes the **net present value.** It recognizes the time value of money. of the customer during his or her lifetime. Net present value discounts the value of future cash flows. It recognizes the time value of money. You can use one of two models: a simple model that examines a single product or a more complex model with additional variables. One of the great benefits in conducting customer lifetime value analysis is combining it with the notion of market segmentation. The use of market segmentation allows for recognizing that certain classes of customers may produce significantly different profits during their lifetimes. Not all customers are the same.

Let us look at a simple case of segmentation based on behavioral factors. Some customers make more frequent purchases; these loyal customers may generate a disproportionate contribution of a firm's overall profit. It has been estimated that only 15 percent of American customers have loyalty to a single retailer, yet these customers generate between 55 percent and 70 percent of retail sales. [21] Likewise, a lifetime-based economic analysis of different customer segments may show that certain groups of customers actually cost more than the revenues that they generate.

Having segmented your customers, you will probably find that some require more handholding during and after the sale. Some customer groups may need you to "tailor" your product or service to their needs.[22] As previously mentioned, market segmentation can be done along several dimensions. Today, some firms use data mining to determine the basis of segmentation, but that often requires extensive databases, software, and statisticians. One simple way to segment your customers is the customer value matrix that is well suited for small retail and service businesses. It uses just three variables: recency, frequency, and monetary value. Its data requirements are basic. It needs customer identification, the date of purchase, and the total amount of purchase. This enables one to easily calculate the average purchase amount of each customer. From this, you can create programs that reach out to particular segments.[23]

Video Clip 4.8- Customer Lifetime Value

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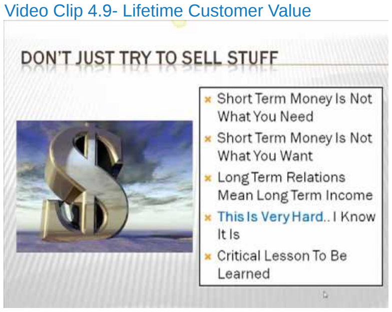
Jack Daly presents the "client for life" concept, featuring Continuity Programs BCL programs of customer loyalty outsourced service.

Video Clip 4.9- Lifetime Customer Value



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

What Your Gut Tells You

The role of market research was already discussed in this chapter. For many small businesses, particularly very small businesses, formal market research may pose a problem. In many small businesses, there may be a conflict between decision making made on a professional basis and decision making made on an instinctual basis.[24] Some small business owners will always decide based on a gut instinct. We can point to many instances in which gut instinct concerning the possible success in product paid off, whereas a formal market research evaluation might consider the product to be a nonstarter.

In 1975, California salesman Gary Dahl came up with the idea of the ideal pet—a pet that would require minimal care and cost to maintain. He developed the idea of the pet rock. This unlikely concept became a fad and a great success for Dahl. Ken Hakuta, also known as Dr. Fad, developed a toy known as the Wallwalker in 1983. It sold over 240 million units. [25] These and other fad products, such as the Cabbage Patch dolls and Rubik's Cube, are so peculiar that one would be hard pressed to think of any marketing research that would have indicated that they would be viable, let alone major successes.

Sometimes it is an issue of having a product idea and knowing where the correct market for the product will be. Jill Litwin created *Peas a Pie Pizza*, which is a natural food pizza pie with vegetables baked in the crust. She knew that the best place to market her unique product would be in the San Francisco area with its appreciation of organic foods.[26]

This notion of going with one's gut instinct is not limited to fad products. Think of the birth of Apple Computer. The objective situation was dealing with a company whose two major executives were college dropouts. The business was operating out of the garage of the mother of one of these two executives. They were producing a product that up to that point had only a limited number of hobbyists as a market. None of this would add up to very attractive prospect for investment. You could easily envision a venture capitalist considering a possible investment asking for a market research study that would identify the target market(s) for its computers. None existed at the company's birth. Even today, there is a strong indication that Apple does not rely heavily on formal marketing research. As Steve Jobs put it:[27]

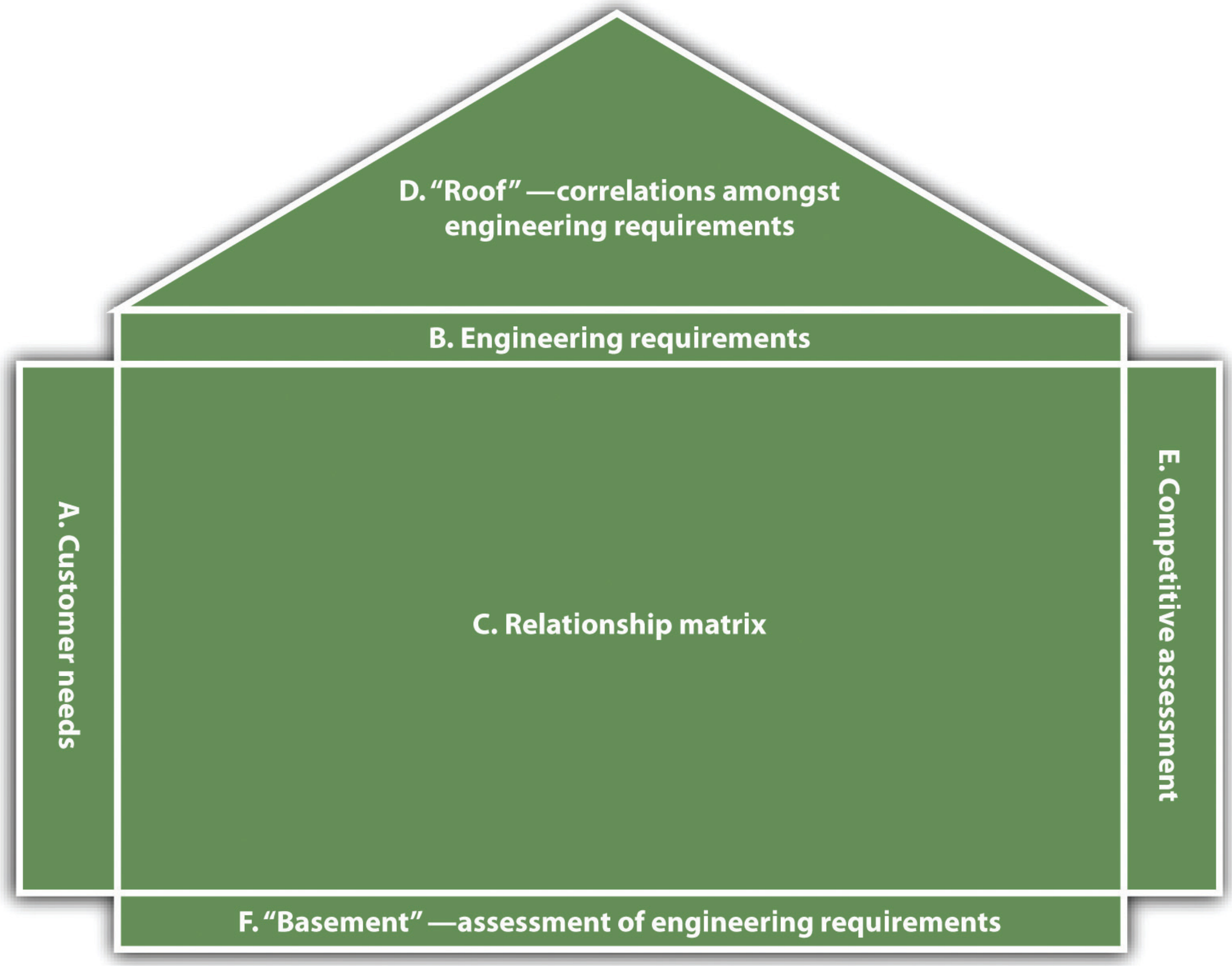
It's not about pop culture, it's not about fooling people, and it's not about convincing people that they want something they don't. We figure out what we want. And I think we're pretty good at having the right discipline to think through whether a lot of other people are going to want it, too. That's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

The Voice of the Customer—QFD

Quality function deployment (QFD) is an approach that is meant to take the VOC concept seriously and uses it to help design new products and services or improve existing ones. It is an approach that was initially developed in Japan for manufacturing applications. It seeks "to transform user demands into design quality, to deploy the functions forming quality, and to deploy methods for achieving the design quality into subsystems and component parts, and ultimately to specific elements."[28] To put it more clearly, QFD takes the desires of consumers and explores how well the individual activities of the business are meeting those desires. It also considers how company activities interact with each other and how well the company is meeting those customer desires with respect to the competition. It achieves all these ends through the means of a schematic; see Figure 4.4 "House of Quality", which is known as the house of quality. The schematic provides the backbone for the entire QFD process. A comprehensive design process may use several houses of quality, moving from the first house, which concentrates on the initial specification of customer desires, all the way down to developing a house that focuses on the specification for parts or processes. Any house is composed of several components:

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

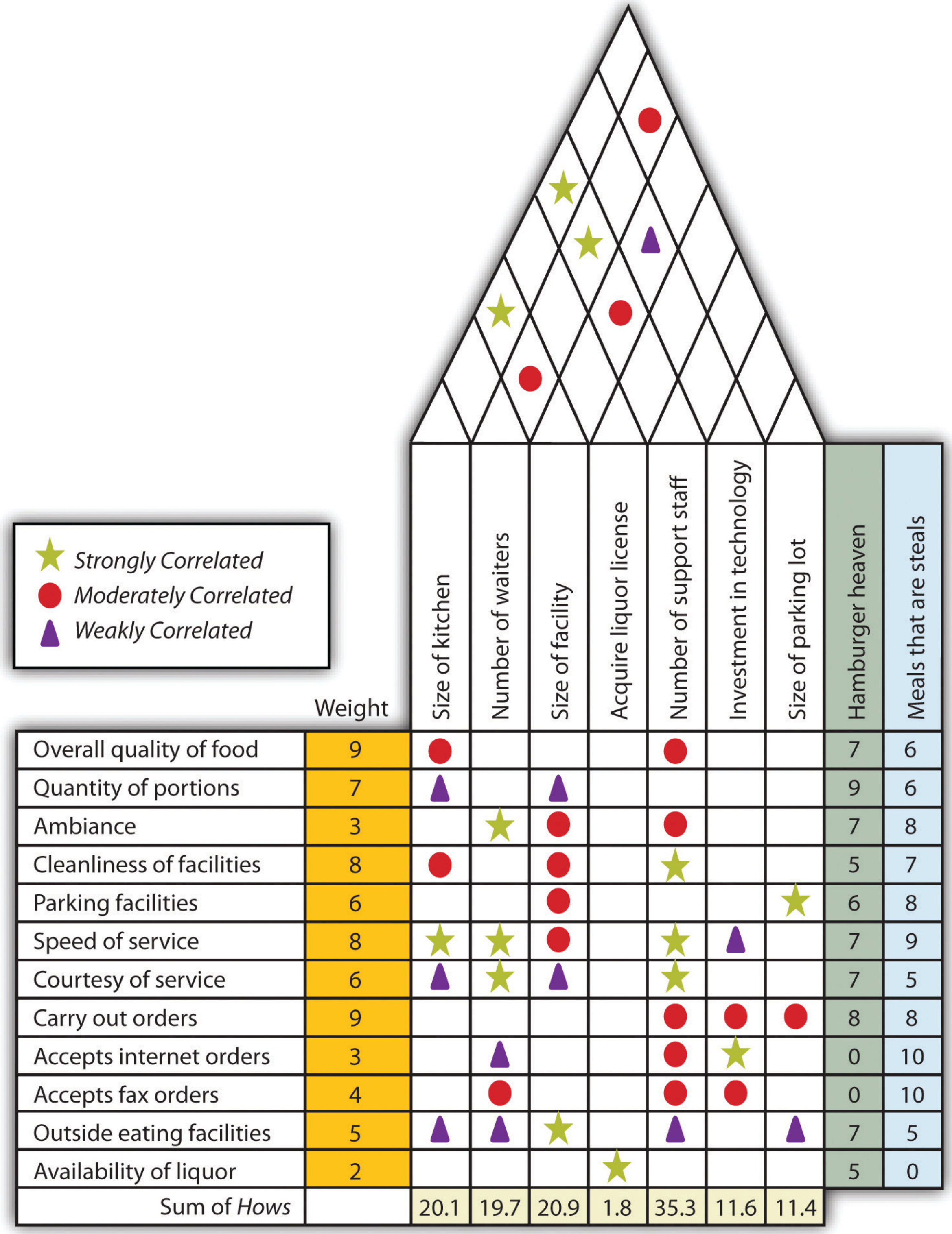
Figure 4.4 House of Quality



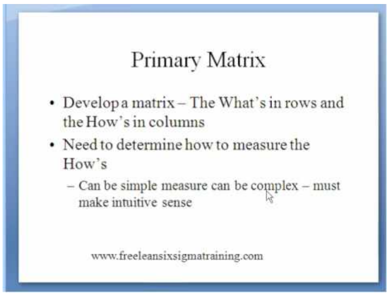
Although it might initially appear to be complex, QFD provides many benefits, including the following: (1) reduces time and effort during the design phase, (2) reduces alterations in design, (3) reduces the entire development time, (4) reduces the probability of inept design, (5) assists in team development, and (6) helps achieve common consensus.[29]

Unfortunately, QFD is most often associated with manufacturing. Few realize that it has found wide acceptance in many other areas—software development, services, education, amusement parks, restaurants, and food services. [30] Further, company size should not be seen as a limitation to its possible application. The QFD approach, in a simplified form, can be easily and successfully used by any business regardless of its size [31]. Its visual nature makes it extremely easy to comprehend, and it can convey to all members of the business the relative importance of the elements and what they do to help meet customers' expectations. Figure 4.5 "Simplified House of Quality for a Restaurant" illustrates this by providing a simplified house of quality chart for a restaurant.

Figure 4.5 Simplified House of Quality for a Restaurant



Video Clip 4.10- Quality Function Deployment Tutorial



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This gives a brief overview of QFD.

QFD Analysis and Excel

Some companies provide Excel-based software that can assist in conducting a QFD analysis. This shows a template in the QI Macros software to help structure your thinking, making sure nothing is left out.[32]

How to Become a Better Listener

Although some succeed by listening to their instincts—their inner voices—it is highly advisable to all businesses to be proactive in trying to listen to the VOC. Listening to the customer is the domain of market research. However, it should not be surprising that many small businesses have severe resource constraints that make it difficult for them to use complex and sophisticated marketing and market research approaches. [33] To some extent, this is changing with the introduction of powerful, yet relatively low cost, web-based tools and social media. These will be discussed in greater detail in Section 2.4.2 "Digital Technology and E-Environment Implications" of this chapter. Another restriction that a small business may face in the area of marketing is that the owner's marketing skills and knowledge may not be very extensive. The owners of such firms may opt for several types of solutions. They may try to mimic the marketing techniques employed by larger organizations, drawing on what was just mentioned. They may opt for sophisticated but easy to use analytical tools, or they may just simply take marketing tools and techniques and apply them to the small business environment.[34]

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

Other ways of listening to customers are through comment cards and paper and online surveys. These approaches have their strengths and limitations (see Note 2.31 "Video Clip 2.11"). Regardless of these limitations, they do provide an insight into your customers. Another way one can gather information about customers is through loyalty programs. Loyalty programs are used by 81 percent of US households.[35] Social media options—see Section 2.4.2 "Digital Technology and E-Environment Implications"—offer a tremendous opportunity to not only listen to your customer but also engage in an active dialog that can build a sustainable relationship with customers.

Video Clip 4.11- Listen to Your Customers and Express How Much You Care

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

Video Clip 4.12- Ask, Listen, and Retain Video #4: Listening and Analyzing What Your Customers Say?

https://youtube.com/watch?v=_fIGefvkT_0

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

Website

Cisco Website for Innovation; A web forum for small businesses to share information [36]

Key Takeaways

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

Exercises

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

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

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

Sources of Business Ideas

Learning Objectives

1. Understand that creativity and innovation are critical for small businesses.
2. Realize that innovation need not be limited to the creation of new products and services. It may involve seeing new uses for a product, new ways of packaging a product, or new ways of marketing a product.
3. Understand that creativity and innovation must be nurtured in any organization and that there are several areas small businesses must learn to avoid in order to promote creativity.
4. Realize that small businesses should be aware of social and consumer trends, which has been made easier because of the existence of online data sources.

Small businesses have always been a driver of new products and services. Many products and inventions that we might commonly associate with large businesses were originally created by small businesses, including air-conditioners, Bakelite, the FM radio, the gyrocompass, the high resolution computed axial tomography scanner, the outboard engine, the pacemaker, the personal computer, frozen food, the safety razor, soft contact lenses, and the zipper.[37] This creativity and innovative capability probably stems from the fact that smaller businesses, which may lack extensive financial resources, bureaucratic restraints, or physical resources, may find a competitive edge by providing customers value by offering new products and services. It is therefore important to consider how small businesses can foster a commitment to creativity and innovation.

Creativity and Innovation

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

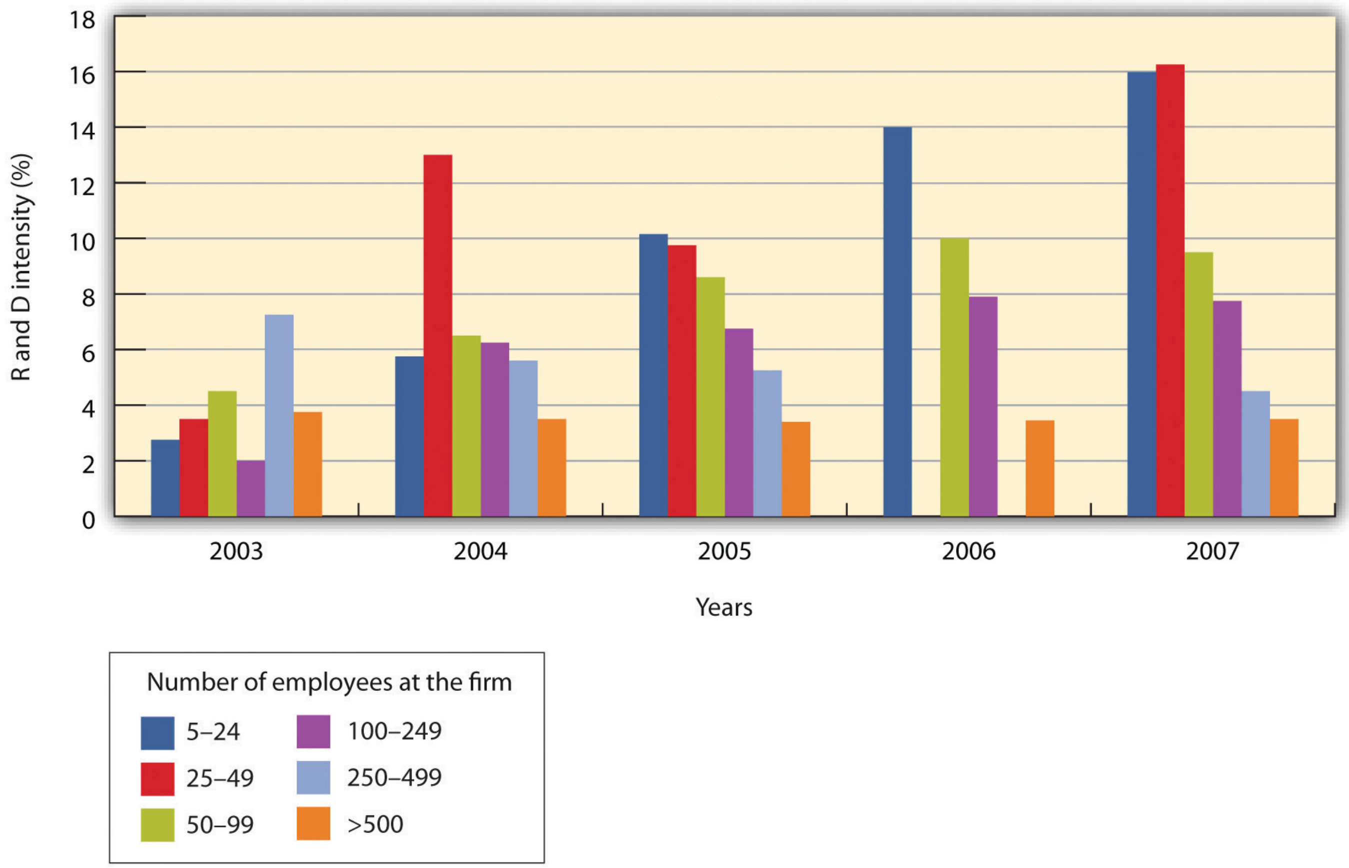
Although some would argue that there is a difference between creativity and innovation, one would be hard pressed to argue that creativity is not required to produce innovative means of constructing customer value. An entire chapter, even an entire book, could be devoted to fostering creativity in a small business. This text will take a different track; it will look at those factors that might inhibit or kill creativity. Alexander Hiam (1998) identified nine factors that can impede the creative mind-set in organizations: [38]

1. **Failure to ask questions.** Small-business owners and their employees often fail to ask the required *why*-type questions.
2. **Failure to record ideas.** It does not help if individuals in an organization are creative and produce a large number of ideas but other members of the organization cannot evaluate these ideas. Therefore, it is important for you to record and share ideas.
3. **Failure to revisit ideas.** One of the benefits of recording ideas is that if they are not immediately implemented, they may become viable at some point in the future.
4. **Failure to express ideas.** Sometimes individuals are unwilling to express new ideas for fear of criticism. In some organizations, we are too willing to critique an idea before it is allowed to fully develop.
5. **Failure to think in new ways.** This is more than the cliché of "thinking outside the box." It involves new ways of approaching and looking at the problem of providing customer value.
6. **Failure to wish for more.** Satisfaction with the current state of affairs or with the means of solving particular problems translates into an inability to look at new ways of providing value to customers.
7. **Failure to try to be creative.** Many people mistakenly think that they are not at all creative. This means you will never try to produce new types of solutions to the ongoing problems.
8. **Failure to keep trying.** When attempting to provide new ways to create customer value, individuals are sometimes confronted with creative blocks. Then they simply give up. This is the surest way to destroy the creative thinking process.
9. **Failure to tolerate creative behavior.** Organizations often fail to nurture the creative process. They fail to give people time to think about problems; they fail to tolerate the "odd" suggestions from employees and limit creativity to a narrow domain.

One of the great mistakes associated with the concept of innovation is that innovation must be limited to highly creative individuals and organizations with large research and development (R&D) facilities. [39] The organization's size may have no bearing on its ability to produce new products and services. More than a decade ago, studies began to indicate that small manufacturing firms far exceeded their larger counterparts with respect to the number of innovations per employee.[40]

A more recent study, which covered the period from 2003 to 2007, showed that R&D performance by small US companies grew slightly faster than the comparable performance measures for larger US firms. During that period, small firms increased their R&D spending by more than 40 percent, compared to an approximate 33 percent increase for large companies. These smaller firms also increased their employment of scientists and engineers at a rate approximately 75 percent greater than larger companies. Further, the results of this study, which are presented in Figure 4.6 "R&D Intensity by Firm Size", illustrate that particularly since 2004, smaller businesses have outpaced their larger rivals with respect to R&D intensity. The term R&D intensity refers to the current dollars spent on R&D divided by a company's reported sales revenue.[41]

Figure 4.6 R&D Intensity by Firm Size



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

- In 1965, Thomas Angove, an Australian winemaker, developed the idea of packaging wine in boxes that had a polyethylene bladder. The package was not only more convenient to carry but also kept the wine fresher for a longer period of time. [42]
- Apple's iPod was certainly an innovative product, but its success was clearly tied to the creation of the iTunes website that provided content.
- Baker Tweet alerts customers via Twitter any time a fresh batch of baked goods emerge from a participating baker's oven.[43]
- Patrons at Wagaboo restaurants in Madrid can book specific tables online.[44]
- Restaurants often mark up bottles of wine by 200 percent to 300 percent. Several restaurants in New York, Sydney, and London have developed relationships with wine collectors. The collectors may have more wine than they can possibly drink, so they offer the wine for sale in the restaurant, with the restaurant selling it at a straightforward markup of 35 percent. This collaboration with customers is beneficial for the wine collector, the restaurant, and the customer.

Video Clip 4.13- Vijay Govindarajan: Innovation Is Not Creativity

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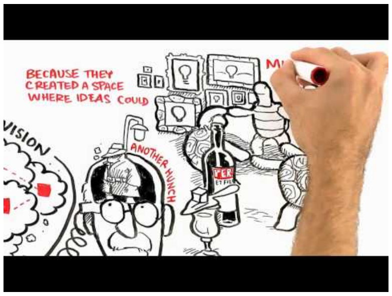
An interview with Vijay Govindarajan on the difference between creativity and innovation.

Video Clip 4.14- Where Good Ideas Come From



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This cartoon was developed for Steven Johnson's book on innovation. He concluded that with today's tools and environment, radical innovation is extraordinarily accessible to those who know how to cultivate it. *Where Good Ideas Come From* is essential reading for anyone who wants to know how to come up with tomorrow's great ideas.

Video Clip 4.15- Steven Johnson: Where Good Ideas Come From

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=48

This relatively long presentation (eighteen minutes) by Steven Johnson maps out the ideas presented in his book.

Video Clip 4.16- Encouraging Innovation with Employees: Innovators Forum Guest Danika Davis

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Danika Davis, Innovators Forum guest and CEO of the Northern California Human Resources Association, discusses the ways to reward innovation among employees and how to foster innovation in your small business.[45]

Video Clip 4.17- Creating an Innovation Mind-set

https://youtube.com/watch?v=sNzkmZdM4A4

Vijay Govindarajan discusses that to create an innovation mind-set, managers must bring in fresh voices from outside the company, encourage collaboration, and consider how emerging market needs can spur ideas for innovative offerings.

Video Clip 4.18- Tom Peters: Innovation Is Actually Easy!

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Tom Peters declares war on the worthless rules and absurd organizational barriers that stand in the way of creativity and success.

Video Clip 4.19- How to Spot Disruptive Innovation Opportunities

https://youtube.com/watch?v=KGzXWO_anLI

Disruptive innovation occurs when an innovator brings something to market that is simple, convenient, accessible, and affordable. Here are some tips to help you pinpoint disruptive opportunities within your organization.

Social and Consumer Trends

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

Trends differ from fads. Fads may delight customers, but by their very nature, they have a short shelf life. Trends, on the other hand, may be a portend of the future. [46] Smaller businesses may be in a position to better exploit trends. Their smaller size can give them greater flexibility; because they lack an extensive bureaucratic structure, they may be able to move with greater rapidity. The great challenge for small businesses is to be able to correctly identify these trends in a timely fashion. In the past, businesses had to rely on polling institutes for market research as a way of attempting to identify social trends. Harris Interactive produced a survey about the obesity epidemic in America. This study showed that the vast majority of Americans over the age of 25 are overweight. The percentage of those overweight has steadily increased since the early 1980s. The study also indicated that a majority of these people desired to lose weight. This information could be taken by the neighborhood gym, which could then create specialized weight-loss programs. Recognizing this trend could lead to a number of different products and services.[47]

In the past, the major challenge for smaller businesses to identify or track trends was the expense. These firms would have to use extensive market research or clipping services. Today, many of those capabilities can be provided online, either at no cost or a nominal cost.[48] Google Trends tracks how often a particular topic has been searched on Google for a particular time horizon. The system also allows you to track multiple topics, and it can be refined so that you can examine particular regions with these topics searched. The data are presented in graphical format that makes it easy to determine the existence of any particular trends. Google Checkout Trends monitors the sales of different products by brand. One could use this to determine if seasonality exists for any particular product type. Microsoft's AdCenter Labs offers two products that could be useful in tracking trends. One tool—Search Volume—tracks searches and also provides forecasts. Microsoft's second tool—Keyword Forecast—provides data on actual searches and breaks it down by key demographics. Facebook provides a tool called Lexicon. It tracks Facebook's communities' interests. (Check out the Unofficial Facebook Lexicon Blog for a description on how to fully use Lexicon.) The tool Twist tracks Twitter posts by subject areas. Trendpedia will identify articles online that refer to particular subject areas. These data can be presented as a trend line so that one can see the extent of public interest over time. The trend line is limited to the past three months. Trendrr tracks trends and is a great site for examining the existence of trends in many areas.

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

Websites

- Google Trends: www.google.com/trends
- Microsoft AdCenter Labs: adlab.microsoft.com
- Microsoft AdCenter Labs Keyword Forecast: adlab.microsoft.com/Keyword-Forecast/default.aspx
- Unofficial Facebook Lexicon Blog: www.facebooklexicon.com
- Twitter Grader: http://tweet.grader.com
- Trendpedia: www.attentio.com
- BuzzMetrics: http://www.nmincite.com/wp-content/uploads/2010/06/MyBuzzMetrics.pdf
- NielsenBuzzMetrics: nielsen-online.com/products_buzz.jsp?section=pro_buzz
- Trendrr: www.trendrr.com
- Google Analytics: code.google.com/apis/checkout/developer/checkout_analytics_integration.html

Key Takeaways

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

Exercises

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

The Three Threads

Learning Objectives

1. Understand that providing customer value can have a tremendous positive impact on a firm's cash flow.
2. Understand that determining customer value is critical to the survival of any business. Customer relationship marketing software, which previously was available only to the largest firms, is now priced so that even small firms can extract their benefit.

Focusing on Providing Value to the Customer

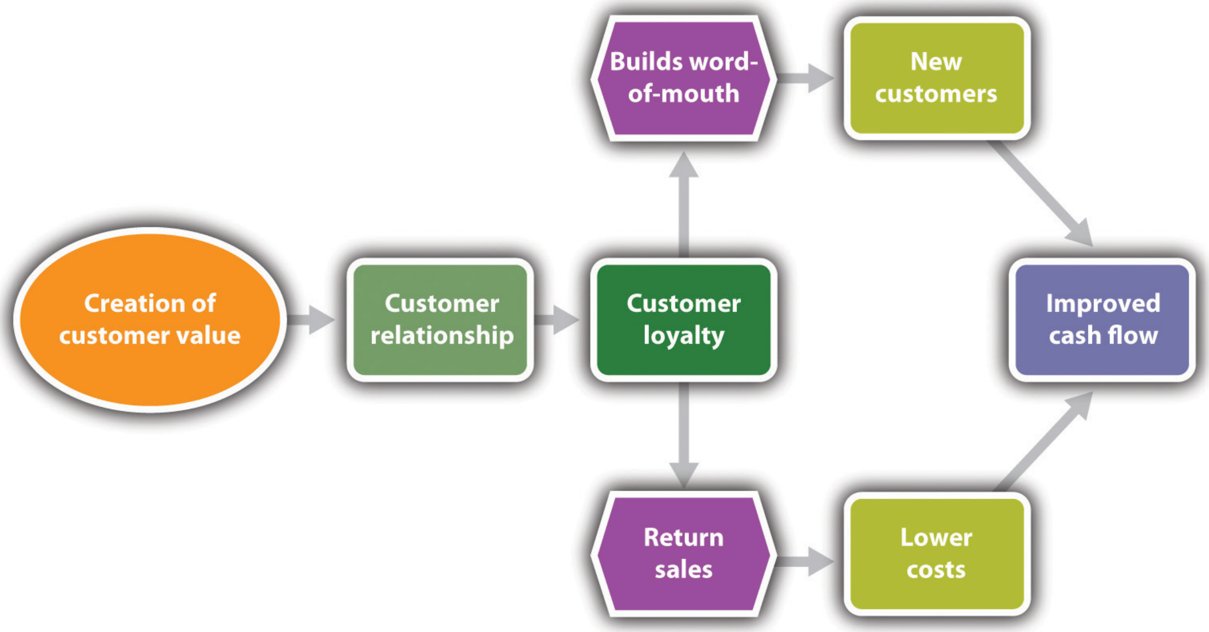
The entire thrust of this chapter has been on the topic of customer value. The essence of the argument presented in this chapter has been that any business that fails to provide perceived customer value is a business that will probably fail.

Value's Impact on Cash Flow

It is not that difficult to envision how the successful creation of customer value can significantly enhance a firm's cash flow. Firms that are successful in correctly identifying the sources of value should be able to provide superior customer value. This may produce a direct relationship with their customers. These relationships produce a back-and-forth flow of information that should enable the business to further enhance its ability to provide customer value. A successful relationship enhances the probability of customer loyalty, hopefully building a strong enough relationship to produce a customer for life.

Customer loyalty can have several positive outcomes. Loyalty will result in increased sales from particular customers. This does more than generate additional revenue; as the business comes to better understand its loyal customers, the cost of serving those customers will decrease. Increased sales, with declining costs, translate into a significant boost in cash flow. Customer loyalty also has the benefit of generating positive word-of-mouth support for a business. Word-of-mouth advertising can be one of the most powerful forms of advertising and can be seen as a form of free advertising. It has been estimated that word-of-mouth advertising is the primary factor in 20–50 percent of all purchasing decisions. A study by the US office of consumer affairs (formally known as the Federal Trade Commission) indicated that satisfied customers are likely to tell five other customers about their positive experiences.[49] It is particularly powerful in the case of first-time buyers or with expensive items and those items that require extensive research before purchase.[50] Positive word-of-mouth advertising coming from loyal customers can generate additional sales, which in turn enhances cash flow. The creation of superior customer value combined with an intelligent cost control system inevitably produces superior cash flow.

Figure 4.7 Superior Cash Flow as a Result of Superior Customer Value



Digital Technology and E-Environment Implications

In the last decade, firms desiring to better understand the customer's notion of perceived value relied on customer relationship management (CRM) software. ***Customer relationship management*** refers to a service approach that hopes to build a long-term and sustainable relationship with customers that has value for both the customer and the company. It is a generic term covering different software and browser applications that collect information about customers and organize it in a way that may be used effectively by management. This term will be referred to repeatedly throughout this text. CRM can assist small businesses with respect to customer value in the following ways: [51]

- It can assist in identifying and targeting the best customers of a business.
- It can help a company develop individualized relationships with customers, thus improving customer satisfaction.
- It can improve customer service, particularly with the best customers.
- It can help management and employees better understand customers and therefore deliver better value to them.

Although originally designed for large corporations with large budgets, CRM is now available to many firms in the small business environment. In addition to being expensive, original fees-first CRM packages were far too complex for small businesses. [52] Now there are many CRM packages that are specifically dedicated to the small business environment.

To maximize the benefits of the CRM package, several factors should be considered. Small businesses should have a clear idea as to their requirements for the CRM solution. Some questions that should be considered are as follows:[53]

- Is our focus on increasing the number of customers?
- Are we attempting to improve our relationships with our customers?
- Will the CRM package help us with e-mail marketing?
- How are we seeking to more effectively use the Internet to communicate with our customers?
- Will we be able to integrate social media?

In some ways, integrating the CRM package may be easier in the small business than in large business because you can overcome some bureaucratic hurdles. However, you must always recognize that the successful implementation of any software package is highly dependent on your employees.[54]

Perhaps the greatest incentive for small businesses to adopt CRM packages is the advent of cloud computing. **Cloud computing**, also known as SaaS (software as a service), refers to the situation in which vendor software does not reside on the computer system of a small business. [55] All aspects of the system, from maintenance to backups, are the responsibility of the vendor. This minimizes the need for computing capability by the small business. Cloud computing can significantly reduce the course of acquiring and maintaining such computer programs.

Key Takeaways

- Focusing on customer value improves customer loyalty, which improves cash flow.
- Customer loyalty can translate into positive word-of-mouth advertising, which increases sales and cash flow.
- Customer value can be improved through the correct use of CRM software.
- CRM software was formerly so complex and expensive that it was suitable for large corporations only. Now it can be used by the smallest of businesses to improve customer value.

Exercises

1. Assume you are managing a small business that is experiencing a very rapid increase in sales. Unfortunately, this increase in sales has been accompanied by an increase in customer complaints that your company is letting "things slip between the cracks." You recognize that the old way of interacting with customers is no longer sufficient. You have a sales force of ten, and you would like to supply each with access to a basic CRM package. Go online and identify several CRM packages that might be appropriate for your business. Specify each package's capabilities and cost. How would you go about selecting one of these packages? Write a report outlining the information you collected and the logic of your selection.

Disaster Watch

The failure to accurately understand a customer's notion of perceived value is the surest recipe for complete disaster. This may be a large requirement because in many cases customers may be quite unsure about their own notion of value or have difficulty in explicitly articulating that notion. One would think that larger firms—those with much greater resources—would be in a better position to clearly identify their customers' notion of value. This does not seem to be the case, however, with all large firms. Even they may stumble in attempting to develop products and services that they believe will meet their customers' concept of value. In this feature, several noticeable product failures are identified. Almost every failure came from a large corporation. This is because we are much more familiar with the failures of large corporations that invest considerable time and effort into the introduction of new products and services. There is far less press given to the failures of small businesses that misread or misunderstand their customers' notion of perceived value.

When Your Notion of Value Is Not the Same as Your Customer's

Perhaps the most famous company failure to adequately gauge customers' notion of value revolved around the introduction of New Coke. In 1985, Coca-Cola was under great pressure, losing market share to its major rival, Pepsi. In an effort to recapture market share, particularly among the younger segment of the market, Coca-Cola initiated one of the largest market research projects of its time. It conducted extensive taste tests throughout the nation and investigated the possibility of introducing a new formula for Coke. The results from the taste tests were positively skewed toward a sweeter version. There was some debate whether this should be an additional option to the Coke line of products or whether it should replace the standard formula for Coke. Although there were some negative indications about this new formula from focus groups, Coke decided to begin a major introduction of New Coke, but it was universally considered a major disaster. Public reaction, particularly in the South, was very negative toward New Coke. A lot of this negative reaction stemmed from the fact that Coke had become an iconic product in the nation, particularly in southern regions. Hundreds of thousands of people called and wrote to Coca-Cola expressing their dissatisfaction with this decision. [56] Coca-Cola failed to recognize the emotional and social components of value for a significant number of its customers.

Many firms fail to realize that they have established, in the eyes of customers, a very strong sense of how a particular company provides value. These companies may wish to diversify their product or service line while at the same time attempting to exploit their brand name. However, customers may perceive the companies as being so closely identified with the original product that any attempt at diversification may be difficult, if not guaranteed to be a failure. Some examples of this are as follows: Smith & Wesson, noted for handguns, attempted to sell a line of mountain bikes in 2002; Coors beer attempted to sell bottled water; and Colgate toothpaste tried to produce a line of products known as Colgate Kitchen Entrées.[57]

Companies may produce products that run directly counter to their customers' notion of perceived value. McDonald's produces value for its customers by offering fast food and a family-friendly environment. Several years ago, in an effort to capture a different segment of the market, McDonald's introduced the Arch Deluxe hamburger, which was supposedly designed for more adult tastes. Even with a $100 million marketing campaign, McDonald's was unable to "sell" this product to its customers.

One health management organization invested more than one third of $1 million on a computerized member information service. The intention was that this would be more efficient, thus providing greater benefit value to customers. Their mistake was not recognizing that members preferred conversing with human beings. Customers did not want to use a computerized system.[58] Although customers of health-care organizations appreciate factors such as ease of access and reliability, they tend to view with greater importance and value the perceived expression of human compassion.

The dry cleaning business industry in the United States is extremely fragmented. The largest 50 firms control only 40 percent of the total industry's business. This translates into a simple fact: dry cleaning is still the domain of small business owners, with nearly 35,000 establishments throughout the United States. A decade ago, two firms wanted to change the structure of the industry. Both companies thought that they would be able to provide unique sources of value to customers. Mixell Technologies operates a franchise—Hanger's Cleaners—that focuses on environmentally responsible dry cleaning. Dry cleaning normally involves some fairly volatile chemicals. Hanger's Cleaners used a new process developed by Mixell Technology. The belief was that customers would respond to this much more environmentally friendly technology. Initially, the cost of this technology was two to three times the cost of normal dry cleaning equipment. One of the major investors in this firm was Ken Langone, a cofounder of Home Depot. In the same time frame, Tom Stemberg, the founder of Staples, was investing in a dry cleaning franchise called Zoots. Their focus on customer value was the ability to have employees pick up clothes for dry cleaning and drop off the clean clothes at the customer's home residence or work.[59] Neither business prospered. Mixell has moved on to other applications of its technologies. Zoots has significantly reduced its number of outlets. The reality was that dry cleaning establishments produce low margins and require long hours and close identification with customers. Unfortunately for both businesses, even though they had an experienced executive staff, they failed to correctly identify the true sources of customer value.[60]

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2.2: Chapter 5- The Search for Efficiency and Effectiveness

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The *small* in small business refers only to the number of employees or the volume of sales. It seldom refers to the level of enthusiasm, the amount of creativity, or the ability to innovate. A great example of this is Carrot Creative, a new social media agency headquartered in the Dumbo section of Brooklyn, New York. Mike Germano and Robert Gaafar started their first company while Mike was a college student and serving as a city councilman in Hamden, Connecticut. They developed sites that enabled students to sell used textbooks and rate their professors. In 2005, they opened Carrot Creative. When it was in its infancy, Carrot Creative was not a traditional marketing agency, and social media barely existed. The social media industry, as a whole, is one of the most innovative and fast-paced industries in the world, forcing companies such as Carrot Creative to stay ahead of the curve and adapt quickly.

From the very beginning, Carrot Creative has been innovative and progressive—not only because of its founders and team members but also out of necessity. It started with no available business model to copy, no rules to follow, and no resources on which to rely. They had one rule: do not accept the status quo. Carrot Creative was designed to become what its founders envisioned and what the market needed. They view themselves as a business that is always open to a challenge. They dare anyone to present them with a problem that they cannot solve. Germano, in a recent interview, put it this way, "We help brands build on social networks, teach them and help them in great ways for them to have conversations with their customers and really turn brands into people."[1]

Some of the brands that they have signed include Crayola, the National Football League, Major League Baseball, AOL, Disney, PepsiCo, Budweiser, the Islands of the Bahamas, and Ford Motor Company. Creative Carrot was the driving force behind Ford's social media campaign for its new Fiesta vehicle. This *small* business has partnerships with some of the world's largest advertising agencies and public relations (PR) firms. They also have the honor to be on the forefront of designing the very tools that define social media. They view their title as an official "Facebook Preferred Developer" as just icing on the cake.

Today, Carrot Creative remains on top of the creative game by giving all its employees the freedom to create in their own way. It keeps creativity flowing by cultivating an environment and culture that removes the idea of micromanaging and gives each Carrot Creative employee the freedom, trust, and responsibility for their own work and actions. One never knows when creativity will strike, but it certainly will not be inside a cubicle or under someone's thumb. Creativity flows through individual expression and personal work style. The Carrot Creative office is designed for just those things. There is space to work on couches, in a room of Astroturf, and private offices with maple desks, and, most importantly, the ability to be freely collaborative. As Germano said, "We appreciate the individual nature of small companies."[2]

Personal Efficiency and Effectiveness

Learning Objectives

1. Recognize the difference between effectiveness and efficiency.
2. Understand the differences among first-, second-, third-, and fourth-generation time-management systems.
3. Learn how using an activity log to see how time is spent.
4. Learn the dos and don'ts of time management.

Open any basic management textbook, and there will always be a discussion of the importance for an organization to be both **effective** and **efficient**. These are fundamental concepts. An organization demonstrates effectiveness when it achieves the outcomes that it wishes to produce. [3] Efficiency is "the capacity of an organization, institution or business to produce the desired results with the minimum expenditure of energy, time, money, personnel, material, etc."[4] In discussing the distinction between the two concepts, Peter Drucker once said, "Efficiency is doing things right; effectiveness is doing the right things."[5] Regardless of the exact definition of these concepts, it should be clear that any business should strive to be both effective and efficient.

It is important to recognize that for any given endeavor, one can be effective but not efficient and vice versa. This can be illustrated with the following example. Two students are working in their college mail room. Each is given a stack of five hundred individual class schedules that are to be sorted and placed in the mailboxes of the undergraduate students. They are told that when they are done, they will be given another job. The first student is meticulous and carefully checks that each class schedule goes to the right recipient. She completes the job in 4.5 hours. The second student is less careful about accuracy and makes several errors by putting the wrong schedule in the wrong box. However, he completes his work in 3 hours. The first student was effective because the task was to get the right schedule to the right student. The second student was more efficient, if efficiency is measured in the number of schedules dispensed per hour.

In the late 1950s and early 1960s, two important works on the nature of a firm introduced an expanded concept known as "organizational slack."[6][7] Slack was seen as the excess capacity maintained by an organization. By definition, slack implies that an organization is not perfectly efficient. Some argue that slack provides resources for innovation and change. Others see it as a buffer for a firm.[8] Although these debates might make for interesting academic discussions, it must be recognized that most small businesses do not have the luxury of maintaining any appreciable slack. Their survival hinges on being *both* highly effective and highly efficient. Therefore, any technique, program, or methodology that improves those ends is vital to the well-being of a small business.

Time Management

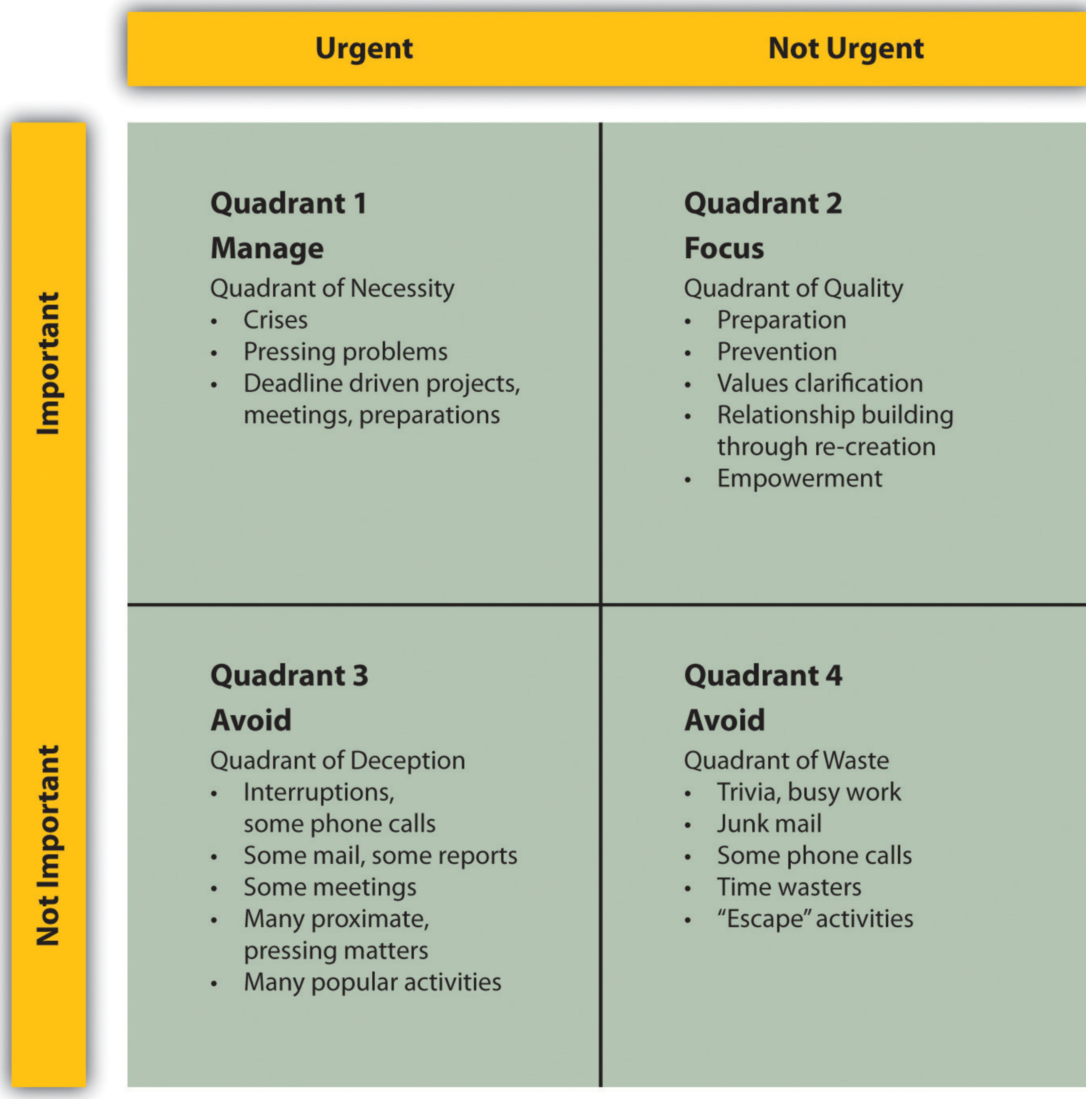
Strategy is the art of making use of time and space. I am less concerned about the latter than the former. Space we can recover, lost time never.[9]

Napoleon

Throughout this chapter, the focus will be on the simple fact that one of the great enemies in life—particularly a businessperson's life—is the existence and acceptance of waste. One of the resources that we can least afford to waste is time. In many ways, time is the most precious of all resources. Other resources can often be purchased or acquired, but time cannot be purchased. Once lost, time can never be recaptured. Time, as a resource, should be of particular importance for the small business owner.

If one is serious about maximizing the use of time, then one should consider two venues: use a time-management system and avoid what are referred to as "time wasters." The term *time-management system* is a broad concept and covers many different approaches. Regardless of the approach used, its adoption provides multiple benefits. As one author puts it—"'**Time management**' involves working on the right things [effectiveness] and doing them the best way [efficiency]."[10] Steven Covey, author of *First Things First*,[11] a "bible" for time management, identifies four generations of time-management systems. He defines a ***first-generation time-management system*** as being composed of essentially a list of tasks that must be done. A ***second-generation time-management system***, ties deadlines to those tasks. A ***third-generation time-management system*** incorporates task prioritization. Many business people are familiar with paper-and-pencil or computerized systems for listing tasks, noting their due dates, and prioritizing them in terms of relative importance. Covey argues for a ***fourth-generation time-management system***. This system is designed to bring balance into the personal and the professional lives of individuals. It is best illustrated by Covey's 2 × 2 matrix, where one axis is composed of tasks that can be categorized as *urgent* or *not urgent*. The other axis is composed of tasks that can be characterized as either *important* or *not important* (see Figure 5.1 "Time-Management Matrix"). He emphasizes that those tasks that might be found in the *important/not urgent* quadrant (quadrant 2) might be critical to an individual's well-being. Unfortunately, because they are listed as *not urgent*, they might fall by the wayside. His goal is to produce a "balanced manager." This balance refers to what he argues are the four fundamental human needs: physical needs, social needs, mental needs, and spiritual needs. His approach to time management is based on valuing relationships and recognizing that the proper management of relationships will reduce the amount of time wasted in activities.

Figure 5.1 Time-Management Matrix



The Time-Management Matrix explains prioritizing using the values of urgency and importance. The first quadrant is valued as important and urgent. This quadrant is labeled the quadrant of necessity. The second quadrant is not urgent however it is important, it is the quadrant of quality. The third quadrant is urgent but not important. It is the quadrant of deception. The fourth quadrant is not urgent or important and is, therefore, the quadrant of waste.

Source: [12][13]

Covey advocates that an individual should have a deep understanding of what is important in one's life and recognize that, on any day, one will assume different roles. Both elements need to be incorporated into the time-management system. For Covey, we all have to assume different roles in our personal and professional lives. The objective is to identify what these roles require time-wise and how they can be successfully integrated. To achieve integration, we need to better understand ourselves. Covey suggests that developing a personal mission statement is vital to achieving balance. Some characteristics of such a statement might include the following:

- What represents the deepest and best within a person?
- What is an expression of a person's unique capacity to contribute to one's family, the organization, and the world at large?
- What represents pursuits that are higher than self-interest?
- What integrates all four fundamental human needs?
- What principles produce quality-of-life results?
- What inspires a person?

The following is an example of a personal mission statement that uses the Covey approach:

I am at my best when I am challenged by a task that has some significance;
I will try to prevent times when I have to work with individuals who think only of their own advancement;
I will enjoy my work when my company provides customers with value and earns a profit;
I will find enjoyment in my personal life when I feel that I have done something that benefits all members of my immediate family;
I will find opportunities that will allow my firm to double its sales every three years;
I can do anything I set my mind to; I will grow my business to the point where I can retire when I am 55;
My life's journey is building my business and providing a comfortable life for my family;
I will be a person who has created a business that provides value to its customers, and I will be an individual who made his family understand how much he loved them;
My most important future contribution to others will be that I expanded my business's operations so that I might provide opportunities and gainful employment for additional workers.

I will stop procrastinating and start working on the following:

Broadening the products offered by my business;
Being more tolerant of others who hold conflicting opinions;
Developing plans for my retirement.

I will strive to incorporate the following attributes into my life:

The ability to make all individuals who work for my business feel as though their views are valued and counted;
Illustrate to others that one does not have to limit oneself to a narrow domain of interests;
Never give up regardless of the difficulty of a situation.

I will constantly renew myself by focusing on the four dimensions of my life:

Exercise;
Greater tolerance for others;
Find more time for reading;
Control my temper.

Covey's complete system of time management is comprehensive and is supported by both paper-and-pencil and software support materials.

If Covey's comprehensive approach appears to be initially overwhelming, where else might a person begin to improve their time-management skills? An excellent—in fact a critical—takeoff point would be to ask the following question: "Where has the time gone?" How often have we asked ourselves or heard others pose this question, and how often are we unable to answer it? Until one has a solid idea of how time is spent, it is impossible to manage time effectively. It is comparable to beginning a journey to a location without knowing the exact starting point. An excellent way of knowing how time is spent is to use an activity log.

An ***activity log*** involves writing down every task and activity a person is involved with during a day. It also requires noting when these activities occurred during the day and how long they lasted. It would be very useful to also comment on one's emotional state and energy level while performing these tasks and activities. The log should be maintained for a period of time—generally one or two weeks. At the end of this period, analyze how time was spent. This analysis should look for some common threads:

- How much time per day or week is spent on particular activities?
- When during the day did you feel the most productive?
- When during the day did you feel the least productive or have the most disruptions to workflow?
- What activities were individuals who created these disruptions to workflow?
- What activities seem to provide little or no value?

The goal of this analysis is to identify what task or activity should be eliminated and when, if there is a pattern to productivity, a high-value challenging task should be scheduled. The activity log should provide useful insights into how a person should structure time flow.[14]. As one author put it, "Find your rhythm and schedule around."[15]

After identifying workflow patterns, then seriously begin planning for time management. The first stage of this process involves identifying the required tasks to be performed across various time horizons, such as the upcoming year, month, week, or day. Draw on Covey and others to include a broad spectrum of life activities, not just work-oriented activities. [16]

In addition to identifying these tasks, it is vital that a person prioritize these tasks. Some tasks are clearly more important than others. As an example, securing a major sale would have a much higher priority than selecting the appropriate stationery for a business. The next step is determining—or more likely estimating—how much time and what resources will be required to complete the tasks. Use these estimates of time to generate a to-do list specifying the completion date for the tasks and the activities. Plan on working within realistic blocks of time. [17] When dealing with a large complex project, learn to break it down into manageable segments and components.

It is one thing to create a prioritized time schedule; it is something entirely different to successfully follow such a schedule. Time management involves learning how to consistently carry out these tasks while avoiding the many time-robbing traps that exist in all our lives. [18]

The following are some dos and don'ts of time management:

- **Learn to "chunk."** Chunking is a process by which similar activities are grouped into common blocks of time. As an example, one might schedule several activities associated with the financial operations of the business—such as paying bills, tallying receipts, and so forth—together during a specific time period. [19]
- **Learn to delegate.** A common complaint leveled at entrepreneurs and small business owners is their propensity to be involved in every aspect of the business. The effective use of one's time will involve recognizing that one person cannot do everything. It is important to learn how to delegate a particular task to subordinates. The challenge is to properly supervise the subordinates so that the task is carried out as desired.[20]
- **Learn to say "no."** It is often said that the most important word for a manager to learn is the word *no*. Time management involves discipline. It means that at times we must stop activities that would become time robbers. [21] What about the colleague who drifts into your work space and asks, "Do you have a few minutes?" When we know that this colleague will be talking more about his or her own personal life rather than work-related activities, then we must have the courage to say, "Sorry, but I do not have the time." In periods of time pressure, we must even find strength to forgo some activities, such as going out to lunch.[22]
- **Learn to not procrastinate.** For many of us, this is the great challenge. It is best dealt with by maintaining a clear focus on the required tasks. This is why a to-do list of tasks tied with prioritization is so important. One way to deal with procrastination is to concentrate on one task and staying with the task until it is complete.[23] Another form of procrastination is the willing acceptance of wasting time. Waiting is a form of wasting time if one is not engaged in some useful activity while waiting for some other outcome—such as working while on hold during a phone call.[24]
- **Learn to manage e-mail.** One of the greatest sources of time wasting is the improper management of e-mail. The ping announcing a new e-mail message often lures one away from productive work to read the message. One should plan set blocks of time during the day to handle e-mail. Outside these blocks, one should not open any e-mail. E-mail should be approached so that each item can be dealt with once and then eliminated.[25] One should also be prepared to "on deadline days…put up the equivalent of a 'do not disturb sign.'"[26]
- **Learn to find private time.** It is vital that an individual find time where to be alone with one's own thoughts and work in isolation without interruptions. Time to think allows the small business owner to think about the "big picture." [27] This type of break can actually improve one's efficiency and effectiveness.[28] As with e-mail, one must be prepared to demand no interruptions.

In addition to these suggestions, one should learn to use some form of time-management system: a paper-and-pencil system, such as a day planner; a computer-based system; or a system that works on one's smartphone or an iPad. Select one system and stay with it.[29]

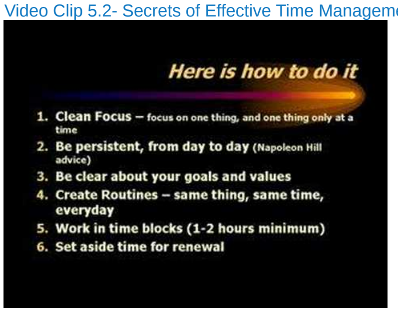
Do not become addicted to the rush of constantly being *busy*. For some individuals, there is confusion between being "on the go" and actually accomplishing what one needs to accomplish. Many of these people view themselves as successful *multitaskers*. This ability to ***multitask*** is often referred to as a modern-day requisite skill. However, the reality is that multitasking appears to reduce one's productivity. Some studies indicate that multitasking prolongs the accomplishment of a list of tasks by as much as 20 percent to 40 percent. [30] A better use of one's time is to focus on one task at a time. [31] In conclusion, it is important to recognize that one should not expect to achieve a perfect allocation of one's time, especially as unexpected events arise. The best that can be hoped for is that "we can actually manage ourselves."[32]

Video Clip 5.1- Time-Management Tips Are Really Self-Management Tips!

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=58

Harvard Business Publishing covers time management.

Video Clip 5.2- Secrets of Effective Time Management



A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=58

Several time-management techniques are discussed.

Web Resources

- Eleven Time-Management Tips, Part 1: Coming to Grips with the Time Management Myth

This site provides useful tips on successful time management. sbinfocanada.about.com/cs/timemanagement/a/timemgttips.htm

- Three Vital Time-Management Principles for Small Business Owners and Entrepreneurs

What principles are key for small business owners and entrepreneurs?

mimosaplanet.com/Small-Business-Blog/bid/55824/3-Vital-Time-Management-Principles-for-Small-Business-Owners-Entrepreneurs.html

- Time Management

Learn how to schedule and manage time wisely and effectively, avoid procrastination, and improve productivity.

www.powerhomebiz.com/leadership/time.htm

- Time-Management Tips for Small Business Owners

Tips that focus on small businesses. ezinearticles.com/?Time-Management-Tips-For-Small-Business-Owners&id=4849540

- Time Management

A sampling of links on time management. www.businesstown.com/time/time.asp

Key Takeaways

- An effective organization achieves the outcomes it wishes to produce.
- Efficiency is the ability of any organization to produce the desired results with the minimum expenditure of resources.[33]
- Time-management systems have evolved through four generations of models.
- Using an activity log can assist anyone in learning how to better manage time.
- Learning the dos and don’ts of time management can significantly improve one’s efficiency.

Exercises

1. Create a time log for a five-day period. Analyze this log and see how you spend time.
2. Identify what you believe to be your own biggest time wasters and how you intend to deal with them.
3. If you do not currently use a formal time-management system, look at several paper-and-pencil or digital versions, evaluate them, and describe which you would select and why.

Creativity

Learning Objectives

1. Understand the three fundamental innovation strategies.
2. Understand what supports creativity in individuals and businesses.
3. Learn what may repress creativity in individuals.
4. Learn about some tools that may help individuals and organizations become more creative.

Money never starts an idea; it is the idea that starts the money.[34]

Owen Laughlin

Thomas Friedman—the author of *That Used to Be Us;*[35]*Hot, Flat, and Crowded;* [36] and *The World Is Flat*[37]—and other pundits consistently argue that the future belongs to those societies and businesses that can best capitalize on creativity and innovation. It is a great tragedy that we often think of creativity and innovation in terms of new technologies only. We fail to realize that creativity and innovation can occur anywhere within a business. There is a story—perhaps it is an urban legend—about a member of the cleaning staff for a company that manufactures shampoo. This employee brought a suggestion to the attention of an executive on the marketing team. The employee pointed out that the instructions on the back of the bottle of shampoo said—“Lather and rinse” and suggested that it should read “Lather, rinse, and repeat.” It may be apocryphal and somewhat unethical, but, if true, it would have led to a significant increase in sales. We recount this legend not to advocate any form of chicanery but to point out that creative insights may come from anyone and anywhere. Creativity is not limited to scientists, engineers, designers, or top executives. It is a property that all human beings possess. Likewise, creativity need not be singularly channeled into new high-tech products or advanced designs. Innovation may pursue different strategies. There are three fundamental innovation strategies for firms: ***need seeker***, a firm that actively interacts with its present and future customers and carefully listens to them so that it can develop new products and services. A ***market reader*** ***is a firm that maintains a close relationship with its customers and provides them value through small innovative changes, and*** technology driver***, a business that puts money into research and development to produce revolutionary breakthroughs and/or incremental changes.***[38]

Need seeker firms actively interact with their present and future customers and carefully listen to them so that they can develop new products and services. These firms tend to be the first in the market. A market reader firm maintains a close relationship with its customers and provides them value through small innovative changes. A technology-driven firm is a business that puts money into research and development to produce revolutionary breakthroughs and/or incremental changes. Such a firm spends more time and effort in anticipating future customer needs and carefully listening to what customers believe they want at this point in time. None of these three innovation strategies is clearly superior to the other. It is interesting to know, however, that none of these strategies precludes or minimizes the potential contribution that could come from a small business. If one examines the three innovation strategies, it could be clearly argued that small businesses have an advantage over their larger rivals for the first two strategies. Both rely on a business having a deep and intimate understanding of the needs and desires of its customers. Small businesses also are better positioned to actively listen to their customers and, because of their size, respond more rapidly. Even the third innovation strategy often is the domain of the smaller business. Think of the number of technological breakthroughs that were initiated by smaller firms (at least, smaller at that time) than the large behemoths.

At one level, creativity should be thought of as a rare flower that should be nurtured at both the individual level and the organizational level. Many businesses create an environment that not only does not foster creativity among its personnel but also actively crushes it. Such firms punish any failure, which increases fear in the personnel to try something new. These firms fail to reward innovative successes. They foster groupthink, often responding with the following reply: “We have always done it this way.” The leadership team believes that leaders are the only ones responsible for creative actions. This type of organization is toxic to creativity.

Before examining the tools and techniques that might enhance creativity, it is important to understand what personal and organizational factors might inhibit creativity.

- **Accepting the belief that one may not be creative.** At a recent sports event, the coach of the team wore a t-shirt that had the following saying: “If you believe you can do something or if you believe you can’t do something, you are right.” Individuals who tell themselves that they are not creative are producing a self-fulfilling prophecy. They will not even attempt to break through barriers that might preclude them from having brilliant, creative, and innovative ideas. It is absolutely vital for the small business owner to be open to the possibility of his or her own tremendous creativity.
- **Acceptance of the current situation.** Sometimes we assume that the current situation is not only fully acceptable but also the only way that it can be. With that type of mental framework, we never will be in a position even to ask, “How could the situation be made better?” This corresponds with the old idiom, “If it ain’t broke, don’t fix it.” A creative mind is always operating under the assumption that things can be different and can be made better.
- **Self-censorship.** This is a situation when an idea occurs to us, but we initially consider it too outlandish or too impractical to successfully implement. We dismiss the idea without any further consideration. One does not even take the opportunity to record the idea. We engage in self-sabotage of our own creativity by dismissing our own ideas out of hand.
- **Allowing ideas to die.** It is not enough to have a creative idea. One must have the courage to defend the idea and the fortitude to see it through to fruition. Unfortunately, individuals adopt the philosophy of W. C. Fields: “If at first you don’t succeed, try, try again. Then quit. No use being a damn fool about it.”[39] A good counterexample of this failure to pursue ideas is the genesis of FedEx. Fred Smith, FedEx’s CEO and founder, was an economics major at Yale University. While there in 1965, Smith wrote a term paper outlining the concept behind FedEx. Legend has it that this paper received a grade of C. Most students would feel that this grade was a clear indication that the concept was infeasible, but Fred Smith was not persuaded, and nine years later he began FedEx. It is not enough to be creative; one also must be courageous.
- **Not maintaining a record of ideas.** What is called inspiration may be rather fickle. Ideas may come to us in the most unlikely of places and at unexpected times. Individuals should be prepared to make note of these ideas as they come. It might simply require having a notepad available at all times or a digital recorder to take down ideas. Sometimes it is useful to write out the ideas, place them where they are visually accessible, and return to them at some point in the future.

Perhaps one of the most commonly used creativity tools is ***brainstorming,*** an approach that emphasizes collaboration within a group. Brainstorming begins by specifying a problem or issue—for example, “How can we boost sales at the restaurant?”; “What can be done to reduce customer complaints?”; or “Why do these particular types of defects keep occurring?” Then one brings together personnel who are directly familiar with the problem or the issue. Sometimes it might be advisable to bring in people not directly familiar with the problem or the issue because they may bring a totally different perspective that might enhance the overall creativity of the problem-solving exercise. The room where the brainstorming exercise is held should be equipped with a whiteboard, or a computer with a projector, or a simple flip chart. The moderator or the facilitator of the brainstorming session should restate the problem. Individuals should be able to shout out possible solutions. The facilitator writes them down or types them into the computer, which is then projected so that all people can see the proposals. The most critical point of the brainstorming session is the openness with which the group accepts any and all ideas. No matter how bizarre or off-the-wall a suggestion might appear to be, no one is allowed to criticize it. Even if an idea is simply crazy, participants do not have the latitude to make any negative remarks. After all the ideas have been presented and written down, the group begins a process of winnowing down the number of suggestions to a smaller number, perhaps five. [40] In the real world, most decisions cannot be done with respect to a simple, single criterion. As an example, one might evaluate the five possible solutions with respect to cost. In the freewheeling environment of brainstorming, one possible solution might yield the lowest cost but might be illegal. Before evaluating the reduced set of solutions, the group must identify all the criteria that would be useful in determining the solutions. Examples of such criteria might be cost, viability, the probability of implementing the solution within a given timeline, or customer acceptance. Once these criteria have been identified, the group can then scale (numerically evaluate) each solution with respect to the criteria. Such an approach should help the group identify the overall best solution. This is the most basic and most common format for brainstorming. Other variations exist that are designed to deal with some possible deficiencies of classical brainstorming, such as naturally reticent members.[41]

Another useful approach to stimulate creative thinking about a problem or an issue is ***mind mapping***. This technique is used widely in a variety of contexts, including creative writing courses. It is a visual model that uses words, phrases, tasks, or concepts centered on an idea or a problem. A node or a figure representing the core notion is drawn at the center. Ideas that are related to this central notion are drawn off, as branches, to the sides. These secondary ideas, in turn, may generate other offshoots. This continues until all interrelationships are mapped on the diagram. Figure 7.2 “Mind Map for Expanding Frank’s All-American BarBeQue” is a mind map that might have been drawn for the restaurant: *Frank’s All-American BarBeQue*, when it was considering an expansion.

Figure 5.2 Mind Map for Expanding Frank’s All-American BarBeQue

The Financial Monitor from Simione Consultants

William Simione Jr., the founding member of Simione Consultants, has always believed that there has been a need for the home health and hospice industries to have timely financial benchmarks. Recognizing that this need was not being met, Simione started Financial Monitor LLC in 2009. This company launched a product known as the *Financial Monitor*. This is an excellent example of a business using its creativity to develop a new business. Using the company's expertise in the home health and hospice industries, Simione designed a program that would benchmark clients' quarterly financial reports against industry standards. Two principals, William Simione III and David Berman, have managed the development of the *Financial Monitor*. In 2009, Rob Simione was added to the *Financial Monitor* team as the senior manager.

The long-term goal of the *Financial Monitor* is to become the industry's major database for financial information. Currently, Simione has a database of 160 providers. With this information, Simione not only provides clients with meaningful financial information but also provides the home health and hospice industry with data that can be used in advocacy efforts on both national and state levels. Simione has begun to work with both the National Association for Home Care and Hospice and several state associations to have the *Financial Monitor* help them in their advocacy efforts. The short-term goal is to have five hundred home health and hospice agencies on the *Financial Monitor* by end of 2011, and the long-range goal is to have in excess of five thousand on it by the end of 2014.

Video Clip 5.3- TED Fullerton—Matthew Jenusaitis—Importance of Creativity in Business

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=58

A discussion of the importance of creativity in business. It is seventeen minutes—but very good.

Video Clip 5.4- TEDxPugetSound—Edgar Papke—Creativity and the Human Art of Business

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=58

Discusses how to match creativity and motivation. Another long video, but it has excellent ideas.

Web Resources

- Let Creativity & Imagination Grow Your Business

Discusses the importance of creativity for business development. www.theopensite.com/marketing-business-promotion/small-business-imagination-creativity

- Passion & Creativity Go a Long Way for Small Business Owners

Reviews the critical role of passion for start-ups. www.catalystmarketers.com/passion-creativity-small-business-owners

- Creativity: Breaking the Mental Blocks

How to overcome barriers to creativity. www.smallbusinessadvocate.com/small-business-articles/creativity-breaking-the-mental-blocks-694

Key Takeaways

- All members of an organization can be creative.
- Organizations need to develop environments that support and nurture creativity.
- Mental blocks can stifle an individual's creative capability.
- Tools such as brainstorming and mind mapping can enhance the creativity of groups.

Exercises

1. What do you believe are your own personal blocks to being more creative?
2. Brainstorm with several colleagues and come up with five innovative concepts for a local restaurant.
3. Draw a mind map for how you might become better in managing time.

Organizational Efficiency

Learning Objectives

1. Understand the eight dimensions of product quality.
2. Understand the five dimensions of service quality.
3. Learn about the Deming philosophy of quality management.
4. Learn about the fundamentals of Six Sigma quality management.

When considering effectiveness or efficiency improvements on an organizational level, one generally thinks in terms of programs: projects with some battery of tools and techniques. Quite often, the businessperson is confronted with choosing from a cornucopia of the most recent business fads. The *fad de jour* is tried and often found wanting. Eventually, business people become inured to the latest hot trend, continue with their standard operations, and become less willing to try something new. This is extremely unfortunate because some of these programs offer the opportunity for significant improvements. Two such programs are quality management and lean thinking. Both approaches grew out of manufacturing environments. Most of the articles and books about them tend to emphasize manufacturing-based examples. However, this does not mean that they are limited to that domain. More and more service industries are recognizing that the adoption of quality management and/or lean thinking offers tremendous benefits in effectiveness and efficiency. The same can also be said about the acceptance of these business models by smaller firms. Although some quality and lean programs are presented as complete and complex systems requiring extensive training routines, many small businesses have adopted the underlying concepts without resorting to significant expenditures. They recognized that the promulgation of the underlying principles of quality and lean management can yield significant returns without significant expenditures.

Quality Management

Quality is never an accident; it is always the result of high intention sincere effort intelligent direction and skillful execution; it represents the wise choice of many alternatives the cumulative experience of many masters of craftsmanship. Quality also marks the search for an ideal after necessity has been satisfied and mere usefulness achieved.[42]

William A. Foster

Throughout this text, the concept of customer value has been emphasized. Intimately linked to customer value is the notion of quality. Therefore, it is extremely unfortunate that for most people, business people included, the term *quality* is either totally misunderstood or viewed from a rather narrow perspective. This stems from two reasons. The first is based on a correct assumption that quality is defined by the user (customer); however, many then go on to believe that because quality is subjective, it then becomes impossible to define. The second problem centers on the tendency to view quality, particularly in products, as singularly the result of the use of costly raw materials, components, careful craftsmanship, and detailed processes. It is assumed that together these expensive elements must necessarily produce a quality but costly outcome. In this belief system, if one wants to identify the quality of the product, one has to look only at the price tag. Quality is synonymous with cost. This is a huge error because, as will be shown, a true commitment to quality can reduce costs and expenses—and do so quite significantly.

Quality in Small Business

To see the practical benefits of using the principles of quality management for small businesses, one can simply review the winners of the Malcolm Baldrige Award. This award, started in 1987, seeks to acknowledge businesses that have a solid commitment to quality. Awards were initially given in the categories of manufacturing, service, and small businesses; subsequently, three more categories were added: education, nonprofits, and health care. A sampling of two recent winners in the small business category clearly shows that the smaller enterprise can produce spectacular results by adopting quality management.

K&N Management, a 2010 winner, operates two fast-casual restaurants in Austin, Texas. With a strong commitment to quality, such as using iPads to gather quick survey data from customers, K&N saw its sales increase from $3 million in 2000 to over $7.5 million in 2010. Its gross profit was consistently related to quality. In 2010, K&N was named the "best place to work in Austin."[43]

The 2009 winner in the small business category was Midway USA, an online retailer for gun owners and hunters. Again, Midway USA's commitment to quality has produced some impressive results. The firm has a customer retention rate of 98 percent. It had a growth rate of 25 percent for 2008, compared to a 10 percent rate for its nearest competitor. From 2003 to 2008, Midway USA saw its net profits increase from 2.5 percent to 10 percent.[44]

These Baldrige award winners are only a few of the indicators that a focus on quality translates into improved customer satisfaction, improved employee satisfaction, and significant improvements to a firm's financials.

Without a fundamental understanding of what quality really means, it is impossible to achieve it—consistently. So how should one approach a useful definition of the term *quality*? Many authors suggest that when discussing quality, it is useful to distinguish between product quality and service quality. Today, there may be no clear-cut distinction between exclusively product-based businesses or exclusively service-based businesses. Few products can be viewed in isolation from supporting services. As an example, an automobile manufacturer clearly produces a product; however, few manufacturers would survive long if they totally excluded the area of follow-up services, such as vehicle maintenance across a car's lifetime. Likewise, many service businesses rely on ancillary products. An investment company provides a service; however, it may also provide its clients with investment perspective reports. Many view McDonald's as essentially a service company—the service being the delivery of fast food; obviously, the ancillary product is the food.

The literature indicates that rather than having a unitary definition of quality, it is important to identify the dimensions of quality. In a seminal 1984 article, David Garvin identified eight dimensions of product quality: performance, features, reliability, conformance, durability, serviceability, aesthetics, and a diagram that specifies all the types of relationships among key elements of a problem or an issue.[45] Table 5.1 "The Eight Dimensions of Product Quality" describes what these dimensions mean and gives examples. Garvin recognized that no consumer will find all eight dimensions equally important. However, to ensure success, a business must identify which of the eight dimensions are important to its customers. As an example, if we are dealing with a product such as a heart pacemaker, customers would be most interested in the reliability and durability dimensions of that product. If a customer is buying a car for street drag racing only, then that person's focus would be on the performance dimensions of the vehicle.

Table 5.1 The Eight Dimensions of Product Quality

Dimension	Characteristics	Examples
Performance, the primary measurable operating characteristics of a product.	The primary measurable operating characteristics of a product.	The following outcomes for each category are of greatest importance t • **Car.** Miles per gallon or acceleration time to go from 0 to 60 miles • **Light bulb.** Wattage • **Laptop computer.** Amount of memory or speed of processor • **Copier.** Pages per minute or cost per page
Features, the secondary operating characteristics of a product.	The secondary operating characteristics of a product.	The following outcomes for each category may not be initially seen a purchasing decision of a consumer: • **Car.** Comfort of ride or the number of cupholders • **Light bulb.** The shade of light given off • **Laptop computer.** Size or brightness of the screen • **Copier.** Ease of use
Reliability, the probability that a product will function for a given period of time or how often it breaks down.	The probability that a product will function for a given period of time or how often it breaks down. This is most often measured by the mean time between failures (MTBF). This is the expectation of how long a product is expected to last.	• **Light bulb.** Expected lifetime • **Electric watch.** Time between replacing batteries • **Copier.** Time between replacing toner cartridge or printer drum
Conformance, the extent to which a product matches established standards.	The extent to which a product matches established standards. This is viewed by many as the critical component of quality and is the basis of statistical process control.	• **Car.** How well replacement parts match original equipment manufa • **Laptop computer.** Voltage measurements
Durability, the expectation of how long a product will last and how it will function under various working conditions.	The expectation of how long a product will last and how it will function under various working conditions. This dimension refers to how well a product lasts over time and under different environments.	• **Car.** Expected lifetime of engine or tires; how a car functions unde • **Laptop computer.** Functionality after being dropped
Serviceability, the speed, competence, and courtesy of repairs or maintenance of a product.	The speed, competence, and courtesy of repairs or maintenance of a product. This dimension corresponds to the ancillary service component of products.	• **Car.** The conduct of scheduled maintenance or repairs • **Laptop computer.** Speed of return to computer after repairs; intact
Aesthetics, how a product looks, feels, sounds, tastes, or smells.	This is how a product looks, feels, sounds, tastes, or smells. This is the most subjective of the eight dimensions. This dimension means that it is extremely important to consider design issues with respect to any product.	• **Car.** The attractiveness of the exterior style of the vehicle; the luxu • **Laptop computer.** Stylish exterior; unique colors; uniqueness of it of input device
Perceived quality, the concept of quality most influenced by brand names, advertising, and commonly held perceptions concerning a product.	Consumers often do not have direct evidence of objective measures of a product's quality—both tangible and intangible measures. This concept of quality is most influenced by brand names, advertising, and commonly held perceptions concerning a product. Powerful brands often provide the perception that a product is of higher quality.	• **Car.** Rolls-Royce: finest quality car produced and commands a pre • **Aspirin.** Compare prices for same number of tablets: generic bottle price difference due to perceived quality.

Another approach to examining quality, this time in the service context, is to explicitly consider quality as a comparison between a customer's expectations and a customer's perception of performance. Parasuraman, Zeithaml, and Berry argued in their 1985 seminal article that there were ten determinants (dimensions) of service quality: reliability, responsiveness, competence, access, courtesy, communication, credibility, security, knowing the customer, and tangibles.[46] After some major research, they reduced this set to five dimensions: tangibles, reliability, responsiveness, assurance, and empathy. [47] Again, it is critical to note that customers will not view all five dimensions as equally important. In fact, the relative rank of these dimensions may differ significantly across industries. The approach of Zeithaml et al. has become well known as the **SERVQUAL** instrument, and it plays a prominent role in improving quality in service environments. The five service quality dimensions are given in Table 5.2 "The Dimensions of Service Quality". This SERVQUAL system explains the notion that quality is associated with a gap between expectations and perceptions. It identifies the following five types of gaps that a service organization should examine and attempt to minimize:

1. The gap between what customers expect and what a business believes are its customers' expectations
2. The gap between a business's evaluation of its own performance and how its customers evaluate its performance
3. The gap between a customer's experience and a business's specified level of performance
4. The gap between the communicated level of service by a business and what a customer actually experiences
5. The gap between a customer's expectation and actual experience.

From looking at these five gaps, it should be obvious that a full utilization of the SERVQUAL instrument is quite a challenge and might be beyond the capacity of most small businesses. That does not mean, however, that a business interested in providing its customers with quality service cannot apply some of the elements of the SERVQUAL instrument or use it as a conceptual template.

Table 5.2 The Dimensions of Service Quality

Dimension	Characteristics	Examples
Tangibles, the physical appearance of a facility, the personnel, and communications media.	The physical appearance of the facility, personnel, and communications media.	The first thing customers notice is appearances. This may involve the cleanliness of a facility, how brightly lit it is, the width of the aisles, or how personnel are dressed. A cheaply designed website may convey a totally inappropriate message about a business. It should be remembered that a business has only one chance to make a first impression. At its start, McDonald's emphasized not speed of service but the cleanliness of its facilities.
Reliability, the ability to perform the service correctly and consistently.	The ability to perform the service correctly and consistently.	Reliability means performing the service correctly each and every time. One failure with a customer may destroy his or her faith in the capability of a business. FedEx emphasizes its guarantee to get a package there overnight—*each and every time*. An accounting firm must make sure that its clients' tax returns are done properly and submitted on time.

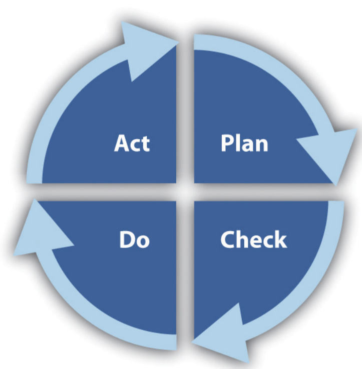
Dimension	Characteristics	Examples
Responsiveness, the speed and courtesy to customer inquiries.	The speed and courtesy to customer inquiries.	A customer who is put on "hold" for any length of time is on the path to becoming an ex-customer. This dimension requires all personnel to be well mannered and focus on the needs of the customer. Disney trains its park staff to recognize that they are not responding for the sixtieth time to the same inquiry; they are responding for the first time to the sixtieth individual who is asking that question.
Assurance, the extent to which a customer trusts and has confidence in the service provider.	The extent to which the customer trusts and has confidence in the service provider.	A medical facility's survival depends on its customers' belief that they are receiving excellent medical care. The same is true for any professional service. Trust is built over time and is a fragile commodity.
Empathy, the extent of the quality of individualized attention given to a customer.	The extent and quality of individualized attention given to a customer.	Empathy should be thought of in terms of a doctor's "bedside manner." Customers want to be thought of as individuals, not as numbers. Businesses should avoid using preprinted labels on envelopes because this clearly conveys the image of a mass mailing.

When using the term *quality management*, we should recognize that there is no universally consistent notion of how one can produce quality products and services. In fact, the quality management movement has been evolving for nearly a century. Perhaps the best way of tracing this evolution is to examine the contributions of some of the key proponents of quality. One of the first bodies of work that should be reviewed is that of Walter A. Shewhart (1891–1967). Similar to two other "quality gurus"—W. Edwards Deming and Joseph Juran (the authors are hesitant to use the term *guru* because this might question the true value of the work of these individuals)—Shewhart worked for Western Electric Company, a division of AT&T.[48] There he developed what is now known as **statistical process control (SPC)**, a mathematical approach that measures how well products conform to previously determined standards. The goal here is to develop a control chart that would enable an operator to distinguish between the random change associated with any manufacturing process and specifically assignable causes of such change. As an example, a machine produces 0.25-inch diameter bolts. Not all the manufactured bolts will be exactly 0.25 inches in diameter. There will be some natural variation around this value. Rather than test the diameter of every bolt, in SPC, a sample of bolts is tested on a regular basis. Based on statistical analysis, one can determine if this sample is within acceptable limits around the 0.25-inch value. If a sample is not within these acceptable limits, then the machine is shut down, and every effort is made to determine the assignable cause—faulty materials, machine error, or operator error. The benefit of this approach is that one can determine, with a high degree of accuracy, the operational characteristics of the system without the expense of testing every item produced. A full discussion of all aspects of SPC is beyond the focus of this text.

Shewhart's two books, [49][50] are still available in print and are viewed as the foundation works in the field.

Shewhart also made major contributions in the way we think about implementing a quality program in any organization. He advocated a systematic approach structured in four cyclical phases. This approach is sometimes referred to as the ***PDCA cycle***, (see Figure 5.3 "The PDCA Cycle") or the Deming cycle. (Yet the Deming cycle is an improper name for the PDCA cycle.) The PDCA cycle calls for a cycle of continuous improvement. The first step is to *plan* for a change that would lead to improvement. The planning process requires data collection to make a decision. Regardless of the approach to quality management, all decision making must be data driven. The second step in the cycle is the *do* phase. This entails implementing the change. It also implies that a business will implement that change on an experimental basis, meaning that the organization would run a pilot program rather than implementing it throughout the entire organization. The third phase of the cycle is *check*. This means that after a sufficient period of time following the initial implementation phase, the results are evaluated to ascertain if the change produced the desired effect. If that answer is positive, then the organization moves onto the fourth stage of the cycle (*act*), where the changes are implemented throughout the entire organization. At the end of the *act* phase, the process is repeated with respect to some new problem area.

Figure 5.3 The PDCA Cycle



The two other quality gurus who worked with Shewhart at Western Electric Company, as previously mentioned, were Joseph Juran and W. Edwards Deming. Juran's numerous contributions to the field include the first standard reference work in the field of quality management: [51] He also developed the Juran Trilogy, an approach to quality management that involves three phases: quality control, quality improvement, and quality planning.

Deming was born in 1900 and received an engineering degree from the University of Wyoming and a doctorate from Yale University. During his career, he worked for Western Electric Company, Bell Labs, and the US Department of Agriculture. During the Second World War, he taught SPC methods to thousands of engineers and plant personnel. After the war, Deming worked in Japan with Douglas McArthur's Office of Supreme Command of Allied Powers. Several years later, he returned to Japan and worked with Japanese scientists and engineers and taught them about SPC. Deming's work with the Japanese improved his understanding of what must transpire in a business organization to ensure quality products and services.[52] The Japanese recognized his accomplishments by creating the Deming Prize, which is awarded to organizations that exemplify a commitment to quality.

Many consider Deming as the world's preeminent proponent of quality. In fact, many see him as one of the most important business thinkers of the twentieth century. In a November 1999 issue, *Fortune* identified Deming, along with Peter Drucker and Frederick Taylor, as three individuals who had more impact on the operations of businesses than any CEO. In its April 22, 1991, edition, *US News & World Report* covered nine important turning points in human history. The final point was Deming's impact on the Japanese quality movement.[53]

What distinguishes Deming from all other quality theorists is his comprehensiveness known as the ***Deming method***. It has been stated that Deming proposed an alternative philosophy of doing business. He argued that one should believe that the purpose of a business is to delight a customer. If customers are delighted, then profits will follow. The Deming philosophy was summarized in his fourteen points, which are given in Table 5.3 "Deming's Fourteen Points".

Table 5.3 Deming's Fourteen Points [54]

#	Point	Explanation
1	Create constancy of purpose toward improvement of product and service, with the aim to become competitive and to stay in business, and to provide jobs.	Deming believed that a firm must have a strong future focus. It should be willing to innovate all areas of operations, serv reduction. It must be willing on all levels to invest in these activities.
2	Adopt the new philosophy. We are in a new economic age. Western management must awaken to the challenge, must learn their responsibilities, and take on leadership for change.	Businesses can no longer accept given levels of errors, defects, and mistakes. This means that a small business must cha

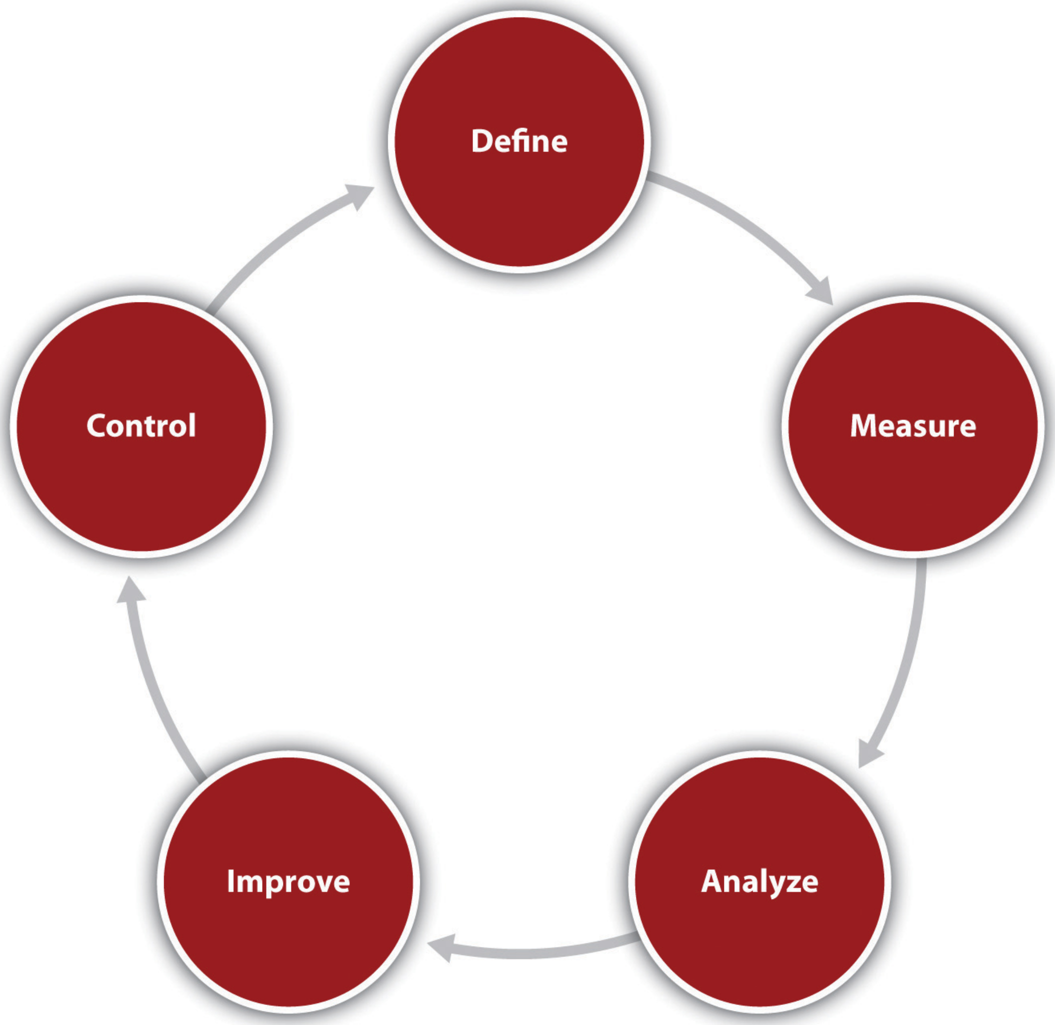
#	Point	Explanation
3	Cease dependence on inspection to achieve quality. Eliminate the need for inspection on a mass basis by building quality into the product in the first place.	Inspecting 100 percent of the finished goods produced by a business is wasteful, costly, and without purpose. A business or the service. Using SPC and sampling will achieve better results than 100 percent inspection at a far lower cost.
4	End the practice of awarding business on the basis of price tag. Instead, minimize total cost. Move toward a single supplier for any one item, on the long-term relationship of loyalty and trust.	Low price has no meaning if a customer is buying poor quality. It is better to find a business that can ensure the quality to achieve a lower price. This is a central tenet in supply chain management.
5	Improve constantly and forever the system of production and service, to improve quality and productivity, and thus constantly decrease cost.	The focus of a quality management program should be on processes rather than merely looking at outcomes. The goal is better utilization of labor.
6	Institute training on the job.	A training program should recognize that people learn in different ways. The training program should be tailored to the l throughout an organization should be to make employees aware of the problems associated with variation.
7	Institute leadership. The aim of supervision should be to help people and machines and gadgets to do a better job. Supervision of management is in need of an overhaul, as well as supervision of production workers.	Businesses have little trouble finding managers and supervisors; the problem is finding leaders. Leadership involves a de provide the vision to employees that enable them to carry out their work with pride.
8	Drive out fear, so that everyone may work effectively for the company.	Fear is often systemic in organizations. It could be the fear of losing one's job. It can be the fear of making a mistake. It employees from taking an initiative and being innovative. In the long run, this can be fatal for any organization.
9	Break down barriers between departments. People in research, design, sales, and production must work as a team, to foresee problems of production and in use that may be encountered with the product or service.	If people in different functional areas of a business do not know what the others are doing, they cannot adopt the perspec only what is good for their silo. A failure to understand the duties and responsibilities of people in other segments of the aggressively attempting to solve problems on a system-wide basis.
10	Eliminate slogans, exhortations, and targets for the workforce asking for zero defects and new levels of productivity. Such exhortations only create adversarial relationships, as the bulk of the causes of low quality and low productivity belong to the system and thus lie beyond the power of the work force.	Exhorting people to work harder is pointless if there are fundamental flaws or problems with the system they are workin and intelligence of management.
11	1. Eliminate work standards (quotas) on the factory floor. Substitute leadership. 2. Eliminate management by objective. Eliminate management by numbers, numerical goals. Substitute leadership.	Work standards that do not include a quality component may be detrimental to the operation of a business. Refer to the e the measure of the number of schedules sorted per hour; however, the students who received the wrong schedule would t true for not only production workers but also management. Using the wrong set of numbers that drive the business may
12	1. Remove barriers that rob the hourly paid worker of his right to pride in workmanship. The responsibility of supervisors must be changed from sheer numbers to quality. 2. Remove barriers that rob people in management and engineering of their right to pride in workmanship. This means, inter alia, abolishment of the annual or merit rating and management by objective.	Employees who do not have a chance for some dignity associated with their work are unlikely to take pride in their work should foster individual initiative to improve processes and quality.
13	Institute a vigorous program of education and self-improvement.	Training programs should be available for all levels of employees. Training should not be limited to short-term outcomes business.
14	Put everybody in the company to work to accomplish the transformation. The transformation is everybody's job.	Quality should never be seen as the responsibility of management or a specialized group, such as quality assurance. It is

The last quality theorist who should be discussed is Philip Crosby. Crosby was an executive at ITT and the Martin Company. His approach to quality reflected a practicing manager's perspective. Although he is often associated (correctly) with the zero-defect program, his great contribution can be found in his first book *Quality Is Free.* [55] In this text, Crosby argued that the definition of quality should be based on conformance to quality, and nonconformance is highly expensive. He estimates that the cost of nonconformance can run as high as 30 percent of revenue. [56] This figure includes costs associated with rework, scrap, warranties, lost goodwill, reputation, and customers. He further argues that expenditures on quality to guarantee conformance to requirements will always be less than the cost of nonconformance; therefore, quality should be seen as being free. Crosby was embraced by many American executives because of his emphasis on the practical and his formal acknowledgment of the importance of the bottom line. His approach is often referred to as ***Total Quality Management*** .

Implementing quality management concepts in American business has had a long and somewhat checkered history. In the last four decades, total quality and continuous quality movements have blossomed in popularity and then quickly died. Two decades ago, Walter Lareau argued that many American businesses, particularly large businesses, have an almost pathological antipathy toward quality management because some of its (quality) fundamental principles run totally counter to corporate belief systems, namely, customers are a pain and employees are an even bigger pain.[57] In the intervening time, however, it appears that one approach to quality has captured the imagination of many businesses—both large and small. This quality program is known as ***Six Sigma***.

Although Six Sigma is often associated, at least in the public's mind, with General Electric, it began at Motorola in the 1980s and was spearheaded by William Smith.[58] The term *sigma* (σ) comes from SPC and represents the concept of the ***standard deviation***.It is used in SPC models. Six standard deviations away from specifications signify that the process produces only 3.4 defects per million opportunities. This is a remarkable accomplishment. Imagine a restaurant that is open 12 hours a day, 365 days per year. On average, the restaurant serves 1 meal every 55 seconds or about 800 meals per day. It would take them approximately 3.4 years to serve one million meals. So if this restaurant was operating at a Six Sigma level, it would make a mistake in taking an order *only once a year*. Six Sigma draws on a battery of tools and techniques derived from SPC and earlier quality management programs. Six Sigma's mantra for continuous improvement involves what is referred to as the *DMAIC* cycle (see Figure 5.4 "The DMAIC Cycle"), where D stands for design, M stands for measurement, A stands for analyze, I stands for improve, and C stands for control. Clearly, this concept is derived from the Shewhart cycle.

Figure 5.4 The DMAIC Cycle



What was different about the Six Sigma program was that all these tools and techniques were packaged in a coherent program. There was a heavy emphasis on quick results and the ability to demonstrate to management tangible cost savings. Six Sigma involves committed training programs that promote statistical tools and management techniques. Graduates of the most basic certification training program are referred to as "green belts," a term derived from the martial arts. Those who receive more advanced training are known as "black belts."[59] Given that Six Sigma is closely associated with large corporate entities and complex training programs, one might think that it would be irrelevant for smaller enterprises. Nothing could be further from the truth. Six Sigma offers a systematic and pragmatic approach for quality improvement in the smaller firm.[60]

Video Clip 5.5- Six Sigma

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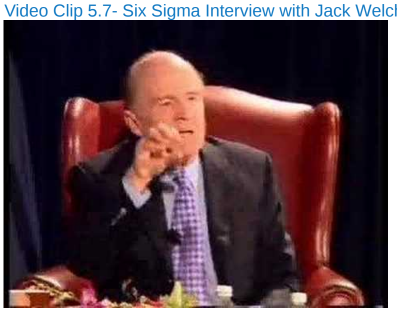
An overview of Six Sigma and a discussion of how organizations use it.

Video Clip 5.6- Pizza Anyone? Six Sigma DMAIC Strategy Introduction

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=58

Explains Six Sigma's DMAIC strategy in simple, nontechnical terms using the familiar setting of a pizza restaurant business.

Video Clip 5.7- Six Sigma Interview with Jack Welch



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Jack Welch, former CEO of General Electric, talks about implementing Six Sigma at General Electric.

Web Resources

- PDCA Cycle: A description of the Shewhart cycle.

asq.org/learn-about-quality/project-planning-tools/overview/pdca-cycle.html

- Deming's Fourteen Points: Discusses Deming's fourteen points and includes links to allied topics.

leanandkanban.wordpress.com/2011/07/15/demings-14-points

- Seven Basic Quality Tools: These seven tools get to the heart of implementing quality principles.

asq.org/learn-about-quality/seven-basic-quality-tools/overview/overview.html

- Seven New Management and Planning Tools: Ways to promote innovation, communicate information, and successfully plan major projects.

asq.org/learn-about-quality/quality-tools.html

Key Takeaways

- Quality for manufactured goods may be defined by using the eight dimensions of product quality.
- Quality in services may be defined by using the five dimensions of service quality.
- Quality should be seen as a continuing cycle (PDCA) of improvement.
- Quality guru W. Edwards Deming offers a complete philosophy of quality management in the workplace.
- The costs of quality improvements are always less than the costs of poor quality; hence quality is free.
- Six Sigma is a modern and highly practical approach to quality improvements.

Exercises

1. Take the eight dimensions of product quality and rank them in terms of relative importance for the following products: a heart pacemaker, a minivan, a laptop computer for high school students, an army assault rifle, an office copy machine, a light bulb, a jet engine, and a pocket lighter.
2. Take the five dimensions of service quality and rank them in terms of relative importance for the following services: a bank, a college classroom, a walk-in clinic, a divorce lawyer's office, a cell phone service, a credit card company, a financial advisor, and a computer repair company.
3. Assume that your college or university suddenly decided to fully accept the Deming philosophy. How would it have to change? What do you think would be the first change that a student would notice? How would a particular course change if an instructor adopted the Deming philosophy?

Going Lean

Learning Objectives

1. Understand the basic logic of lean thinking.
2. Understand the sources of waste for a manufactured product.
3. Understand the sources of waste for a service.
4. Learn about the five S's of lean.

Waste is worse than loss. The time is coming when every person who lays claim to ability will keep the question of waste before him constantly. The scope of thrift is limitless.[61]

Thomas A. Edison

The most dangerous kind of waste is the waste we do not recognize.[62]

Shigeo Shingo

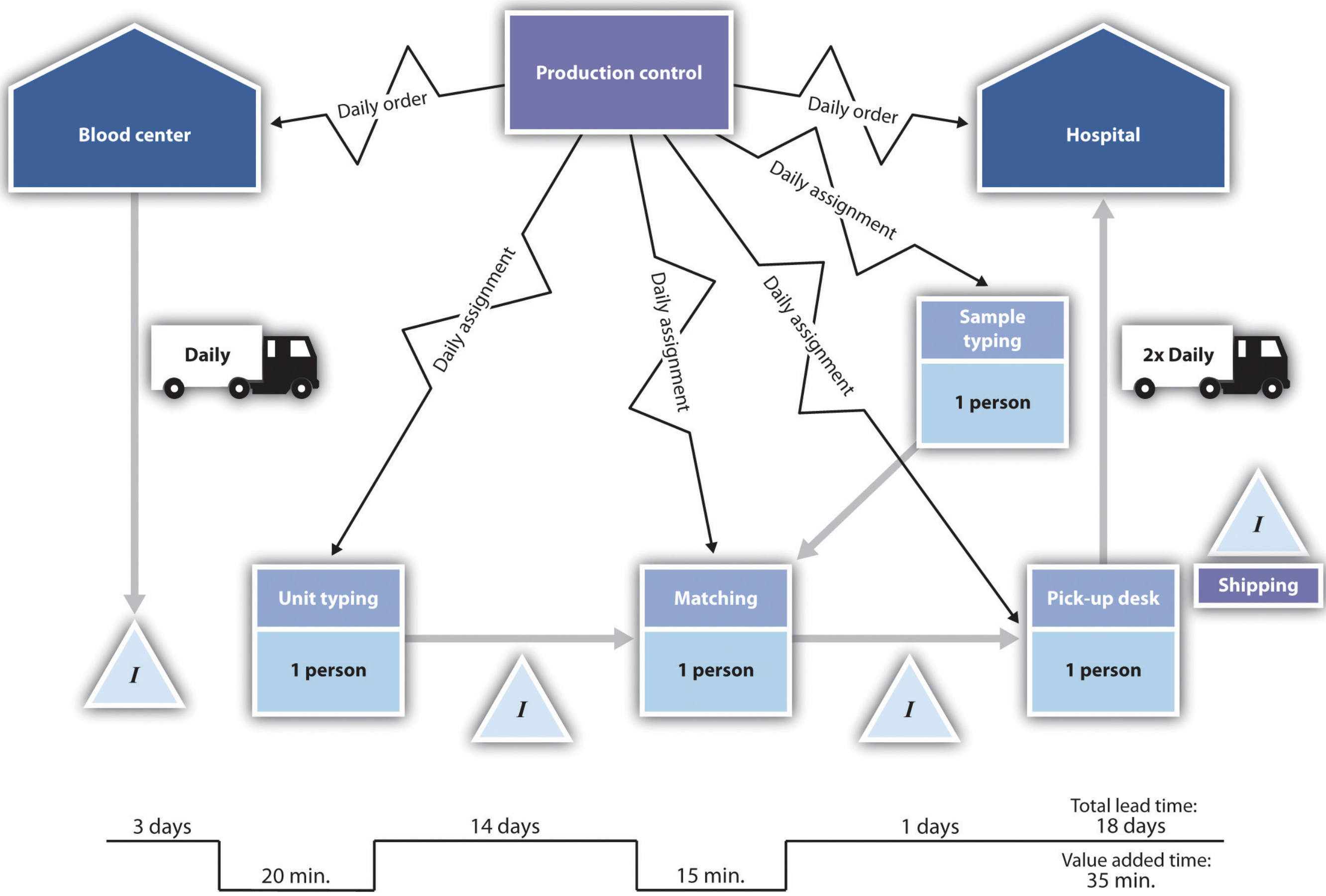
Another organization-wide movement that has become popular at a global level during the last two decades is the concept of ***lean thinking***. This concept was first introduced to American business people in the book *The Machine That Changed the World: The Story of Lean Production—Toyota's Secret Weapon in the Global Car Wars That Is Now Revolutionizing World Industry.*[63] This book focused on the global automobile industry. It highlighted the significant differences in productivity between Japanese firms, Toyota in particular, and their American and European rivals. At the time the book was written, Toyota was half the size of General Motors; today, on a global basis, Toyota is larger than General Motors. The book highlighted the approach adopted by Toyota, which is, as articulated by Taiichi Ohno, its developer, centered on "the absolute elimination of waste."

Although lean is most closely associated with Toyota, its central principles are applicable for any small and midsize enterprise. Audubon Media Corporation is a publisher of cookbooks. It adopted a program that included a variety of lean techniques. In a two-year period, it increased sales by 25 percent without increasing staffing, reduced lead time by at least 50 percent, and increased available floor space by 20 percent through inventory reduction and more efficient redesign. Corporate Image, a manufacturer of packaging, adopted lean methods and reduced lead times by over 35 percent and reduced costs by nearly $180,000 in one year.[64]

Lean thinking is predicated on five major principles.[65]. The first principle can be summarized as follows: *know who your customers are and know how they define value*. This principle coincides nicely with the underlying philosophy of the quality movement, namely, placing the customer first. Without understanding what the customer wants and what the customer values, an organization runs the risk of producing a wasteful quantity of goods and services that the customer does not want or need.

The second principle of lean thinking centers on *determining and visualizing the value stream*. The ***value stream*** is the entire set of activities associated with the production of goods and services. The goal of such mapping is to identify any and all activities that provide no value to the customer. Once those nonvalue activities have been identified, they are to be eliminated. Students are required, every semester, to go to their advisor and begin the process to register for the next semester or prepare for graduation. Imagine mapping out every step in that process. Having done that, colleges and universities could probably find some steps or activities that do not add value. In a lean operation, those steps would be eliminated. One could also think in terms of the process that most patients face when going to some type of medical facility. They are often required to fill out multiple forms that require the same information. In Figure 5.5 "Value Stream Map for Supplying Hospitals with Blood", we provide an example of a value stream map for the process of supplying hospitals with blood.

Figure 5.5 Value Stream Map for Supplying Hospitals with Blood [66]



The third principle of lean thinking argues that every effort should be made to *make the remaining steps flow* . The term *flow* here refers to the notion that from design to delivery to the customer, all steps and activities should be structured in such a way that there will be minimal or nonexistent downtime, waste, or waiting within or between the steps. [67] This is perhaps the most challenging of all the five principles of lean thinking. To make operations flow in a seamless manner often requires substantive changes in production and service processes. In fact, it may require substantive changes to the structure of a business.

The fourth principle involves a ***pull system*** . The term *pull* means that the production of goods and services is triggered by customer demand. This aspect of lean is what is commonly referred to as just-in-time inventory. The central idea is that the entire value stream is fired up only by customer demand. Thus inventory throughout the system is minimized.

The fifth and last principle is *pursuing perfection*. This clearly shows that lean thinking is not totally separate and divorced from the concepts of total quality management or Six Sigma. This last principle advocates that removing the impediments to quality will mean a significant reduction in waste. Like Crosby's work, lean advocates often talk of striving for zero defects.

One of the first steps in any lean program is identifying where waste exists within the system. Taiichi Ohno and Shigeo Shingo, the two cofounders of the Toyota Production System, identified seven possible sources of waste: transportation, inventory, motion, waiting, overprocessing, overproduction, and defects. (A nice mnemonic to remember these seven sources is TIM WOOD.) Table 5.4 "Seven Sources of Manufacturing Wastes" identifies and gives examples of the original seven sources of waste used throughout Toyota.

Table 5.4 Seven Sources of Manufacturing Wastes

Type of Waste	Description	Examples
Transportation, the movement of components and parts that is not associated with their transformation.	The movement of components and parts not associated with their transformation. Unnecessary movement (that which is not required by the customer) runs the risk of damage.	When looking for suppliers, Toyota takes into consideration their proximity to its production plants. Toyota plants are designed so that suppliers can bring their items directly to where they will be used on the factory floor.
Inventory, materials not being actively used to meet customer demand represent a waste of capital.	The three types of inventory—raw materials, work in process, and finished goods—are all forms of investment. When these inventories are not being actively used to meet customer demand, they represent a waste of capital.	Just-in-time inventory strives to produce inventory according to the demand of the customer. Every effort is made to smooth production processes so that there is no need to produce any component in bulk quantities. Many restaurants cook meals only when ordered by the customer. This minimizes leftovers.
Motion, unnecessary motion by employees and equipment.	This term refers to employees and equipment, not components or products. Unnecessary motion is a waste of time and money. Like transportation, it runs the risk of damage to the final product or the employees.	Excess movement by workers or machinery is to be avoided. Workers and equipment are positioned so that they are in close proximity and movements are minimized. Machines are sometimes grouped in a U-shape so that one worker can operate them with minimal movement.
Waiting, components or products not being processed.	If components or products are not being processed, then there is waiting. This represents a waste of investment.	Eliminating this form of waste is the reason for the concept of "flow." Production processes need to be redesigned to minimize the time spent waiting. Special paints are used that dry quickly so that vehicles can move on to the next processing step without having to wait.
Overprocessing, a component or a product that requires more time to process than the standard estimate.	A component or a product that requires more time to process than the standard estimate represents a waste. This concept also involves the notion that using inappropriate or excessively complex manufacturing processes or tools also represent a form of waste.	The essence here can be summarized by KISS—keep it simple, stupid. This is a well-known engineering principle whereby "less is more." The process can be accomplished with a simple machine preferable to a complex machine. Simplicity accomplishes the task, minimizes the chance for failure, and reduces waste. A classic example of this would be the engineers who were asked to determine the volume of a complex part. Some began by taking accurate measurements to compute the volume of some segments of the part. Another engineer simply tossed the part into a bucket of water and measured the volume of water displaced.
Overproduction, producing more than a customer wants at a particular point in time.	Producing more than the customer wants at a particular point in time is a source of waste. Some businesses have set up operations where they believe that production in large batches is the most economically efficient method. This generally means large inventory levels. Overproduction is seen by some as the driving force behind the other six sources of waste. Lean thinking tasks them to reexamine these basic assumptions.	A manufacturer has a good idea of the annual demand of a particular part. Setting up the machine that is used to produce this part is an expense proposition. Financial analysis indicates that the company should produce one batch of the part every quarter (three months' worth of supply). A three-month supply of the part means that a considerable portion sits in inventory for a long period of time. This quantity of inventory may also mask any defects in manufacturing. It would take quite a while to go through this batch before one would realize that the batch might have had problems in production. A company that focused on reducing the setup cost of the machine could then produce smaller batches, which, in turn, would produce lower inventory levels and therefore catch quality problems earlier.
Defects, the waste and expense of producing defects.	Defects in products produce expensive waste—rework costs, scrapping costs, or excess warranty costs.	Here is where lean thinking and quality management merge. Poor quality of product and service represents a dramatic waste.

The continued references to the Toyota Production System might lead the reader to believe that lean thinking is appropriate only for the manufacturing environment. That would be profoundly misleading because lean has tremendous applicability to service, particularly in the areas of health care, banking, and retail. Some authors believe that these seven sources of waste are absolutely applicable to service environments.[68] Others have suggested that the original seven sources of manufacturing waste be modified to cover the service environment, as follows: delay, duplication, unnecessary motion, unclear communication, incorrect inventory, errors, and opportunity lost.[69] These seven sources and corresponding examples are described in Table 5.5 "Seven Sources of Service Waste".

Table 5.5 Seven Sources of Service Waste

Type of Waste	Description	Examples
Delay, this corresponds to the waiting waste concept.	Any instance in which a customer must wait for any aspect of the service.	One walks into a fast-food restaurant and finds a long queue (line). Any service time spent in that queue is a delay. Another example of the delay would be waiting on the phone to speak to a sales representative.
Duplication, anytime a customer must repeat any activity unnecessarily.	When a customer has to repeat any activity unnecessarily.	Patients in a medical facility who have to repeatedly fill out forms would be an example of duplication. A website requires customer input of information, but then the website crashes, causing the customer to reinput the information is another example. Such instances are extremely annoying to most consumers.
Unnecessary Motion, a customer is shuttled between a variety of operations and where each move does not substantially add to value.	A customer who is shuttled between a variety of operations and where each move does not substantially add to value.	A customer wishes to lodge a complaint. The customer calls the complaint department and then is moved from one sales representative to another. This type of frustration may cause customers to drop the service.
Unclear Communication, the failure to provide clear instructions for any stage of a service.	The failure to provide clear instructions for any stage of the service environment.	Unclear communication, particularly with respect to instructions to customers, is contained in the entire service experience. Examples would include instructions that are filled with jargon or that easily confuse customers.
Incorrect Inventory, a product is not available to the customer, causing the customer to wait for it.	Services often have ancillary products. If a product is not available, the customer has to wait for it.	A customer places an online order for multiple items. At the time of the order, the customer is told that all the items are available and will be shipped at once. When the customer receives the order, not all the items are in the shipment, and some items are on backorder. "Murphy's Law" would dictate that the items on backorder are the ones the customer most wanted.
Errors In Services, this corresponds to defects.	Any errors or mistakes associated with either the ancillary goods or the service itself.	Telling a customer that the repair service will arrive between 10 a.m. and 1 p.m. and then showing up at 4 p.m. is the type of error that few customers are willing to forgive or forget.

Type of Waste	Description	Examples
Opportunity Lost, an engagement with the customer to a service environment that is a failure.	Every engagement with the customer in a service environment is an opportunity to succeed or fail. Failure can be associated with a bad behavioral interaction with the customer, ignorance about the service, or providing incorrect information to the customer.	Services differ from products in many ways. One of the most important is that quality services tend to be in real time. In manufacturing, one can test the product before it is shipped. This does not always occur in services. A few words from a rude clerk can describe the customer's vision of the company. Subsequent apologies may do nothing to erase this negative image. Providing customers with the wrong information, even about minor details, can also destroy their perception of a company.

Lean thinking uses several techniques to achieve its ends. We have mentioned value stream mapping. Other techniques include just-in-time inventory control, ***quick changeover*** (a program to reduce setup times to make it more attractive to produce in smaller batches), ***Kaisen*** (a Japanese term that refers to any program that seeks small improvements on a regular basis rather than a huge quality initiative), and ***visual management*** (a program of visually presenting key metrics to all personnel so that they can be aware of any and all progress). One technique that has broad application in both manufacturing and service environments is known as the ***5 S's***. The five S's refer to Japanese terms for, in effect, housekeeping.[70] The five *S*s, which together strive for simplicity and neatness to improve efficiency and effectiveness, are as follows:

- **Seiei or organization.** Only those tools and equipment that are absolutely needed are available at any one time. All other equipment is stored away until needed.
- **Seiton or orderliness.** Every part is in its correct place. The Japanese use pegboards to store tools. They sometime draw an outline of the tool on the board so that it is returned to its correct place.
- **Seiso or cleanliness.** Work environments are kept immaculate. This is done to reinforce the notion of perfect. Some factory floors are painted white so that anything dropped or any litter becomes immediately apparent.
- **Seitetsu or standardized cleanup.** This is a reinforcement of the prior three points. Starting in Japanese kindergartens, children are required to clean their classroom—together—before they are released to go home.
- **Shitsuke or discipline.** A program to adhere to set procedures because of pride in one's own work.

More and more businesses are realizing that lean thinking and quality are not two distinct management approaches but two extremely complementary models. One finds more and more references to a concept known as Lean Six Sigma, which is a program that combines aspects of both lean thinking and quality management. It recognizes that lean by itself cannot bring processes under control, and Six Sigma significantly reduces process time or capital investment.[71] Both approaches offer benefits to small businesses that cannot be ignored if these businesses want to remain viable in an increasingly competitive world.

Video Clip 5.8- Lean Process Improvement—Funny

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=58

A silent comedy to illustrate lean principles.

Video Clip 5.9- Building a Lean Culture

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=58

Lean requires change throughout an organization.

Video Clip 5.10- Lean Office: Applying Lean to Business Processes

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=58

Lean is not limited to manufacturing but can be applied to office management.

Web Resources

- Introduction to Lean: A great introduction to lean concepts by a consulting firm.

www.leanthinking.info/aboutlean.html

- Glossary of Lean Tools: Definitions of key terms.

www.shopwerkssoftware.com/lean_glossary.aspx

- Bringing "Lean" Principles to Service Industries: The application of lean concepts to the service environment.

hbswk.hbs.edu/item/5741.html

- Achieving a "Lean Service" Breakthrough: An example of lean concepts applied to the service environment.

www.stratform.com/lean_services.htm

Key Takeaways

- Lean thinking represents a program to eliminate all forms of waste in an organization.
- For any production or service process, one could map out all the currently existing steps and then remove those that do not add value to the customer.
- There are seven sources of waste in manufacturing processes.
- There are seven sources of waste in service processes.

Exercises

1. Interview several local small business owners about how they try to minimize waste.
2. Pick a particular college course you are currently taking and identify sources of waste in that class. How could you redesign that college class to minimize those wastes?
3. Discuss how the 5 Ss approach could be used in your personal life to improve efficiency and effectiveness.

Personnel Efficiency

Learning Objectives

1. Understand the importance of meetings.
2. Understand why meetings fail.
3. Understand the importance of an agenda.
4. Learn about behavioral issues in meetings.

If you had to identify, in one word, the reason why the human race has not achieved, and never will achieve, its full potential, that word would be "meetings."[72]

Dave Barry

Meetings are indispensable when you don't want to do anything.[73]

John Kenneth Galbraith

Managing Meetings

As a business grows, it will—in all probability—increase the number of its employees. As the employee base grows, there is increased demand to coordinate activities, exchange information, and engage in decision-making activities. These usually occur at meetings, and one would think that these would be straightforward events. Yet the reality is that many managers and employees come to dread participation at meetings. Data indicate that many, if not most, meetings fail to produce the desired outcome. A study conducted in 1993 found that executives were seen as a spending seventeen hours per week in meetings, and one-third felt that time was wasted.[74] Another survey of thirty-eight thousand managers found that 66 percent felt that the meetings they attend were a waste of time.[75] Still another study found that managers spend as much as 40 percent of their work time in meetings, but only 64 percent of those meetings were seen as achieving their intended outcome;[76] another study found that executives were spending as much as 70 percent of their time at meetings, but only 40 percent of those meetings had clear objectives, and only 28 percent of those meetings with objectives actually met them.[77] Yet 80 percent of the participants viewed running a successful meeting as a crucial test of manager's abilities.[78] These figures are particularly tragic because so many meetings occur in the business world. One estimate puts the number of meetings, on a daily basis, globally, at 73 million.[79] These are rather depressing figures, but the clear lesson for small business owners is that they cannot afford the luxury of not running their meetings effectively.

The good news is that the successful management of a meeting is a learnable skill.[80] Conducting an effective meeting requires that a manager focus on both procedural and behavioral issues. We will first look at procedural issues associated with running a meeting. Before considering holding a meeting, ask the following question: "Is this meeting really necessary?" Frequent meetings are sometimes held merely out of habit.[81] Can the goals of a meeting be achieved by other mechanisms?[82] These might include using the Internet; e-mail; teleconferencing; or technologies, such as MS Communicator, which allows for bulletin board interaction, voice communication, and videoconferencing. Interestingly, for all the complaints about meetings, a recent study indicated that face-to-face meetings were seen by 95 percent of those surveyed as being positive, especially in the interest of developing long-term relationships. [83]

After deciding that a meeting is necessary, it is important to determine the nature of that meeting. Meetings may have many different types of goals. They can be directed to problem solving, decision making, conflict resolution, providing information, or generating new ideas.[84][85] This is necessary because the nature of the meeting will drive its structure and internal dynamics. As an example, if a meeting is directed to a decision-making task, it should probably proceed in two parts. The first portion should be directed toward identifying solutions, while the second portion should focus on what might be the best solution.[86] The next decision would be to determine who will participate in the meeting. Ideally, this list would be limited to those who would be directly affected by the outcome of the meeting; however, in the case of informational meetings, the list may be expanded to those who will be directly or indirectly affected. The next decision is associated with determining who will be assigned particular roles in the meeting. The chair is the individual who calls the meeting, provides the initial agenda, and specifies the purpose of the meeting. It may be useful to assign the role of facilitator to an individual. This neutral person can push the meeting along, particularly when conflict arises. It is desirable to have people trained as facilitators and rotate this position among facilitators.[87] Another important role is the individual who is officially assigned to take notes. The notes of the meeting should be written up and sent to all participants in the meeting within two business days. This position should also be rotated among the participants of the meeting. It also might be advisable to assign the role of timekeeper to an individual. The timekeeper has the task of limiting the amount of time spent on any one agenda item to the previously agreed-on time frame.[88]

Perhaps the most important activity prior to the actual meeting is the proper structuring of an ***agenda***. In another study, 75 percent of those surveyed said that a good agenda is critical for a successful meeting.[89] The agenda is the formal strategic plan for a meeting. It is the mechanism for ensuring that a meeting is focused on relevant topics. A failure to have a clear focus will guarantee that the participants will have a sense that nothing had been accomplished.[90] Focus stems from having everyone understand a meeting's purpose and what one intends to achieve[91]. Items on the agenda should be prioritized in terms of their importance, which is often done by allocating a specific amount of time to each agenda item.[92] Any and all resources that will be required for the meeting should be identified along with the individuals who are responsible for securing the resources. The roles of chair, timekeeper, note taker, and facilitator (where possible) should be assigned in advance. The agenda should be sent out at least five business days before the meeting so that participants can gather the required information. This timeline also allows for people to make suggestions for changing the agenda. It is also highly advisable to make it a policy that all participants arrive on time at the beginning of the meeting. [93]

Allowing individuals to contribute to the agenda will provide them with a sense that they are contributing.[94] In setting the timeline for the different items on the agenda, it is advisable that one allow for a few extra minutes at the end of the meeting to discuss how well the meeting went and how it could be improved.[95] These few moments should be expanded into a formal system. Assessing meeting effectiveness can be done through an external observer conducting an evaluation, focus groups, or surveys.[96]Figure 5.6 "Agenda Format" provides a format for a part of the overall agenda that addresses some of the previous suggestions. It is available as an agenda format wizard in Microsoft Word 2007.

Figure 5.6 Agenda Format

Expansion Plans

6/26/2012
10:00 AM to 11:00 AM
Main Meeting Room

Meeting called by:
Frank Rainsford

Type of meeting:
Information and Decision Making

Facilitator:
Frank Rainsford

Note taker:
Bill Rogers

Timekeeper:
Alice Jacobs

Attendees:
F. Rainsford, R. Rainsford,J. Enders, A.Jacobs, L.Rogers, W. Rogers

Please read:

1. Real Estate Report for Darien Commercial Properties
2. Contractors Responses to Our RFP
3. Budget Estimate for Remodeling Properties
4. Gantt Chart for Remodeling Project

Please bring:

1. Personal Analysis of Real Estate Properties
2. Critiques of Contractors' Proposals
3. Critique of Budget for Remodeling

Agenda Topics

Review of Available Properties	Jack Enders	15
Evaluation of Possible Contractors	Bill Rogers	15
Funding Requirements	Alice Jacobs	15
Develop Time Line for Next Stage	Lucy Rogers	15
Review	Frank Rainsford	5

Agenda Topics

Review of Available Properties Jack Enders 15 minutes

Discussion: Review and critique possible commercial properties in Darien

Conclusions:

Action Items:	**Person Responsible:**	**Deadline:**
Final selection of property	Frank Rainsford 9/26/1012	

Evaluation of Possible Contractors	Bill Rogers	15

Discussion: Evaluate proposals to remodel commercial properties from the three contractors that provided responses to our RFP

Conclusions: Evaluate economic viability of all three proposals

Action Items:	Person Responsible:	Deadline:
Enter into negotiations with winning contractor	Frank and Robert Rainsford	10/15/2011

Funding Requirements	Alice Jacobs	15

Discussion: Review Budget estimates for Remodeling and purchase of new equipment

Conclusions: Evaluate accuracy of budget estimates

Action Items:	Person Responsible:	Deadline:
Review comments and revise budget estimates	Alice Jacobs	9/31/2012

Develop Time Line for Next Stage	Lucy Rogers	10

Discussion: Review Gantt Timeline for New Restaurant Project

Conclusions:

Action Items:	Person Responsible:	Deadline:

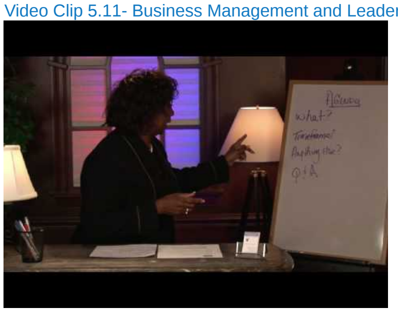
Develop Time Line for Next Stage	Lucy Rogers	10

Discussion: Review Gantt Chart time line for new restaurant project

Conclusions: Revise and resubmit

Action Items:	Person Responsible:	Deadline:
Generate revised Gantt Chart	Lucy Rogers	7/11/2011

Video Clip 5.11- Business Management and Leadership Skills: How to Conduct an Effective Meeting



A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=58

The basics of meeting management.

Video Clip 5.12- Conducting Effective Small Scale Meetings

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=58

How to conduct a meeting, even in one's home.

Video Clip 5.13- How to Avoid Meetings That Suck

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=58

How to escape the traps behind bad meetings.

Web Resources

- Managing Business Meetings: An excellent list of suggestions on business meetings.

www.cbsnews.com/8301-505125_162-51057051/managing-business-meetings/?tag=bnetdomain

- Managing Your Meeting Monsters: Identifying the types of personalities at meetings.

www.impactfactory.com/p/business_meeting_skills_training_development/friends_111-1107-40530.html

Key Takeaways

- Poorly run meetings are common and costly.
- Successful meetings require structure and an agenda.
- The agenda should identify the purpose of the meeting, the participants and their roles, the requisite resources, and agenda topics with timelines.
- Behavioral issues must always be considered when managing a meeting.

Exercises

1. Interview the owners of five businesses and determine what percentage of meetings they attend they find to be "effective."
2. Ask them what constitutes a *bad* meeting.
3. Ask them what constitutes a *good* meeting.
4. Create an agenda for a meeting with a fellow student who came up with an idea for a new business.

The Three Threads

Learning Objectives

1. Understand that in addition to quality management and lean thinking, creativity, time management, and well-executed meetings can improve value to customers.
2. Understand that quality management and lean programs can produce significant increases in operational efficiency that increases positive cash flow.
3. Learn about computer tools that can improve time management, creativity, quality management, and lean operations.

When all think alike, then no one is thinking.[97]

-Walter Lippman

Customer Value Implications

It should be clear that quality management and lean thinking have the notion of customer value at their cores. Both approaches actively incorporate needs and wants into the design of products and services and, even more importantly, into the design of the processes used to create these products and services. Regardless of what quality program one adopts for an organization, the issue of customer value is the single most important question. Lean thinking also recognizes the vital importance of first identifying the customer's notion of value so that any activity that does not add value is ruthlessly eliminated. As one article put it, "Lean enterprise never misses an opportunity to capture information about customers."[98]

The linkages between quality management, lean thinking, and customer value, therefore, should be obvious. What is less obvious is the connection between customer value and topics such as creativity, time management, and running meetings effectively. Nonetheless, indirect connections do exist. Without creativity, there will not be any new product development, and there will be no innovations in design, packaging, promotion, or distribution that can be so vital to the enhancement of value.

Owners, managers, supervisors, and employees who cannot manage their time effectively or efficiently will be unable to provide appropriate attention to improving customer value. Poorly run meetings are inefficient and degrade morale; neither is a recipe for enhancing customer value.

Cash-Flow Implications

The old saying "time is money" may be shopworn, but it is an absolute truism. Wasting time inexorably turns into a waste of money. Poor time management means that time is wasted, which costs the individual and the organization.

In a depressed economy, both large and small firms attempt to preserve cash flow by adopting a program of cost cutting. This often begins with laying off employees. However, this presents a rather significant problem. As Nancy Koehn, a business historian at Harvard business School, points out, "If demand picks up, you can't exploit it because you don't have the resources." [99] Lean thinking offers an alternative to cost cutting by reducing staff. Lean thinking, a focus on more intelligent cost-cutting, and the efficient use of all business resources have produced significant results, such as an 80 percent to a 90 percent reduction in inventory investment, an 80 percent to a 90 percent reduction in manufacturing lead times, a 50 percent reduction in space requirements, and a 50 percent reduction in material handling equipment. Such results translate into tremendous cost savings.[100]

Firms that have used the principles of the Toyota Production System have also found that they can achieve a 50 percent reduction in human effort and a 200 percent to a 500 percent improvement in quality. One small manufacturer, Gelman Sciences, adopted a lean approach to operations, and during a nine-month period, one section of the company saw inventory turns go from twenty to fifty-seven, inventory value dropped from $86,000 to $33,000, and lead time dropped from three to four weeks to one to three days.[101] Estee Bedding Company applied lean concepts to its operations and reduced its labor cost as a percentage of sales by one-half; Ameripay, a payroll service firm, saw sales increase from $1.8 million to $6 million in three years.[102] Some small businesses that are part of a larger supply change may find their movement toward lean thinking supported by firms that are further up the supply chain. In the 1990s, Pratt & Whitney initiated a program to assist smaller firms in its supply chain by requiring them to move to more of a lean focus.[103] Even small foreign firms are beginning to recognize the economic benefits from adopting lean methodologies. A polyvinyl chloride manufacturer in Thailand adopted a lean management program and saw its average production time per unit decline from forty-four minutes to twenty-three minutes while decreasing the number of operators from fifty to forty-one.[104] The concepts behind lean thinking, with its focus on efficiencies, should dictate that a small business should automate as many processes—such as bookkeeping—as possible and rely on outsourcing when feasible.[105]

One does not have to commit to major organizational programs, such as a quality management system or lean thinking, to find ways to save on cash flow. Earlier in this chapter we cited two studies. One said that better than one-third of executives believed that all meetings were a waste, while the second study said that two-thirds of all meetings were a waste. We split the difference between these two studies and arrive at a figure that one-half of all meetings are perceived as useless. This can have significant cash-flow implications, even for small firms.

Let us illustrate this through a simple example. The owner of a small hardware store believes it is important to have weekly meetings with the store's supervisor and five employees. Let us assume that the owner values his or her time at $70 per hour. The supervisor's value is given at $35 an hour, while each employee's time is valued at $10 per hour. Employees are expected to produce 2.5 times their pay. This means that a 1-hour meeting should be valued at $282.50 [$70/hour + 2.5 × (5 employees × $10/hour) + 2.5 × (1 supervisor × $35/hour)]. Assuming 52 meetings per year, the total opportunity cost for these meetings is $14,690. If one-half of those meetings are a waste, then the business is losing nearly $7,350 a year. There are many areas throughout a firm's operations that can be evaluated to reduce wasteful activities and improve its cash-flow position.

Implications of Technology and the E-Environment

Time-management systems are available in a variety of paper-and-pencil and software formats. They generally allow for listing to-do tasks, setting due dates, identifying required resources, and prioritizing their importance. Some allow for a project format, where one can break down the project into smaller interrelated tasks. Many of them provide the capability to synchronize this information across several computers and smartphones. This would allow a person to have the time-management system available on an office computer, a home computer, and in the pocket (smartphone). One system is based on Covey's fourth-generation approach to time management.

Multiple software packages are geared to assist individuals and groups who wish to improve their creativity. There are packages to help with brainstorming in its various forms. Numerous companies provide mind-mapping software in a variety of formats: computers, iPads, and even smartphones.

Quality management encompasses many tools and techniques, far more than could ever be covered in this chapter. There are packages geared just for statistical process control (SPC) models. Some can receive data from a process and then automatically inform the operator of a "drift" from conformance to standards. In addition to SPC models, other packages include tools that are used to improve quality. These packages range from less than $100 to many thousands of dollars.

Web Resources

- Achieve: A time-management system.

www.effexis.com/achieve/planner.htm

- My Life Organized: A time-management system.

www.mylifeorganized.net

- PlanPlus for Outlook v7: A time-management system (based on Covey's fourth-generation time-management system).

franklincoveysoftware.com/individual/individual-products/planplus-for-outlook-v7

- SciPlore: Mind-mapping software.

en.Wikipedia.org/wiki/SciPlore_MindMapping

- MindManager: Mind-mapping software.

en.Wikipedia.org/wiki/MindManager

- MindMaple: Mind-mapping software.

en.Wikipedia.org/wiki/MindMaple

- MindMapper: Mind-mapping software.

en.Wikipedia.org/wiki/MindMapper

- Creative Whack Pack: Brainstorming software app for the iPad.

itunes.apple.com/us/app/creative-whack-pack/id307306326?mt=8

- Mind View 4: Brainstorming software.

www.matchware.com/mv3be_landing.php?gclid=CKyWyorEiasCFWUZQgodAQjG1Q

- Sigma Magic: Quality management software plus lean components.

www.sigmamagic.com

- Sigma XL: Quality management software

www.sigmaxl.com

- SPC XL: Quality management software add-in for Excel.

www.sigmazone.com/spcxl.htm

- Lean Tuppas Software: Quality management software.

www.tuppas.com/lean-manufacturing-software/lean-manufacturing-software.htm

Key Takeaways

- Customer value can be enhanced not only through organizational programs such as quality management and lean thinking but also by increasing creativity, time-management skills, and meeting effectiveness.
- Quality management and lean programs can generate efficiencies that produce significant cost savings.
- Software exists that can assist with improving one's own time management.
- Similar programs are available to improve the creativity of teams and support both quality and lean improvement programs.

Exercises

1. Evaluate several computerized time-management systems and write a report covering your selection process.
2. Evaluate several creativity packages and select one that you might buy. Write a one-page paper that talks about why you selected this package.
3. Assume you are a small manufacturer of hypodermic needles. You have sixty employees, and sales are $23 million. You are nervous about overseas competitors, whose products are getting better. You want to further improve your quality and may be interested in applying lean thinking to your operations. Evaluate several software packages and write a report specifying why you support the acquisition of this package.

Disaster Watch

Successful small business owner often rapidly acquire a sixth sense—one that warns them of impending dangers. They begin to sense when there are changes in consumer preferences, when there is a need for an infusion of additional financial resources, or when closer attention needs to be paid to cash flow. These are fundamental issues, and the failure to recognize them will lead to disaster. Subtler issues associated with operations are sometimes missed, and just because they are less obvious does not mean that they cannot be as dangerous. Small businesses can die when they fail to focus on the necessity of being efficient. As said by one commentator, "As the economy grows leaner, this focus on efficiency is paramount to SMEs [small and midsized enterprises], and may indicate chances of business sustainability."[106]

In personal efficiency and effectiveness, time is identified as perhaps the most vital resource, since once lost it can never be recovered. This perspective may be particularly true for small businesses. Most small businesses are under tremendous financial pressures. They normally don't have the luxury of having large staffs, and this means that much of the work falls on the shoulders of the owner. Those owners who cannot effectively manage their time are asking for problems in their business and personal lives.[107] Their businesses can suffer because the owners don't have sufficient time to generate new business.[108] Family life suffers because the owner's inability to successfully manager his or her time translates into time inefficiently spent at work.

Small business is often touted, correctly, as the driving mechanism for innovation in this country. The implication is that innovation and creativity in small business is limited to the development of new products and services. This belief can be disastrous for any small business because it may preclude creative innovations in other areas, such as operations and marketing. Recognizing this as a possibility, IBM has begun to operate "boot camps" to instruct smaller business how to fully exploit social media to drive sales.[109]

A failure to maintain a clear focus on quality can have disastrous consequences. While quality in and of itself may not guarantee success, its absence, in the long run, will guarantee failure. Given the complexity of many quality programs and tools, small businesses should overcome a reticence to bring outside quality experts in-house.[110]

Lastly, businesses—large and small—can be slowly poisoned by an unending stream of poorly managed meetings. Those types of meetings waste managers' and employees' precious time and can wreck morale.

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2.3: Chapter 6- Icebergs and Escapes

SoBe

Source: Used with permission from John Bello.

John Bello and Tom Schwalm founded SoBe Beverages in Norwalk, Connecticut, in 1996. The name is an abbreviation of South Beach, the well-known upscale area in Miami, Florida. John describes SoBe as playfully irreverent, having brand equity with meaning, a cult brand that resonates in the marketplace. He attributes the company's success to some luck, missteps by the competition, being aggressive, and tapping into a cultural shift.

SoBe tapped into a cultural shift toward healthier living and wellness and the rise of companies like General Nutrition that focused on wellness products: vitamins, supplements, minerals, and herbs. Their first product, Black Tea 3G, contained ginseng, guarana, and ginkgo. Orange Carrot, another of SoBe's first successful products, is a blend of orange and carrot juices enhanced with calcium, chromium picolinate, and carnitine. An extensive line of other flavors was added. All ingredients were linked to specific health benefits.

The first two years of operation saw SoBe losing money, but by the end of 1997, the company was on fire. In five years, the company went from $0 to $300 million in sales, and it became a national brand. SoBe was competing effectively at a premium price. Coca-Cola, Pepsi, Arizona, and other brands took notice. Within three years, Coca-Cola was talking to SoBe about a possible strategic partnership. There were fifteen meetings, only two of which were with marketing. The rest were with corporate lawyers (John calls them "sales preventers") and regulators. At the end of 1999, Minute Maid presented the proposal to the Coca-Cola board. Surprisingly, it was rejected. Coca-Cola saw no reason to go beyond carbonated soft drinks, and there were also some leadership issues. Back to square one.

John and Tom started looking at liquidation because of pressure from investors who wanted their money. But there were other reasons they thought about selling. They were not interested in managing a disparate group of investors—bankers, investors, and private equity companies. With 250 employees, the company was growing into something they did not want it to be—and they were not having as much fun. In 2000, the market was flattening, so with a big brand image, it was a good time to get out. They also wanted to get into larger markets, such as schools and golf clubs, but only big companies could get them into a broader marketplace. They hired an investment bank and again went into negotiations with Coca-Cola as a strategic partner. The situation became very complicated and frustrating. Ultimately, a deal with Coca-Cola was again a no-go.

All was not lost. Pepsi (and others) had expressed an interest. John made a presentation to forty people at Pepsi—rather than the multiple presentations he had to make to Coca-Cola—and within two weeks, they had a deal. SoBe was sold in 2000 to Pepsi for an impressive $370 million…a very nice return on an investment of $7 million in cash and $1 million in trade-out services. Part of the deal was that John would stay on at Pepsi for two years to manage the brand, but after one day, it was clear to him that he was not going to be managing anything. Things were moved into committee, and the corporate bureaucracy took over. John likened the experience to "Making Ho Chi Minh a general in the US Army," that is, he had a very different way of doing things. He is independent, is unconventional, speaks his mind, and would rather do things and make them work—an approach that tends to be at odds with the culture in large corporations.

SoBe inspired a whole line of functional beverages that people like to buy to make them feel smarter, healthier, and sexier. The company helped to build careers that have lasted. John is very happy with his legacy…and with his piece of the $370 million sale price.[1]

Most textbooks on small business and entrepreneurship emphasize, quite correctly, the benefits and joys of owning and operating one's own business. However, they often neglect to cover many of the challenges of continuing to operate a business successfully—the icebergs that can sink a business. The first half of this chapter covers one of the biggest icebergs: a natural or a man-made disaster and the disaster planning that should precede it. Being able to anticipate a disaster will contribute significantly to its effective handling so that a business can survive.

Even if a small business survives a disaster or another kind of iceberg, the owner may still wish to walk away. If a business does not survive, the owner will have no choice but to walk away. There may be other reasons forcing the owner to walk away, or escape, as well. The second half of this chapter discusses the forced escape and the other end of the spectrum—when things go so well that the business owner is ready to move on to another phase of his or her life. In both cases, an exit strategy will be required.

Icebergs

Learning Objectives

1. Understand the kinds of disasters that can face a small business.
2. Understand why disaster planning is important to a small business.
3. Describe the process of disaster planning.
4. Describe the sources of disaster assistance for small businesses.

A natural or a man-made disaster is but the tip of the iceberg. Planning for the complexity of what lies below the tip is important for every small business. Small- to medium-sized businesses are the most vulnerable in the event of a disaster.[2] It has been estimated by the US Department of Labor that 40 percent of businesses never reopen following a disaster. At least 25 percent of the remaining companies will close within two years. The Association of Records Managers and Administrators estimated that over 60 percent of small businesses that experience a major disaster close by the end of two years.[3]

Given these odds, planning for disaster recovery makes great sense—even if, in the end, walking away makes the most sense. If a small business owner decides to rebuild, the process can begin after human health and safety are restored, the electricity is back on, and transportation is up and running. Everyone will want life to return to normal following the destruction, but that may not be possible for every small business. The market may change. Conditions may change, and a business must change to succeed in disaster recovery.[4]

Disaster Planning

In the film *Apollo 13*, astronauts and engineers went through seemingly endless simulations of what might go wrong on a flight to the moon. The astronauts complained that some of the scenarios were unrealistic and almost impossible to occur. But when a near disaster occurred on Apollo 13, the engineers and astronauts were confronted with a problem that had never been considered; however, because of their prior experience with disaster training, they were able to develop a solution.

Rather than being negative, anticipating what can go wrong can be profoundly positive through either prevention or quickly responding to a crisis. The wise small business owner should appreciate Murphy's Law ("Anything that can go wrong will go wrong") and Murphy's first corollary ("And it will go wrong at the worst possible moment"). The most pragmatic small business owner will also realize that Murphy was an optimist.

The Federal Emergency Management Agency declared 741 natural disasters in the United States for the period 2000 to 2011. Of that number, 66 percent were declared across the following six states: Texas (#1), California, Oklahoma, New York, Florida, and Louisiana (#6). However, every state and territory was represented.[5] Planning for the aftermath of severe storms, flooding (e.g., perhaps snow melts too fast), fire, a hurricane or a tornado, a terrorist attack, or—in some areas—an earthquake is the key to getting back to business with a minimum of disruption. Not all businesses will face the same likelihood of these disasters occurring, but everyone faces the possibility of fire, severe storms, and flooding. Every situation will be unique, with the complexity of issues depending on the particular industry, size, location, and scope of a business.[6] The widespread nature of a the typical disaster means that public services, such as police, fire fighters, and medical assistance, will be unable to reach everyone right away. A business might be going it alone for a while.[7]

According to a recent poll conducted by the National Federation of Independent Business, man-made disasters affect 10 percent of small businesses, and natural disasters have impacted more than 30 percent of all small businesses in the United States.[8]***Man-***

made disasters are disastrous events caused directly and principally by one or more identifiable deliberate or negligent human actions.[9] They include such things as arson, radiation contamination, terrorism, structural collapse due to engineering failures, civil disorder, and industrial hazards.[10] The better prepared a business is, the faster it will be able to recover and resume operations…if that is the decision. Having a disaster plan can mean the difference between being shut down for a few days and going out of business entirely.[11]

A Disaster Planning Success Story

Joe Bogner of Dodge City, Kansas, learned the importance of disaster planning firsthand. He owns Western Beverage, Inc., a beverage distribution company serving twenty-nine counties in western Kansas. In 2002, Western Beverage sustained millions of dollars in fire damage. Yet the company resumed deliveries after just three days. Bogner was named the Kansas City Small Businessperson of the Year for 2006, partially because of his company's ability to respond to adversity. As his nomination package stated, "Setting up plans of action and following through are Joe's way of life. He has proven and is continuing to prove that dreams can come true."[12]

Four key facts about disaster planning must be kept in mind: (1) disasters will occur, (2) an owner must have a plan *before* the disaster occurs, (3) react with urgency but do not panic, and (4) ride it out.[13] If an owner is committed to having a disaster plan for a business, the plan and process can be structured in a variety of ways. For this section, however, the recommendations on Ready.gov serve as the structure for our discussion. These recommendations reflect the Emergency Preparedness Business Continuity Standard (NFPA 1600) developed by the National Fire Protection Association and endorsed by the American National Standards Institute and the Department of Homeland Security.[14] The recommendations are divided into three areas: plan to stay in business, talk to the people, and protect the investment. The topics discussed here are presented in Figure 6.1 "Disaster Planning". They have the greatest immediacy for a small business.

Figure 6.1 Disaster Planning [15]

Plan to Stay in Business

A business owner has invested a tremendous amount of time, money, resources, and emotions into building a business, so he or she will want to be able to survive a natural or man-made disaster. This requires taking a proactive approach so that the chances of the business surviving are increased. Unfortunately, nothing can be done to guarantee the survival of a business because there is no way to know what kind of disaster may occur—or when. There is also no way to know what kind of business environment the owner will face after the disaster. There are, however, several things can be done to increase those chances of survival. Resist the temptation to put emergency planning on the back burner.

Be Informed

It is important to look realistically at the types of disasters that might affect a business internally and externally and prepare a risk assessment. Consider the natural disasters that are most common in the areas where the business operates and think about the business's vulnerability to man-made disasters. Fires are the most common disasters in the United States, and they are extremely destructive to businesses,[16] but an owner may not be aware that a community is very vulnerable to flooding from snow melt or that the proximity to a chemical plant makes a business vulnerable to the results of explosions. This is why it is important to prepare a risk assessment so that the business can plan accordingly.

Make a Continuity Plan

It is said that a business continuity plan is the least expensive insurance any business can have—especially a small business—because it costs virtually nothing to produce.[17] The better the continuity planning is before a disaster, the greater the chances that a business will survive and recover. There are many things that can be done.[18][19] The following is not an exhaustive list:

1. Carefully assess how the business functions. Document internal key personnel and backups (i.e., the personnel without whom a business absolutely cannot function). The list should be as large as necessary but as small as possible.
2. Identify suppliers, shippers, resources, and other businesses that are interacted with on a daily basis. Document these and other external contacts, such as bankers, attorneys, information technology (IT) consultants, utilities, and municipal and community offices (police, fire, etc.) that may be needed for assistance.
3. Identify people who can telecommute. Take steps to ensure that critical staff can telecommute if necessary.
4. Plan for payroll continuity.
5. Document critical equipment. Personal computers, fax machines, special printers and scanners, and software are critical to most businesses. An accurate inventory will help a business restore critical equipment.
6. Make sure that all data and critical documents are protected. Critical documents include articles of incorporation and other legal papers, utility bills, banking information, and human resources documents; all these will be required to start over again. The Small Business Administration (SBA) recommends that vital business records—information stored on paper and computer—should be copied and saved at an offsite location at least fifty miles away from the main business site.[20] Companies such as Carbonite can store records “on the cloud.”
7. Identify a contingency location where business can be conducted while the primary office is unavailable. Many hotels have well-equipped business facilities that can be used, but remember that other businesses may need to do the same thing. It is good to have a contingency plan for a contingency location.
8. Put all the information together. The continuity plan is an important document, a copy of which should be given to all key personnel. Do not distribute the plan to people who do not need to have it. The plan will contain sensitive and secure information that could be used by a disgruntled employee for inappropriate purposes.
9. Plan to change the plan. There will always be events that could not have been factored into the plan. For example, the contingency site is damaged beyond use or the business’s bank is in an area that will be without power for days. Situations such as these will require immediate changes to the plan.
10. Review and revise the plan.

Talk to People

Without good communication, the internal and external structure of a business—and its daily operations—will face challenges that may ultimately lead to its downfall.[21] Strong communication skills are, therefore, a vital part of business success. When first starting out, the owner will need good communication skills to attract and keep new customers. As the business grows and new employees are required, these skills will be needed to hire, motivate, and retain good staff.[22] It is for this reason that the employees of a business should play a central role in creating a disaster plan.

Involve Coworkers

Providing for the well-being of all employees is one of the best ways to ensure that a business will recover from a disaster. A business must be able to communicate with them before, during, and after a disaster. There are several recommendations for doing this, including the following:[23]

- Employees from all levels in the organization should be involved.
- Internal communications tools, such as newsletters and intranets, should be used to communicate emergency plans and procedures.
- Set up procedures to warn people, being sure to plan how to warn employees who are hearing impaired, are otherwise disabled, or do not speak English.
- Encourage employees to find an alternate way of getting to and from work in case their usual way of transportation is interrupted.
- Keep a record of employee emergency contact information with other important documents.

Write a Crisis Communication Plan

The owner must decide how the business will contact suppliers, creditors, other employees, local authorities, customers, media, and utility companies during and after the disaster. One easy way to do this is to assign key employees to make designated contacts. Provide a list of these key employees and contacts to each affected employee and keep a copy with other protected contacts. Each key employee should also keep a copy of the list at home. In addition,[24] do the following:

- Make sure that top executives have all the relevant information needed to protect employees, customers, vendors, and nearby facilities.
- Update customers on whether and when products will be received and services rendered.
- Let public officials know what the business is prepared to do to help in the recovery effort.
- Let public officials know whether the business will need emergency assistance to conduct essential business activity.

Support Employee Health—and the Owner's Health

Disasters often result in business disorientation and environmental detachment, with the psychological trauma of key decision makers leading to company inflexibility (perhaps inability) to deal with the change required to move forward.[25] If the owner or other key personnel experience post traumatic stress disorder, it can cripple a business's decision-making ability.

No matter the disaster, there will be psychological effects (e.g., fear, stress, depression, anxiety, and difficulty in making decisions) as well as—depending on the nature of the disaster—physical effects such as injuries, burns, exposure to toxins, and prolonged pain.[26] As a result, the owner and the employees may have special recovery needs. To support those needs, do the following:[27]

- Provide for time at home to care for family needs, if necessary.
- Have an open-door policy that facilitates seeking care when needed.
- Reestablish routines as best as possible.
- Offer special counselors to help people address their fears and anxieties.
- Take care of yourself. Leaders tend to experience increased stress after a disaster. The leader's own health and recovery are also important to both family and the business as a whole.

Protect the Investment

Last but certainly not least, take steps to protect the business and secure its physical assets. Among the things that can be done, having appropriate insurance coverage; securing facilities, buildings, and plants; and improving cybersecurity are at the top of the list.

Insurance Coverage

Having inadequate insurance coverage can leave a business vulnerable to a major financial loss if it is damaged, destroyed, or simply interrupted for a period of time. Because insurance policies vary, meet with an insurance agent who understands the needs of a particular business.[28]

- Review coverage for things such as physical losses, flood coverage, and business interruption. Normal hazard insurance does not cover floods, so make sure the business has the right insurance.[29] ***Business interruption insurance*** protects a business in the event of a natural disaster, a fire, or other extenuating circumstances that affect the ability of a company to conduct business.[30] Small business owners should seriously consider this type of insurance because it can provide enough money to meet overhead and other expenses while out of commission. The premiums for these policies are based on a company's income.[31]
- Understand what the insurance policy covers and what it does not cover.
- Add coverage as necessary.
- Understand the deductible and make adjustments as appropriate.
- Think about how creditors and employees will be paid.
- Plan how to pay yourself if the business is interrupted.
- Find out what records the insurance provider will require after an emergency and store them in a safe place. It would be a good idea to take pictures of your physical facilities, equipment, buildings, and plant so that insurance claims can be processed quickly. These pictures will also provide a good basis for putting the operation back into working order.

Secure Facilities, Buildings, and Plants

One cannot predict what will happen in the case of a disaster, but there are steps that can be taken in advance to help protect a business's physical assets, including the following:[32]

- Fire extinguishers and smoke detectors should be installed in appropriate places.
- Building and site maps with critical utility and emergency routes clearly marked should be available in multiple locations—and they should be protected with other important documents.
- Think about whether automatic fire sprinklers, alarm systems, closed circuit television, access control, security guards, or other security measures would make sense.
- Secure the entrance and the exit for people, products, supplies, and anything else that comes into and leaves the business.
- Teach employees to quickly identify suspect packages and letters, for example, packages and letters with misspelled words, no return address, the excessive use of tape, and strange coloration or odor. Have a plan for how such packages and letters are to be handled.

Improve Cybersecurity

Many, perhaps most, small businesses will have data and IT systems that may require specialized expertise. They need to be protected. The industry, size, and scope of a business will determine the complexity of cybersecurity, but even the smallest business can be better prepared.[33] Small businesses are the most vulnerable to cybersecurity breaches because they have the weakest security systems, thereby making them easier online targets.[34]

Video Clip 6.1- Cybersecurity

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=64

An overview of cybersecurity.

Video Link 6.1- Chubb Group of Insurance Companies

The Chubb Group of Insurance Companies provides a very good video discussion of cybersecurity.

www.chubb.com/businesses/csi/chubb822.html

Every computer can be vulnerable to attack. The consequences can range from simple inconvenience to financial catastrophe.[35] There are several things that can be done to protect a business, its customers, and its vendors, including the following:[36][37][38]

- **Explore cybersecurity liability insurance.** This coverage is available at reasonable rates to protect against credit card identity theft, with limits up to $5 million. This insurance will cover the loss of digital assets plus expenses for public relations, damages, and service interruption. It will also protect customers. The notification of customers whose credit was compromised is included plus any legal costs and a year of credit monitoring for each individual affected. Although other cybersecurity insurance policies can cover data loss, applicants must break down loss estimates on an hourly basis because most breaches are resolved in hours, not days. This is not an easy thing to do.
- **Use antivirus software and keep it up to date.** If an owner is not already doing this, he or she should probably have a mental examination.

- **Do not open e-mail from unknown sources.** Always be suspicious of unexpected e-mails that include attachments, whether or not they are from a known source. When in doubt, delete the file and the attachment—and then empty the computer's deleted items file. This should be a procedure that all employees know about and follow. The owner must do it as well.
- **Use hard-to-guess passwords.** An application for cyberinsurance requires, among other things, answering the following question: "Are passwords required to be at least seven characters in length, alphanumeric, and free of consecutive characters?" (Check yes or no.) Whether or not a business plans to apply for cyberinsurance, instituting this kind of password policy is well worth consideration.

Key Takeaways

- Small- to medium-sized businesses are the most vulnerable in the event of a disaster.
- Some estimates claim that over 60 percent of small businesses that experience a major disaster close by the end of the second year.
- Planning for disaster recovery makes great sense for protecting a business.
- Every state and territory has experienced disasters. Planning for the aftermath is the key to getting back to business with a minimum of disruption. However, every situation will be unique.
- Man-made disasters affect 10 percent of small businesses, while natural disasters have impacted more than 30 percent of all small businesses in the United States.
- A man-made disaster is a disastrous event caused directly and principally by one or more identifiable deliberate or negligent human actions—for example, arson, terrorism, and structural collapse.
- The better prepared a business is, the faster it will recover from a disaster and resume operations. Having a disaster plan can mean the difference between being shut down for a few days and going out of business entirely.
- Even the smallest business should have a disaster plan.
- The three main areas that an owner should focus on in a disaster plan are the plan to stay in business, talk to people, and protect the investment.

Exercises

Frank's BarBeQue just missed being impacted by a tornado that ripped through southwestern Connecticut. Many small businesses were lost, never to reopen, while others sustained major physical and economic damage. Frank's son, Robert, asked his father about whether he was prepared for something like that. Frank's response was troubling. Although he kept some important documents in a safety deposit box at the bank, there was little planning or protection. Robert explained the importance of disaster planning, but Frank was overwhelmed by the prospect of the process.

Robert contacted a local university and arranged with its school of business for a team of five students to prepare a disaster plan for Frank's BarBeQue. He presented the project idea to his father and was relieved that his dad was willing to participate. It was clearly understood that no proprietary or confidential information would be shared with the students.

1. Assume that you are the leader of the team. Describe the approach you will take and the recommendations that you will make. It is expected that you will go beyond the information provided in the text. Creativity is strongly encouraged.

Disaster Assistance

Learning Objectives

1. Learn about the sources of disaster assistance for the physical and/or economic losses of small business.

Do not assume that all small businesses will qualify for disaster loan assistance or that insurance will cover the costs of all losses. A small business owner may have to depend on other forms of financial assistance—for example, savings, friends, and family.[39] However, if a small business has sustained economic injury after a disaster, it may be eligible for financial assistance from the Small Business Administration (SBA). If a business is located in a declared disaster area, the owner may apply for a long-term, low-interest loan to repair or replace damaged property.[40]

Physical and Economic Injury Disaster Loans

In the case of a physical disaster, a small business owner may apply for a low-interest SBA loan of up to $2 million to repair or replace damaged real estate, equipment, inventory, and fixtures: “The loan may be increased by as much as 20 percent of the total amount of disaster damage to real estate and/or leasehold improvements, as verified by SBA, to protect property against future disasters of the same type. These loans will cover uninsured and or under-insured losses.”[41] It is also possible that small business disaster relief loans may be available at the local, county, regional, or state level.[42]

The SBA can also help small businesses that were not damaged physically but have suffered economically.[43] An Economic Injury Disaster Loan of up to $2 million can be granted to meet necessary financial obligations—expenses the business would have paid if the disaster had not occurred.

The interest rate on both Physical and Economic Injury Disaster Loans will not exceed 4 percent if you do not have credit available elsewhere. Repayment can be up to 30 years, but this will depend on the business’s ability to repay the loan. For businesses that may have credit available elsewhere, the interest rate will not exceed 8 percent. SBA determines whether the applicant has credit available elsewhere.[44]

Disaster Assistance from the Internal Revenue Service

The Internal Revenue Service (IRS) provides some disaster assistance and emergency relief for businesses through special tax law provisions, especially when the federal government declares their location to be a major disaster area. The IRS may grant additional time to file returns and pay taxes. While doing disaster planning, check the latest special tax law provisions that may help a business recover financially from the impact of a major disaster.[45] It would also be a good idea to check out what kind of record keeping the IRS requires so that a business will be fully prepared should it be necessary to take advantage of what the IRS offers.

SCORE Business Advice

Disaster recovery will push the limits of a small business…and then some. Locate the closest offices of **SCORE (Service Corps of Retired Executives)**—a nonprofit association dedicated to educating entrepreneurs and helping small businesses start, grow, and succeed nationwide—and enlist their support. SCORE provides confidential business counseling services at no charge.[46]

Online Disaster Assistance

DisasterAssistance.gov is a one-stop web portal, self-described as access to disaster help and resources, that details over sixty different forms of assistance from seventeen US government agencies where a business owner can apply for SBA loans through online applications, receive referral information on forms of assistance that do not have online applications, or check the progress and status of online applications.[47][48]

Benefits.gov wants to let survivors and disaster relief workers know about the many disaster relief programs that are available. There are questions for a small business owner who has suffered damage because of a natural disaster to answer to find out which government benefits the business may be eligible to receive. The site also provides a link to DisasterAssistance.gov [49]; [50]

Key Takeaways

- Do not assume that a small business will qualify for disaster loan assistance or that insurance will cover the costs of all losses. A small business owner may have to depend on others for financial assistance—for example, friends, family, and savings.
- A small business owner may apply for a low-interest SBA loan of up to $2 million to repair or replace damaged real estate. The interest rate on this loan will not exceed 4 percent if credit is not available elsewhere.
- The SBA also provides financial assistance to small businesses that were not damaged physically but suffered economic losses. The interest rate on this loan will also not exceed 4 percent if the business does not have credit available elsewhere.
- The IRS provides disaster assistance and emergency relief through special tax provisions.
- It would be worthwhile checking out SCORE for assistance.
- Online disaster assistance is available through two website portals: DisasterAssistance.gov and Benefits.gov.

Exercises

1. As part of the disaster management plan, Robert has asked the student team to prepare a specific plan for obtaining disaster assistance under the assumption that both physical and economic damages will occur. Review the various options and the material from the previous section in this chapter and then make specific recommendations. It is expected that you will go beyond the information presented in the text.

Escapes: Getting Out of the Business

Learning Objectives

1. Identify the situations in which an owner may choose to get out of business.
2. Identify and understand the situations that may lead to being forced out of business.
3. Understand the resources that can help an owner make a decision.

There are many reasons why an owner might want to walk away from a business; the choice is oftentimes the owner's. Perhaps the owner wants to sell the business before retirement. Perhaps someone has approached the owner with a terrific offer. Perhaps investors are pressuring the owner for their money. Perhaps no one in the owner's family wants to take over the business. Perhaps it is no longer fun; the entrepreneurial spirit is gone, and the owner's passion has changed. It could be that either the owner or the team is not committed to making things work.[51] Perhaps the owner would like to cash out the equity built in the business.[52][53] There are many other reasons as well:

- The owner is spending more time fixing nominal problems, it feels as if he or she is working backward, and no end seems in sight.
- Instead of being the most optimistic person on the team, the owner starts taking a negative view on most of the decisions the team is making about future prospects for growth.
- Continuing with the business may have serious, lasting personal repercussions, such as threatening one's marriage, familial relationships, or health. The potential risk is no longer worth the reward.
- The owner sees the writing on the wall: no repeat or referral customers, no positive feedback from any source, or no demand for the business's product or service. Positive feedback can take many forms: word of mouth, referrals, favorable press, favorable posts and reviews on Facebook and Twitter, and plenty of inquiries. If a business owner is not satisfying customers and attracting new ones, why be in business at all?

When Walking Away Is Not the Owner's Choice

There will also be those times when walking away from a business may not be the owner's choice.

- **The owner wants no one else to run the business and is unwilling to give up equity.** Every small business founder faces the **founder's dilemma**—that is, the dilemma between making money and controlling the business.[54] It is tough to do both because they tend to be incompatible goals. Founders often make decisions that conflict with maximizing wealth.[55] If an owner wants to make a lot of money from a business, the owner will need to give up more ***equity***(the money put into the business) to attract investors, which requires relinquishing control as equity is given away; investors may alter the board membership of a business.[56] To retain control of a business, the owner will have to keep more equity, relying on his or her own capital instead of taking money from investors. The result will be less capital to increase a company's value, but he or she will be able to run the company.[57]
- **The owner is facing bankruptcy.** One study, [60] found that firms with less sophisticated owners or managers with respect to experience and training increases the likelihood of bankruptcy as do a deteriorating market and having less access to capital. There can be other reasons as well—for example, employee theft, fraud, or a consumer liability lawsuit that drains a company's assets.
- **The owner may be the cause.** The owner could be killing the company or, at the very least, shooting himself or herself in the foot. There are several ways in which this could happen: [61] (1) micromanaging, which may lead to, for example, employees presenting problems or issues but no solutions, unusually high turnover, and never receiving a project that the owner does not change; (2) spending money in the wrong places—for example, spending money on items not needed, such as a fancier location, hiring more staff than needed, and attending costly trade shows with limited or no return on investment; (3) chasing after every customer instead of focusing on the ideal and regular customers that should be reached; (4) the owner is not on top of the numbers, perhaps because he or she is not financially minded and has not taken the time to become financially minded or

hire someone as the finance person; and (5) the owner is not a people person, perhaps being a “my way or the highway” kind of person who invests no emotion or warmth when dealing with employees and colleagues, or is an egomaniac.

- **The owner is seriously ill.** Being ill will raise doubts about a company’s future, and new businesses are the most vulnerable.[62] If there is no one in the owner’s family who is interested in or willing to take over the business, this can add additional stress to the situation.
- **The industry dies or implodes.** Sometimes the demand for a service or a product just dies—for example, web-consulting companies during the dot-com bust in 2000 and 2001.[63] Henrybuilt Corporation, a Seattle firm that specialized in designing kitchens from $30,000 to $100,000, saw its sales come to a standstill in 2008. Everyone was cancelling projects. The company modified its product and was able to survive.[64]

Resources to Help Make a Decision

The decision to walk away from a business—whether that decision is voluntary or forced—is not an easy one to make. Consult with an appropriate mix of individuals; a partner or partners if applicable, your spouse, your family, an attorney, an accountant, and perhaps someone from SCORE. Each individual can offer a different perspective and different counsel. Ultimately, however, the decision is the owner’s.

One thing is for certain. Whether the escape is voluntary or forced, there should be an exit strategy.

Key Takeaways

- Escaping from a business is the owner’s choice when, for example, he or she wants to sell the business before retirement, someone has approached the owner with a terrific offer, investors are pressuring the owner for their money, no family member wants to take over the business, or it is not fun anymore.
- An escape may be forced when, for example, an owner wants no one else to run the business and is unwilling to give up equity or is facing bankruptcy or is seriously ill.
- The owner should consult with a mix of resources before making a decision.

Exercises

1. You are the twenty-eight-year-old founder of a very successful, five-year-old software company. For the last three years, sales have doubled in each year. Last year’s sales were $75 million. A major high-tech firm wants to buy your company. They will offer cash and will sweeten the offer by allowing you the option of being CEO for at least two years. How much would the firm have to offer you to take this deal? How would you know if it was a fair offer? Would you exercise the option to act as CEO for the two years? If you took the offer, what would be your life plans?

Exit Strategies

Learning Objectives

1. Understand the importance of an exit strategy.
2. Explain the exit strategies that a small business can consider.

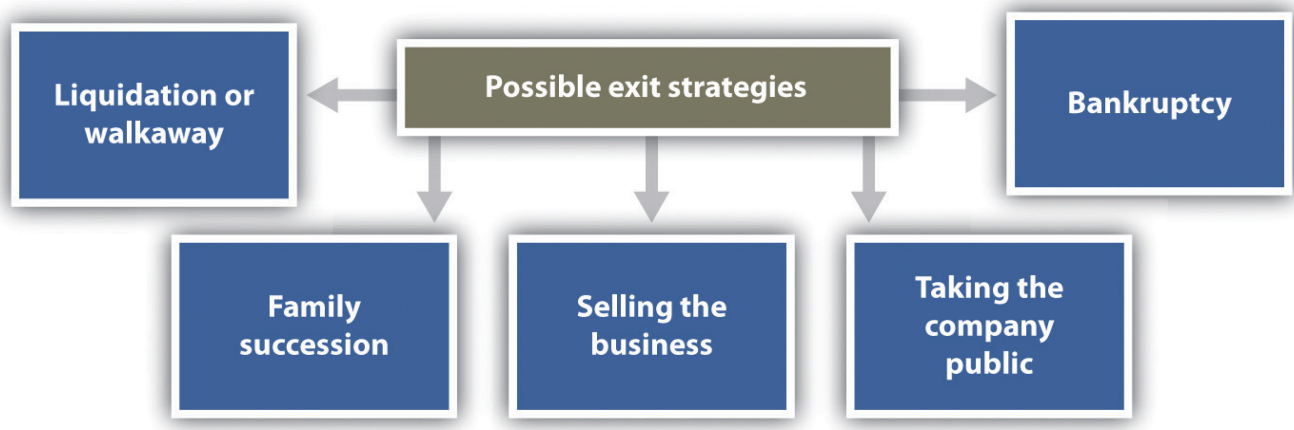
The most emotional topic a small business owner will face while building a business—and the hardest decision to make—is when and how to exit the business. This very personal decision should be considered while building the business because this decision will impact many other decisions made along the way.[65] Ultimately, however, an exit strategy must be developed whether or not it is considered along the way. The strategy should be developed early in the business, and it should be reviewed and changed periodically because conditions change. Unfortunately, many small business owners have no exit strategy. This will make an already very emotional decision and process even more difficult.

There are many exit strategies that a small business owner can consider. Liquidation or walk away, family succession, selling the business, bankruptcy, and taking the company public are discussed here. Selecting an exit strategy is important because the way in which an owner exits can affect the following:[66]

- The value that the owner and/or shareholders (if any) can realize from a business
- Whether a cash deal, deferred payments, or staged payments are received
- The future success of the business and its products or services (unless one is closing the business)

- Whether the owner wants to retain any involvement in or control of the business
- Tax liabilities

Figure 6.4 Possible Exit Strategies



The best exit strategy (see Figure 6.4 "Possible Exit Strategies") is the one that is the best match to a small business and the owner's personal and professional goals. The owner must first decide what he or she wants to walk away with—for example, money, management control, or intellectual property. If interested only in money, selling the business on the open market or to another business may be the best choice. If, on the other hand, one's legacy and seeing the small business continue are important, family succession or selling the business to the employees might be a better solution.[67]

Liquidation or Walkaway

There are times when a small business owner may decide that enough is enough, so he or she simply calls it quits, closes the business doors, and calls it a day.[68] This happens all the time, to hundreds of businesses every day—for example, a small shop, a restaurant, a small construction company, a shoe store, a gift shop, a consignment shop, a nail salon, a bakery, or a video store.[69] This closing of the business involves ***liquidation***, the selling of all assets. If all debts are paid, it can also be referred to as a ***walkaway***.

To make any money with the liquidation exit strategy, a business must have valuable assets to sell—for example, land or expensive equipment. The name of the business may have some value, so it could be purchased by someone for pennies on the dollar and restarted with different owners. There is also a possibility that there may be a substantial amount of goodwill or even badwill if a business has been around for a long time. ***Goodwill*** is an intangible asset that reflects the value of intangible assets, such as a strong brand name, good customer relationships, good employee relationships, patents, intellectual property, size and quality of the customer list, and market penetration.[70] However, if a business is simply closed, the value of the goodwill will drop, and the selling price will be lower than it would have been prior to the business being closed.[71]

Badwill is the negative effect felt by a company when it is found out that a company has done something not in accord with good business practices. Although badwill is typically not expressed in a dollar amount, it can result in such things as decreased revenue; the loss of clients, customers, and suppliers; the loss of market share; the loss of credit; federal or state indictments for crimes committed, and censure by the community.[72] For the small business owner who wants to close under these circumstances, there will be nothing much to sell but tangible assets because the business will have very little, if any, market value.

In all instances of liquidation, the proceeds from the sale of assets must first be used to repay creditors. The remaining money is divided among the shareholders (if any), the partners (if any), and the owner.[73] In an ideal walkaway situation, the following occurs:[74]

- All bills are paid off (or scheduled).
- All taxes are paid, and the various levels of government are informed of the closure.
- Contracts, leases, and the like are fulfilled or formally terminated.
- Employees are let go to find other jobs.
- Assets or inventory is depleted.

- No lawsuits are consuming money and time.
- Customers are placed so that they get needed goods or services.
- If needed, insurance is continued to cover unexpected claims after the firm closes.

The walkaway is the cleanest and best way to exit, but it is not always possible for all businesses that decide to close their doors. There will, of course, always be those instances in which the owner closes the business and takes off, leaving a mess behind.

Any small business owner thinking about liquidation should consider the pros and cons, which are as follows:[75][76]

- **Pros**
  - It is easy and natural. Everything comes to an end.
  - No negotiations are involved.
  - There are no worries about the transfer of control.
- **Cons**
  - Get real! It is a waste. At most, the owner will get the market value of the company's assets.
  - Things such as client lists, the owner's reputation, and business relationships may be very valuable. Liquidation destroys them without an opportunity to recover their value.
  - Other shareholders, if any, may be less than thrilled about how much is left on the table.
  - If a company's brand has any value, there is a loyal or sizeable customer base, or there is a stable core of employees, an owner would be significantly better off selling the company.

Family Succession

Many small business owners dream of passing the business to a family member. Keeping the business in the family allows the owner's legacy to live on, which is clearly an attractive option. Family succession as an exit strategy also allows the owner an opportunity to groom the successor; the owner might even retain some influence and involvement in the business if desired.[77] However, given that very few family firms survive beyond the first generation and even fewer survive into the third generation. [78][79][80]***Succession*** is the most critical issue facing family firms.[81] Succession is the transference of leadership from one generation to the next to ensure continuity of family ownership of the business.[82]

A sudden decision to hand over the business to a family member is unwise. The owner will be burdened with problems that will likely lead to business failure. Succession in family firms is a multistage, complex process that should begin even before the heirs enter the business, and effects extend beyond the point in time when they are named as successors. Many factors are involved, and the succession should evolve over a long period of time.[83][84] Further, because succession is usually followed by changes in the organization, particularly the change in the top position, it is thought to be an indicator of the future of the business. The better prepared and committed the successor is, the greater the likelihood of a successful succession process and business.[85] The quality of interpersonal relationships, successors' expectations, and the role of the predecessor are also relevant to success.[86]

The ideal is for the family business to have engaged in ***formal succession planning***: planning for the family business to be transferred to a family member or members. The failure to plan for succession is seen as a fundamental human resource problem as well as the primary cause for the poor survival rate of family businesses.[87] Unfortunately, a very small percentage of family businesses plan appropriately for succession, and those that do frequently have mental, not written, plans.[88]

Video Clip 6.2- Family Business Succession

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=64

Tarzan Zerbini Circus

Bankruptcy

Feeling the need to file for bankruptcy is a tough pill for any small business owner to swallow. ***Bankruptcy*** is an extreme form of business termination that uses a legal method for closing a business and paying off creditors when the business is failing and the debts are substantially greater than the assets.[89] Because bankruptcy is a complicated legal process, it is important to get an attorney involved as soon as possible. There may be options other than bankruptcy, and consulting with an attorney will help. The owner must understand how bankruptcy works and the options that are available. It is also good to know that not all bankruptcies are voluntary; creditors can petition the court for a business to declare bankruptcy.[90]

Chapter 7 small business bankruptcy, more commonly referred to as liquidation, is appropriate when a business is failing, has no future, and has no substantial assets. This form of bankruptcy makes sense only if the owner wants to walk away. It is particularly suited to sole proprietorships and other small businesses in which the business is essentially an extension of its owner's skills.[91][92]Under Chapter 7 bankruptcy law, a trustee will take a business apart, selling assets to satisfy outstanding debts and discharging debts that cannot be satisfied with the assets that are available.[93][94]

Small business bankruptcy allows an owner to run a business with court oversight. The owner loses control of the firm, but it continues to operate. The owner is protected from creditors in the short term because the court orders an automatic stay that prevents the creditors from seizing your assets. Unfortunately, the outcome is not pleasant. The owner is out as manager, and the creditors end up owning the business. If the owner cannot pay the $75,000+ in legal fees, the judge will probably order liquidation.[95] This form of bankruptcy applies to sole proprietorships, corporations, and partnerships.[96]

The amount that creditors can collect will depend on how a business is structured. If a business is a sole proprietorship, the owner's personal assets may be used to pay off business debts, depending on the chosen bankruptcy option. If a business is a corporation, a limited liability company, or some form of a partnership, the owner's personal assets are protected and cannot be used to pay off business debts.[97]

Alternatives to Bankruptcy

Instead of going the bankruptcy route, a small business owner could do the following things: [98] This is also known as a *Consumer Proposal* within Canada.

- **Negotiate debt.** This involves trying to reorganize a business's finances outside a legal proceeding. The owner can work with the creditors to renegotiate the terms of payment and the amount owed to each creditor. If a business is basically profitable but the debt situation is due to an unusual circumstance, such as a lawsuit or a temporary industry slowdown, this could be a successful solution.

- **Improve operations.** If the owner is in a position to fix the cash problem by fixing the underlying problems in the business, it may not be necessary to declare bankruptcy. An owner should look at cash-flow controls; eliminate unprofitable products, services, and divisions; and restructure into a leaner and meaner organization.
- **Turn around and restructure the business.** This alternative combines debt negotiation and operational improvement—perhaps the best choice. By doing both things at the same time, an owner will be in an even stronger position to improve the balance sheet, cash flow, and profitability—and avoid insolvency.

Taking a Company Public

An **initial public offering (IPO)** is a stock offering in which the owner or owners of equity in a formerly private company have their private holdings transferred into issues tradable in public markets, such as the New York Stock Exchange (NYSE).[99] From the initial owners' perspective, an IPO is often seen as liquidation, but it is also a money event for a company. For this reason, an IPO makes sense only if a small business can benefit from a substantial infusion of cash. [100]

IPOs receive lots of press, even though they are really very rare. In a typical year, there may be 200 IPOs, perhaps even less. Consider the following data:[101][102][103][104]

- 2008: 32 IPOs
- 2009: 63 IPOs
- 2010: 157 IPOs
- 2011: 159 IPOs

Why are the numbers so small? [105] The IPO process is costly, labor intensive, and usually requires an up-front investment of more than $100,000. Detailed reports are required on a business's financials, staffing, marketing, operations, management, and so forth. Preparing these reports typically costs hundreds of thousands of dollars, sometimes millions, every year. The Sarbanes-Oxley Act alone, a product of the Enron scandal, costs even the smallest companies several hundred thousands of dollars in consulting fees. Lastly, many companies are not valued very highly on the stock market.

When thinking about an IPO, consider the following pros and cons: [106]

- **Pros**
  - The owner will be on the cover of *Newsweek*.
  - The stock will be worth in the tens—or even hundreds—of millions of dollars.
  - Venture capitalists will finally stop bugging the owner as they frantically try to ensure their shares will retain value.
- **Cons**
  - Only a very few number of small businesses actually have this option available to them because there are so few IPOs in the United States each year.
  - A business needs financial and accounting rigor from day one that is way beyond what many small business owners put in place.
  - The owner will spend most of his or her time selling the company, not running it.
  - Investment bankers take 6 percent off the top, and the transaction costs of an IPO can run into the millions.

Stever Robbins of *Entrepreneur* paints an amusing but very dismal picture of what is actually involved in an IPO.[107]

You start by spending millions just preparing for the road show, where you grovel to convince investors your stock should be worth as much as possible…Unlike an acquisition, where you craft a good fit with a single suitor, here you are romancing hundreds of Wall Street analysts. If the romance fails, you've blown millions. And if you succeed, you end up married to the analysts. You call that a life? Once public, you bow and scrape to the analysts. These earnest 28-year-olds—who haven't produced anything of value since winning their fifth grade limerick contest—will study your every move, soberly declaring your utter incompetence at running the business you've built over decades. It's one thing to receive this treatment from your loving spouse. It's quite another to receive it from Smith Barney. We won't even talk about the need to conform to Sarbanes-Oxley, or the 6 percent underwriting fees you'll pay to investment bankers, or lockout periods, or how markets can tank your wealth despite having a healthy business, or how IPO-raised funds distort your income statement, or… In short, IPOs are not only rare, they're a pain in the backside. They make the headlines in the very, very rare cases that they produce 20-year-old billionaires. But when you're founding [and running] your company, consider them just one of many exit strategies. Realize that there are a lot of ways to skin a cat, and just as many ways to get value out of your company. Think ahead, surely, but do it with sanity and gravitas. And if you find yourself tempted to start looking for more office space in preparation for your IPO in 18 months, call me first. I'll talk you down until the paramedic arrives.

For some small businesses, although not many, an IPO might make sense—and may even be necessary. For most, however, an IPO is clearly not a viable exit strategy.

Selling the Business

Another possible exit strategy is selling the business. Although the sale of a business is sometimes described as the end of entrepreneurship or as failure or defeat,[108] selling the business can also be a relief and the beginning of the next phase of the owner's personal and professional life. As in the case of SoBe (highlighted at the beginning of this chapter), the owners sold the business because, among other things, it was becoming something they did not want it to be—and it was no longer fun. Whatever the reason, an owner can sell a business only once, so be sure that it is the right exit strategy. The owner should address the following questions:[109][110]

1. **Can the business be sold?** There are many things that make a business attractive to buyers: a solid history of profitability, a large and loyal base of customers, a good reputation, a competitive advantage (e.g., intellectual property rights, patents, long-term contracts with clients, and exclusive distributorships), opportunities for growth, a desirable location, a skilled workforce, and a loyal workforce. If a business does not have at least some of these things or others of equal value, it will not likely generate much interest in the market.
2. **Is the owner ready to sell or does the owner need to sell?** Selling a business, when it is a choice, requires emotional and financial readiness. The owner must think about what life will be like after the business is sold. What will be a source of income? How will time be spent? Has the owner "sold out" or could more have been done with the business? Does the owner love what he or she is doing? Many small business owners suffer real remorse after handing their businesses over to a new owner. Selling the business because the owner is forced to will engender very different emotional and financial challenges.
3. **What is the business worth?** The owner may have no idea. For example, the owner of a small professional services firm felt the firm was worth more than $1 million. After a lengthy search, however, the owner received less than one-half that amount from the buyer. On the other side of the coin, the owner of an information technology (IT) company planned to sell the company to an employee for $200,000. However, after advertising the business for sale nationwide, the owner sold it for one dollar shy of $1 million.

It is recommended that an owner start planning for a sale at least three to four years in advance. Sometimes, even five years is not long enough. It is very easy to become overly attached to a business, so it will be difficult to see how the business really looks to an outsider.[111] Selling a business is an art and a science. If the asking price is too high, this may signal to potential buyers that the owner is not really interested in selling. Because there are several methods used to value a business, it is a good idea to hire a professional.[112]

There are different ways to sell a business (see Figure 6.5 "Four Ways to Sell a Small Business"). Acquisition, friendly buyout, selling to the employees, and selling on the open market are discussed here. Be aware, however, that if a business is floundering and it is well known that the business is having major problems paying bills, ***vulture capitalists***, might start circling. A vulture capitalist is a ***venture capitalist*** who invests in floundering firms in the hope that they will turn around.[113][114] A venture capitalist is an investor who either provides capital to start-up ventures or supports small companies to expand but does not have access to public funding. Venture capitalists typically expect higher returns because they are taking additional risks.[115]

Figure 6.5 Four Ways to Sell a Small Business

Four Ways to Sell a Small Business. 1. Acquisition. 2. Friendly buyout. 3. Sell to your employees. 4. Sell in the open market.

Acquisition

When one business buys another business, as in the case of Pepsi buying SoBe, it is called an ***acquisition***. Businesses buy other businesses for all kinds of reasons—for example, as a quick path to expansion or diversification or to get rid of the competition. When Pepsi was considering acquiring SoBe, their first thought was to kill the brand. But the bottlers convinced them otherwise, saying that it was a very strong brand.[116]

Acquisition is one of the most common exit strategies for a small business. One key to success is to target the potential acquirer(s) in advance, position the business accordingly, and convince the acquirer that the small business is worth the asking price.[117] Another way to become the target of an acquisition is to be successful in the marketplace. This happened with SoBe. Coca-Cola, Pepsi, Arizona, and Campbell's all expressed an interest after SoBe became a national brand. Pepsi ended up being the acquirer in the end.[118]

In an acquisition, the owner negotiates the price—a good thing because public markets value a business relative to its industry, which limits the value of a business. In an acquisition, however, there is no limit on the perceived value of a company. Why? The person making the acquisition decision is rarely the owner of the acquiring company, so there is no problem with the checkbook. It is someone else's money.

When thinking about an acquisition, consider the following pros and cons:

- **Pros –** [119]
  - If a business has strategic value to an acquirer, it may pay far more than the business is worth to anyone else.
  - If multiple acquirers are in a bidding war, the owner can raise the price "to the stratosphere."
- **Cons –** [120]
  - If the owner organizes the business around a specific acquirer, the business may be unattractive to other buyers.
  - Acquisitions are messy and often difficult when cultures and systems clash in the merged company. Although not a small business example, the Warner-AOL combination was a failure largely due to a major culture clash.
  - Acquisitions are frequently accompanied by noncompete agreements and other strings that, while making the owner rich, can make life unpleasant for a while. Noncompete agreements are enforceable, but their enforcement depends on the

applicable facts and circumstances—including which state's law governs.[121]

Friendly Buyout

A ***friendly buyout*** occurs when ownership is transferred to family members, customers, employees, current managers, children, or friends. It is still considered selling the business, but the terms and nature of the transaction are usually very different. No matter who the "friendly" buyer may be, figure on starting to plan early—and engage a professional before, during, and after the sale.[122] [123]

When thinking about friendly buyout, consider the following pros and cons:

- **Pros –** [124] [125]
  - The owner knows much more about the buyer, and the buyer knows the owner. There is less due diligence required.
  - The buyer will most likely preserve what is important about the business.
  - If management buys the business, it has a commitment to make it work.
- **Cons –** [126] [127]
  - The owner will be less objective about the buyer and more likely to let his or her guard down in negotiations and planning. The owner leaves too much money on the table.
  - If the owner sells to a friend, the friend will be less than thrilled when discovering, for example, decades' worth of unpaid taxes.
  - Selling to family can tear a company apart with jealousies and promotions that put emotion ahead of business needs.

Selling to Employees

Selling the business to employees and/or managers is another option to consider. "Arranging an employee buyout can be a win-win situation as they get an established business they know a great deal about already and you get enthusiastic buyers that want to see your business continue to thrive."[128] The owner can accomplish this process by setting up an **employee stock option plan (ESOP)**. However, because the owner is giving control of the business to the employees, a transition plan is critical to make sure that they are ready to carry on the business after the owner leaves. It is a good idea to hire an ESOP specialist. Keep in mind, though, that only corporations are eligible to form an ESOP. An ESOP is expensive to set up and maintain, so this might not be the best choice.[129]

If an ESOP is not appealing or the business is not eligible to have an ESOP, selling the business could be as simple as having a current employee take it over. The owner could also consider a ***worker-owned cooperative***, in which interested employees become members of a cooperative that buys the business.[130] In the case of Select Machine of Brimfield, Ohio, "[the owners] sold 30 percent of their stock to the co-op in the first of several installments. The co-op took out loans in the amount of $324,000, which were personally guaranteed by the sellers. The loans were paid off out of company profits over three years; subsequent installments have been owner-financed. Today the co-op owns 59 percent of the company's stock, and sale of an additional 10 percent is now on the table."[131]

For a worker-owned cooperative to work, the business owner(s) must be totally committed to the sale of the business to the employees. It is a good option if the business is small (fewer than twenty-five employees), profitable, relatively debt free, already has a culture of participatory management, and the owners are willing to stay on throughout the transition.[132]

Selling on the Open Market

Selling a business on the open market is the most popular exit strategy for small businesses.[133] Unfortunately, it has been estimated that 75 percent of US businesses do not sell,[134] so if this is how the owner wants to sell the business, it must be marketed in a way that maximizes its value in the eyes of a potential buyer.

An owner also needs to spread the word. Most savvy business buyers use the Internet to research available businesses for sale, so post the sale notice on the two largest websites:[135]BizBuySell.com, self-described as the "Internet's Largest Business for Sale Marketplace," and BizQuest.com, self-described as the "Original Business for Sale Website."

Key Takeaways

- The most emotional topic an owner will face when building a business—and the hardest decision he or she will probably have to make—is when and how to exit.

- An exit strategy should be planned while running the business. Unfortunately, many small businesses do not have an exit plan.
- There are many exit strategies that a small business owner can consider, including liquidation or walkaway, family succession, selling the business, bankruptcy, and taking a company public.
- The best exit strategy is the one that best matches the small business and the owner's personal and professional goals.
- Liquidation is the selling of all assets. If all debts are paid, it can also be referred to as a walkaway. Walking away is the cleanest and best way to exit a business.
- Family succession is the transference of leadership from one generation to the next to ensure continuity of family ownership in the business. It is a critical issue in family businesses because few family firms survive beyond the first generation and even fewer survive into the third generation.
- The failure to plan for succession is seen as a basic human resource problem as well as the primary cause for the poor survival rate of family businesses.
- Bankruptcy is an extreme exit strategy that uses a legal method for closing a business and paying off creditors when a business is failing and the debts are substantially greater than the assets.
- Debt negotiations, operational improvements, or business turnaround and restructuring are alternatives to bankruptcy.
- An IPO is a stock offering in which the owner or owners of equity in a business have their private holdings transferred into issues tradable in public markets, such as the NYSE.
- There are several options for selling a business: acquisition, friendly buyout, selling to the employees, and selling in the open market.
- An acquisition is when another business buys a business. In an acquisition, there is no limit on the perceived value of the business.
- A friendly buyout is the transfer of ownership to family members, customers, employees, current managers, children, or friends—but it is still a sale.
- Selling to the employees can be a win-win situation because they get an established business that they know a great deal about already, and the owner gets enthusiastic buyers who want to see a business continue to thrive.
- Selling in the open market is the most popular exit strategy for small businesses.
- It has been estimated that 75 percent of small businesses do not sell, so a business must market in a way that maximizes its value in the eyes of the potential buyer.

Exercises

1. Two executives of a regional food company are regular customers and big fans of Frank's All-American BarBeQue. They recently learned that Frank has been selling his sauces in local grocery stores and have been a big hit. The executives bought jars of each flavor, took them back to their company, and talked to the people who would decide about adding products to their line. Everyone loved the sauces, and there was definite interest in acquiring the sauce-making side of Frank's business. It would fill a hole in their product line that they had been looking to fill.

   The company contacted Frank about its interest, and Frank—with some urging from his son, Robert—is thinking about it. It would provide Frank with a nice retirement (when he decides to do that), money for his son and daughter, and a legacy. How should Frank proceed?

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1. Source: Interview with John Bello, cofounder of SoBe, August 23, 2011. ↵
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2.4: Chapter 7- Teamwork and Communications

Learning Objectives

1. Define a *team* and describe its key characteristics.
2. Explain why organizations use teams, and describe different types of teams.

What Is a Team? How Does Teamwork Work?

A **team** (or a *work team*) is a group of people with complementary skills who work together to achieve a specific goal.[1] In the case of Motorola's RAZR team, the specific goal was to develop (and ultimately bring to market) an ultrathin cell phone that would help restore the company's reputation as a designer of stylistically appealing, high-function phones. The team achieved its goal by integrating specialized but complementary skills in engineering and design and by making the most of its authority to make its own decisions and manage its own operations.

Teams versus Groups

"A group," suggests Bonnie Edelstein, a consultant in organizational development, "is a bunch of people in an elevator. A team is also a bunch of people in an elevator, but the elevator is broken." This distinction may be a little oversimplified, but as our tale of teamwork at Motorola reminds us, a *team* is clearly something more than a mere *group* of individuals. In particular, members of a group—or, more accurately, a *working group*—go about their jobs independently and meet primarily to share information. A group of department-store managers, for example, might meet monthly to discuss their progress in cutting plant costs, but each manager is focused on the goals of his or her department because each is held accountable for meeting only those goals. Teams, by contrast, are responsible for achieving specific common goals, and they're generally empowered to make the decisions needed to complete their authorized tasks.

Some Key Characteristics of Teams

To keep matters in perspective, let's identify five key characteristics of work teams:[2][3]

1. *Teams are accountable for achieving specific common goals*. Members are collectively responsible for achieving team goals, and if they succeed, they're rewarded collectively.
2. *Teams function interdependently*. Members cannot achieve goals independently and must rely on each other for information, input, and expertise.
3. *Teams are stable*. Teams remain intact long enough to finish their assigned tasks, and each member remains on board long enough to get to know every other member.
4. *Teams have authority*. Teams possess the decision-making power to pursue their goals and to manage the activities through which they complete their assignments.
5. *Teams operate in a social context*. Teams are assembled to do specific work for larger organizations and have the advantage of access to resources available from other areas of their organizations.

Why Organizations Build Teams

Why do major organizations now rely more and more on teams to improve operations? Executives at Xerox have reported that team-based operations are 30 percent more productive than conventional operations. General Mills says that factories organized around team activities are 40 percent more productive than traditionally organized factories. According to in-house studies at Shenandoah Life Insurance, teams have cut case-handling time from twenty-seven to two days and virtually eliminated service complaints. FedEx says that teams reduced service errors (lost packages, incorrect bills) by 13 percent in the first year.[4][5]

Today it seems obvious that teams can address a variety of challenges in the world of corporate activity. Before we go any further, however, we should remind ourselves that data like those we've just cited aren't necessarily definitive. For one thing, they may not be objective—companies are more likely to report successes than failures. As a matter of fact, teams *don't* always work. Indeed, according to one study, team-based projects fail 50 to 70 percent of the time.[6][7]

The Effect of Teams on Performance

Research shows that companies build and support teams because of their effect on overall workplace performance, both organizational and individual. If we examine the impact of team-based operations according to a wide range of relevant criteria—

including product quality, worker satisfaction, and quality of work life, among others—we find that overall organizational performance improves. Table 7.1 "Effect of Teams on Workplace Performance" lists several areas in which we can analyze workplace performance and indicates the percentage of companies that have reported improvements in each area.

Table 7.1 Effect of Teams on Workplace Performance [8]

Area of Performance	Percent of Firms Reporting Improvement
Product and service quality	70
Customer service	67
Worker satisfaction	66
Quality of work life	63
Productivity	61
Competitiveness	50
Profitability	45
Absenteeism/turnover	23

Types of Teams

Teams, then, can improve company and individual performance in a number of areas. Not all teams, however, are formed to achieve the same goals or charged with the same responsibilities. Nor are they organized in the same way. Some, for instance, are more *autonomous* than others—less accountable to those higher up in the organization. Some depend on a team leader who's responsible for defining the team's goals and making sure that its activities are performed effectively. Others are more or less self-governing: though a leader lays out overall goals and strategies, the team itself chooses and manages the methods by which it pursues its goals and implements its strategies.[9] Teams also vary according to their membership. Let's look at several categories of teams.

Manager-Led Teams

As its name implies, in the **manager-led team**, the manager is the team leader and is in charge of setting team goals, assigning tasks, and monitoring the team's performance. The individual team members have relatively little autonomy. For example, the key employees of a professional football team (a manager-led team) are highly trained (and highly paid) athletes, but their activities on the field are tightly controlled by a head coach. As team manager, the coach is responsible both for developing the strategies by which the team pursues its goal of winning games and for the final outcome of each game (not to mention the season). He's also solely responsible for interacting with managers above him in the organization. The players are responsible only for executing plays.[10]

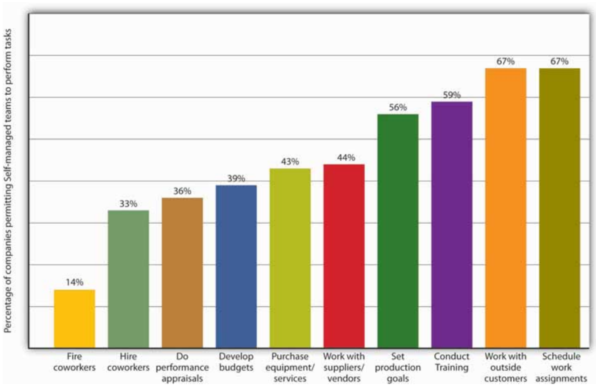
Self-Managing Teams

Self-managing teams (also known as *self-directed* or *self-regulating teams*) have considerable autonomy. They are usually small and often absorb activities that were once performed by traditional supervisors. A manager or team leader may determine overall goals, but the members of the self-managing team control the activities needed to achieve the goals, such as planning and scheduling work, sharing tasks, meeting quality standards, and handling day-to-day operations.

Self-managing teams are the organizational hallmark of Whole Foods Market, the largest natural-foods grocer in the United States. Each store is run by ten teams (produce, prepared foods, and so forth), and virtually every store employee is a member of a team. Each team has a designated leader and its own performance targets. (Team leaders also belong to a store team, and store-team leaders belong to a regional team.) To do its job, every team has access to the kind of information—including sales and even salary figures—that most companies reserve for the eyes of traditional managers.[11]

Needless to say, not every self-managed team enjoys the same degree of autonomy. Companies vary widely in choosing which tasks teams are allowed to manage and which ones are best left to upper-level management only. As you can see in Figure 7.1 "What Teams Do (and Don't) Manage", for example, self-managing teams are often allowed to schedule assignments, but they are rarely allowed to fire coworkers.

Figure 7.1 What Teams Do (and Don't) Manage



Cross-Functional Teams

Many companies use cross-functional teams —teams that, as the name suggests, cut across an organization's *functional areas* (operations, marketing, finance, and so on). A cross-functional team is designed to take advantage of the special expertise of members drawn from different functional areas of the company. When the Internal Revenue Service, for example, wanted to study the effects on employees of a major change in information systems, it created a cross-functional team composed of people from a wide range of departments. The final study reflected expertise in such areas as job analysis, training, change management, industrial psychology, and even ergonomics.[12]

Cross-functional teams figure prominently in the product-development process at Nike, where they take advantage of expertise from both inside and outside the company. Typically, team members include not only product designers, marketing specialists, and accountants but also sports-research experts, coaches, athletes, and even consumers. Likewise, Motorola's RAZR team was a cross-functional team: Responsibility for developing the new product wasn't passed along from the design team to the engineering team but rather was entrusted to a special team composed of both designers and engineers.

We can also classify the RAZR team as a *product-development* or *project team* (a topic we'll discuss in more detail in Chapter 10 "Product Design and Development"). *Committees* and *task forces*, both of which are dedicated to specific issues or tasks, are often cross-functional teams. *Problem-solving teams*, which are created to study such issues as improving quality or reducing waste, may be either intradepartmental or cross-functional.[13]

Virtual Teams

"Teamwork," said someone (we're not sure who), "doesn't tolerate the inconvenience of distance." Indeed, technology now makes it possible for teams to function not only across such organizational boundaries as functional areas, departments, and divisions but also across time and space, as well. Working in virtual teams, geographically dispersed members interact electronically in the process of pursuing a common goal. Such technologies as videoconferencing, instant messaging, and electronic meetings, which allow people to interact simultaneously and in real time, offer a number of advantages in conducting the business of a virtual team.[14] Among other things, members can participate from any location or at any time of day, and teams can "meet" for as long as it takes to achieve a goal or solve a problem—a few days, a few weeks, or a few months.

Nor does team size seem to be an obstacle when it comes to calling virtual-team meetings: In building the F-35 Strike Fighter, U.S. defense contractor Lockheed Martin staked the $225 billion project on a virtual product-team of unprecedented global dimension, drawing on designers and engineers from the ranks of eight international partners ranging from Canada and the United Kingdom to Norway and Turkey.[15]

Key Takeaways

- Teamwork brings diverse areas of expertise to bear on organizational problems and projects.
- Reaching teamwork goals requires skills in negotiating trade-offs, and teamwork brings these skills into play at almost every step in the process.
- To be successful, teams need a certain amount of autonomy and authority in making and implementing their decisions.
- A **team** (or a *work team*) is a group of people with complementary skills who work together to achieve a specific goal. Members of a *working group* work independently and meet primarily to share information.
- Work teams have five key characteristics:

1. They are accountable for achieving specific common goals.
2. They function interdependently.
3. They are stable.
4. They have authority.
5. They operate in a social context.

- Companies build and support teams because of their effect on overall workplace performance, both organizational and individual.
- Work teams may be of several types:
  1. In the traditional **manager-led team**, the leader defines the team's goals and activities and is responsible for its achieving its assigned goals.
  2. The leader of a **self-managing team** may determine overall goals, but employees control the activities needed to meet them.
  3. A **cross-functional team** is designed to take advantage of the special expertise of members drawn from different functional areas of the company.
  4. On **virtual teams**, geographically dispersed members interact electronically in the process of pursuing a common goal.

Exercise

(AACSB) Analysis

You're a marketing researcher for a multinational food-products corporation, and for the past two years, you've been able to work at home. The international division of the company has asked you to join a virtual team assigned to assess the prospects for a new sandwich planned for the Indian market.

List a few of the challenges that you're likely to encounter as a member of the virtual team. Explain the steps you'd take to deal with each of the challenges that you've listed.

Why Teamwork Works

Learning Objectives

1. Explain why teams may be effective or ineffective.
2. Identify factors that contribute to team cohesiveness.

Now that we know a little bit about *how* teams work, we need to ask ourselves *why* they work. Not surprisingly, this is a fairly complex issue. In this section, we'll answer these closely related questions: Why are teams often effective? Why are they sometimes *in*effective?

Factors in Effective Teamwork

First, let's begin by identifying several factors that, in practice, tend to contribute to effective teamwork. Generally speaking, teams are effective when the following factors are met:[16]

- *Members depend on each other*. When team members rely on each other to get the job done, team productivity and efficiency are high.
- *Members trust one another*. Teamwork is more effective when members trust each other.
- *Members work better together than individually*. When team members perform better as a group than alone, collective performance exceeds individual performance.
- *Members become boosters*. When each member is encouraged by other team members to do his or her best, collective results improve.
- *Team members enjoy being on the team*. The more that team members derive satisfaction from being on the team, the more committed they become.
- *Leadership rotates*. Teams function effectively when leadership responsibility is shared over time.

Most of these explanations probably make pretty clear intuitive sense. Unfortunately, because such issues are rarely as clear-cut as they may seem at first glance, we need to examine the issue of group effectiveness from another perspective—one that considers the effects of factors that aren't quite so straightforward.

Group Cohesiveness

The idea of group cohesiveness refers to the *attractiveness* of a team to its members. If a group is high in cohesiveness, membership is quite satisfying to its members; if it's low in cohesiveness, members are unhappy with it and may even try to leave it. The principle of group cohesiveness, in other words, is based on the simple idea that groups are most effective when their members like being members of the group.[17][18]

What Makes a Team Cohesive?

Numerous factors may contribute to team cohesiveness, but in this section, we'll focus on five of the most important:

1. *Size*. The bigger the team, the less satisfied members tend to be. When teams get too large, members find it harder to interact closely with other members; a few members tend to dominate team activities, and conflict becomes more likely.
2. *Similarity*. People usually get along better with people like themselves, and teams are generally more cohesive when members perceive fellow members as people who share their own attitudes and experience.
3. *Success*. When teams are successful, members are satisfied, and other people are more likely to be attracted to their teams.
4. *Exclusiveness*. The harder it is to get into a group, the happier the people who are already in it. Status (the extent to which outsiders look up to a team, as well as the perks that come with membership) also increases members' satisfaction.
5. *Competition*. Members value membership more highly when they're motivated to achieve common goals—especially when those goals mean outperforming other teams.

Figure 7.2 Cohesive Teams

A cohesive team with goals that are aligned with the goals of the organization is most likely to succeed. Teamwork and team spirit – CC BY-ND 2.0.

There's such a thing as too much cohesiveness. When, for instance, members are highly motivated to collaborate in performing the team's activities, the team is more likely to be effective in achieving its goals. Clearly, when those goals are aligned with the goals of the larger organization, the organization, too, will be happy. If, however, its members get too wrapped up in more immediate team goals, the whole team may lose sight of the larger organizational goals toward which it's supposed to be working.

Groupthink

Likewise, it's easier for leaders to direct members toward team goals when members are all on the same page—when there's a basic willingness to conform to the team's rules and guidelines. When there's too much conformity, however, the group can become ineffective: It may resist change and fresh ideas and, what's worse, may end up adopting its own dysfunctional tendencies as its way of doing things. Such tendencies may also encourage a phenomenon known as **groupthink**—the tendency to conform to group pressure in making decisions, while failing to think critically or to consider outside influences.

Groupthink is often cited as a factor in the explosion of the space shuttle *Challenger* in January 1986: Engineers from a supplier of components for the rocket booster warned that the launch might be risky because of the weather but were persuaded to reverse their recommendation by NASA officials who wanted the launch to proceed as scheduled.[19]

Why Teams Fail

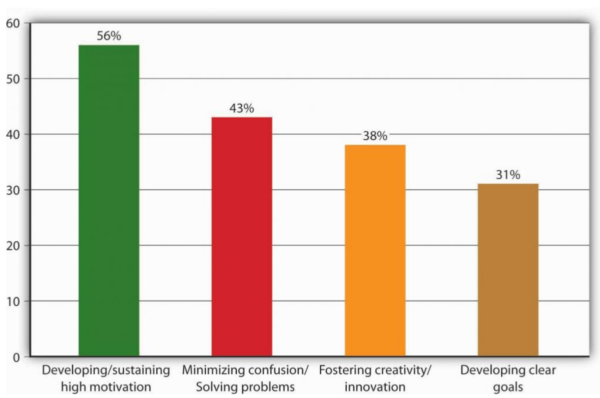
Teams don't always work. To learn why, let's take a quick look at four common obstacles to success in introducing teams into an organization:[20]

- *Unwillingness to cooperate*. Failure to cooperate can occur when members don't or won't commit to a common goal or set of activities. What if, for example, half the members of a product-development team want to create a brand-new product and half want to improve an existing product? The entire team may get stuck on this point of contention for weeks or even months.
- *Lack of managerial support*. Every team requires organizational resources to achieve its goals, and if management isn't willing to commit the needed resources—say, funding or key personnel—a team will probably fall short of those goals.
- *Failure of managers to delegate authority*. Team leaders are often chosen from the ranks of successful supervisors—first-line managers who, as we saw in Chapter 6 "Managing for Business Success", give instructions on a day-to-day basis and expect to have them carried out. This approach to workplace activities may not work very well in leading a team—a position in which success depends on building a consensus and letting people make their own decisions.
- *Failure of teams to cooperate*. If you're on a workplace team, your employer probably depends on teams to perform much of the organization's work and meet many of its goals. In other words, it is, to some extent, a team-based organization, and as such, reaching its overall goals requires a high level of cooperation *among teams*.[21] When teams can't agree on mutual goals (or when they duplicate efforts), neither the teams nor the organization is likely to meet with much success.

Motivation and Frustration

Finally, remember that teams are composed of people, and whatever the roles they happen to be playing at a given time, people are subject to psychological ups and downs. As members of workplace teams, they need motivation, when motivation is down, so are effectiveness and productivity. As you can see in Figure 7.3 "Sources of Frustration", the difficulty of maintaining a high level of motivation is the chief cause of frustration among members of teams. As such, it's also a chief cause of ineffective teamwork, and that's one reason why more employers now look for the ability to develop and sustain motivation when they're hiring new managers.[22]

Figure 7.3 Sources of Frustration



Key Takeaways

- Generally speaking, teams are effective when the following are true:
  1. Members are interdependent.
  2. Members work better together than individually.
  3. Teams work well enough to satisfy members.
  4. Leadership rotates.
  5. Members help one another.
  6. Members become boosters.
  7. Members trust one another.
- **Group cohesiveness** refers to the *attractiveness* of a team to its members. If a group is high in cohesiveness, membership is quite satisfying to its members; if it's low in cohesiveness, members are unhappy with it and may even try to leave it.
- Common obstacles to team success include the following:
  1. Unwillingness to cooperate

2. Lack of managerial support
3. Failure of managers to delegate authority
4. Failure of teams to cooperate

Exercise

(AACSB) Analysis

At some point in the coming week, while you're working on an assignment for any one of your classes, ask at least one other member of the class to help you with it or to collaborate with you in studying for it. After you've completed your assignment, make a list of the advantages and disadvantages of working on the assignment with another person.

The Team and Its Members

Learning Objectives

1. Understand the importance of learning to participate in team-based activities.
2. Identify the skills needed by team members and the roles that members of a team might play.
3. Learn how to survive team projects in college (and actually enjoy yourself).
4. Explain the skills and behaviors that foster effective team leadership.

"Life Is All about Group Work"

"I'll work extra hard and do it myself, but please don't make me have to work in a group."

Like it or not, you'll probably be given some teamwork assignments while you're in college. More than two-thirds of all students report having participated in the work of an organized team, and if you're in business school, you will almost certainly find yourself engaged in team-based activities.[23][24]

Why do we put so much emphasis on something that, reportedly, makes many students feel anxious and academically drained? Here's one college student's practical-minded answer to this question:

In the real world, you have to work with people. You don't always know the people you work with, and you don't always get along with them. Your boss won't particularly care, and if you can't get the job done, your job may end up on the line. Life is all about group work, whether we like it or not. And school, in many ways, prepares us for life, including working with others".[25]

She's right. In placing so much emphasis on teamwork skills and experience, college business departments are doing the responsible thing—preparing students for the business world that awaits them. A survey of *Fortune* 1000 companies reveals that 79 percent already rely on self-managing teams and 91 percent on various forms of employee work groups. Another survey found that the skill that most employers value in new employees is the ability to work in teams.[26][27] If you're already trying to work your way up an organizational ladder, consider the advice of former Chrysler Chairman Lee Iacocca: "A major reason that capable people fail to advance is that they don't work well with their colleagues".[28] The importance of the ability to work in teams was confirmed in a survey of leadership practices of more than sixty of the world's top organizations.[29] When top executives in these organizations were asked, "What causes high-potential leadership candidates to derail? (stop moving up in the organization)," 60 percent of the organizations cited "inability to work in teams." Interestingly, only 9 percent attributed the failure of these executives to advance to "lack of technical ability." While technical skills will be essential in your getting hired into an organization, your team skills will play a significant role in your ability to advance.

To be team-ready or not to be team-ready—that is the question. Or, to put it in plainer terms, the question is not whether you'll find yourself working as part of a team. You will. The question is whether you'll know how to participate successfully in team-based activities.

Will *You* Make a Good Team Member?

What if your instructor in this course decides to divide the class into several three-, four-, or five-member teams and assigns each team to develop a new product plus a business plan to get it into production and out on the market? What teamwork skills could you bring to the table? What teamwork skills do you need to work on? What qualities do you possess that might make you a good team leader?

What Skills Does the Team Need?

Sometimes we hear about a sports team made up of mostly average players who win a championship because of coaching genius, flawless teamwork, and superhuman determination.[30] But not terribly often. In fact, we usually hear about such teams simply because they're newsworthy—exceptions to the rule. Typically a team performs well because its members possess some level of talent. This doesn't mean, however, that we should reduce team performance to the mere sum of its individual contributions: Members' talents aren't very useful if they're not managed in a collective effort to achieve a common goal.

In the final analysis, of course, a team can succeed only if its members provide the skills that need managing. In particular, every team requires some mixture of three sets of skills:

- *Technical skills*. Because teams must perform certain tasks, they need people with the skills to perform them. For example, if your project calls for a lot of math work, it's good to have someone with the necessary quantitative skills.
- *Decision-making and problem-solving skills*. Because every task is subject to problems, and because handling every problem means deciding on the best solution, it's good to have members who are skilled in identifying problems, evaluating alternative solutions, and deciding on the best options.
- *Interpersonal skills*. Because teams are composed of people, and because people need direction and motivation and depend on communication, every group benefits from members who know how to listen, provide feedback, and smooth ruffled feathers. The same people are usually good at communicating the team's goals and needs to outsiders.

The key to success is ultimately the right mix of these skills. Remember, too, that no team needs to possess all these skills—never mind the right balance of them—from day one. In many cases, a team gains certain skills only when members volunteer for certain tasks and perfect their skills in the process of performing them. For the same reason, effective teamwork develops over time as team members learn how to handle various team-based tasks. In a sense, teamwork is always work in progress.

What Roles Do Team Members Play?

Like your teamwork skills, expect your role on a team to develop over time. Also remember that, both as a student and as a member of the workforce, you'll be a *member* of a team more often than a *leader* (a subject that we'll take up in the next section). Team members, however, can have as much impact on a team's success as its leaders. The key is the quality of the contributions they make in performing nonleadership roles.[31]

What, exactly, are those roles? At this point, you've probably concluded that every team faces two basic challenges:

1. Accomplishing its assigned task
2. Maintaining or improving group cohesiveness

Whether you affect the team's work positively or negatively depends on the extent to which you help it or hinder it in meeting these two challenges.[32] We can thus divide teamwork roles into two categories, depending on which of these two challenges each role addresses. These two categories (task-facilitating roles and relationship-building roles) are summarized in Table 7.2 "Roles that Team Members Play".

Table 7.2 Roles that Team Members Play [33]

Task-facilitating Roles	Example	Relationship-building Roles	Example
Direction giving	"Jot down a few ideas and we'll see what everyone has come up with."	Supporting	"Now, that's what I mean by a practical application."
Information seeking	"Does anyone know if this is the latest data we have?"	Harmonizing	"Actually, I think you're both saying pretty much the same thing."
Information giving	"Here are latest numbers from.…"	Tension relieving	"Before we go on to the next section, how many people would like a pillow?"
Elaborating	"I think a good example of what you're talking about is.…"	Confronting	"How does that suggestion relate to the topic that we're discussing?"

Task-facilitating Roles	Example	Relationship-building Roles	Example
Urging	"Let's try to finish this proposal before we adjourn."	Energizing	"It's been a long time since I've had this many laughs at a meeting in *this* department."
Monitoring	"If you'll take care of the first section, I'll make sure that we have the second by next week."	Developing	"If you need some help pulling the data together, let me know."
Process analyzing	"What happened to the energy level in this room?"	Consensus building	"Do we agree on the first four points even if number five needs a little more work?"
Reality testing	"Can we make this work and stay within budget?"	Empathizing	"It's not you. The numbers *are* confusing."
Enforcing	"We're getting off track. Let's try to stay on topic."		
Summarizing	"Before we jump ahead, here's what we've decided so far."		

Task-Facilitating Roles

Task-facilitating roles address challenge number one—accomplishing the team goals. As you can see from Table 7.2 "Roles that Team Members Play", such roles include not only providing information when someone else needs it but also asking for it when you need it. In addition, it includes *monitoring* (checking on progress) and *enforcing* (making sure that team decisions are carried out). Task facilitators are especially valuable when assignments aren't clear or when progress is too slow. Moreover, every team needs people who recognize when a little task facilitation is called for.

Relationship-Building Roles

When you challenge unmotivated behavior or help other team members understand their roles, you're performing a relationship-building role and addressing challenge number two—maintaining or improving group cohesiveness. This type of role includes just about every activity that improves team "chemistry," from *confronting* to *empathizing*.

Bear in mind three points about this model of team-membership roles: (1) Teams are most effective when there's a good balance between task facilitation and relationship building; (2) it's hard for any given member to perform both types of roles, as some people are better at focusing on tasks and others on relationships; and (3) overplaying any facet of any role can easily become counterproductive. For example, *elaborating* on something may not be the best strategy when the team needs to make a quick decision; and *consensus building* may cause the team to overlook an important difference of opinion.

Blocking Roles

Finally, review Table 7.3 "How to Block Teamwork", which summarizes a few characteristics of another kind of team-membership role. So-called blocking roles consist of behavior that inhibits either team performance or that of individual members. Every member of the team should know how to recognize blocking behavior. If teams don't confront dysfunctional members, they can destroy morale, hamper consensus building, create conflict, and hinder progress.

Table 7.3 How to Block Teamwork [34]

Blocking Strategy	Tactics
Dominate	Talk as much as possible; interrupt and interject
Overanalyze	Split hairs and belabor every detail
Stall	Frustrate efforts to come to conclusions: decline to agree, sidetrack the discussion, rehash old ideas
Remain passive	Stay on the fringe; keep interaction to a minimum; wait for others to take on work

Blocking Strategy	Tactics
Overgeneralize	Blow things out of proportion; float unfounded conclusions
Find fault	Criticize and withhold credit whenever possible
Make premature decisions	Rush to conclusions before goals are set, information is shared, or problems are clarified
Present opinions as facts	Refuse to seek factual support for ideas that you personally favor
Reject	Object to ideas offered by people who tend to disagree with you
Pull rank	Use status or title to push through ideas, rather than seek consensus on their value
Resist	Throw up roadblocks to progress; look on the negative side
Deflect	Refuse to stay on topic; focus on minor points rather than main points

Class Team Projects

As we highlighted earlier, throughout your academic career you'll likely participate in a number of team projects. Not only will you make lasting friends by being a member of a team, but in addition you'll produce a better product. To get insider advice on how to survive team projects in college (and perhaps really enjoy yourself in the process), let's look at some suggestions offered by two students who have gone through this experience.[35][36]

- *Draw up a team charter*. At the beginning of the project, draw up a team charter (or contract) that includes the goals of the group; ways to ensure that each team member's ideas are considered and respected; when and where your group will meet; what happens if a team member skips meetings or doesn't do his or her share of the work; how conflicts will be resolved.
- *Contribute your ideas*. Share your ideas with your group; they might be valuable to the group. The worst that could happen is that they won't be used (which is what would happen if you kept quiet).
- *Never miss a meeting*. Pick a weekly meeting time and write it into your schedule as if it were a class. Never skip it. And make your meetings productive.
- *Be considerate of each other*. Be patient, listen to everyone, communicate frequently, involve everyone in decision making, don't think you're always right, be positive, avoid infighting, build trust.
- *Create a process for resolving conflict*. Do this before conflict arises. Set up rules to help the group decide whether the conflict is constructive, whether it's personal, or whether it arises because someone won't pull his or her weight. Decide, as a group, how conflict will be handled.
- *Use the strengths of each team member*. Some students are good researchers, others are good writers, others have strong problem-solving or computer skills, while others are good at generating ideas. Don't have your writer do the research and your researcher do the writing. Not only would the team not be using its resources wisely, but two team members will be frustrated because they're not using their strengths.
- *Don't do all the work yourself*. Work with your team to get the work done. The project output is not as important as the experience of working in a team.
- *Set deadlines*. Don't leave everything to the end; divide up tasks, hold team members accountable, and set intermediary deadlines for each team member to get his or her work done. Work together to be sure the project is in on time and in good shape.

What Does It Take to Lead a Team?

"Some people are born leaders, some achieve leadership, and some have leadership thrust upon them." Or so Shakespeare might have said if he were managing a twenty-first-century work team instead of a sixteenth-century theater troupe. At some point in a successful career, whether in business, school, or any other form of organizational work, you may be asked (or assigned) to lead a team. The more successful you are, the more likely you are to receive such an invitation. So, what will you have to do as a leader? What skills will you need?

Like so many of the questions that we ask in this book, these questions don't have any simple answers. As for the first question—what does a leader have to do?—we can provide one broad answer: A leader must help members develop the attitudes and behavior that contribute to team success: interdependence, collective responsibility, shared commitment, and so forth.

Influence Team Members and Gain their Trust

Team leaders must be able to influence their team members. And notice that we say *influence*: except in unusual circumstances, giving commands and controlling everything directly doesn't work very well.[37] As one team of researchers puts it, team leaders are more effective when they work *with* members rather than *on* them.[38] Hand in hand with the ability to influence is the ability to gain and keep the *trust* of team members. People aren't likely to be influenced by a leader whom they perceive as dishonest or selfishly motivated.

Figure 7.4 Team Leaders

Team leaders are most effective when they can not only influence members but also gain their trust. [39]

Assuming you were asked to lead a team, there are certain leadership skills and behaviors that would help you influence your team members and build trust. Let's look at seven of these:

- *Demonstrate integrity*. Do what you say you'll do, and act in accordance with your stated values. Be honest in communicating with members, and follow through on promises.
- *Be clear and consistent*. Let members know that you're certain about what you want, and remember that being clear and consistent reinforces your credibility.
- *Generate positive energy*. Be optimistic and compliment team members. Recognize their progress and success.
- *Acknowledge common points of view*. Even if you're about to propose some kind of change, before embarking on a new stage of a project recognize the value of the views that members already hold in common.
- *Manage agreement and disagreement*. When members agree with you, focus on your point of view and present it reasonably. When they disagree with you, acknowledge both sides of the issue and support your own with strong, clearly presented evidence.
- *Encourage and coach*. Buoy up members when they run into new and uncertain situations and when success depends on their performing at a high level. Give them the information they need and otherwise help them to perform tasks.
- *Share information*. Let members know that you're knowledgeable about team tasks and individual talents. Check with team members regularly to find out what they're doing and how the job is progressing. Collect information from outside sources, and make sure that it gets to the team members who need it.

Key Takeaways

- As the business world depends more and more on teamwork, it's increasingly important for incoming members of the workforce to develop skills and experience in team-based activities.
- Every team requires some mixture of three skill sets:
  1. *Technical skills*: skills needed to perform specific tasks
  2. *Decision-making and problem-solving skills*: skills needed to identify problems, evaluate alternative solutions, and decide on the best options
  3. *Interpersonal skills*: skills in listening, providing feedback, and resolving conflict
- Team members deal with two basic challenges: (1) accomplishing the team's assigned task and (2) maintaining or improving group cohesiveness.
- **Task-facilitating roles** address challenge number one—accomplishing team tasks. **Relationship-building roles** address challenge number two—maintaining or improving group cohesiveness. **Blocking roles** consist of behavior that inhibits either

team performance or that of individual members.
- The following are eight ways to add value to and survive team projects in college:
  1. Draw up a team charter.
  2. Contribute your ideas.
  3. Never miss a meeting.
  4. Be considerate of each other.
  5. Create a process for resolving conflict.
  6. Use the strengths of each team member.
  7. Don't do all the work yourself.
  8. Set deadlines.
- The following are seven types of skills and behaviors that help team leaders influence their members and gain their trust:
  1. Demonstrating integrity
  2. Being clear and consistent
  3. Generating positive energy
  4. Acknowledging common points of view
  5. Managing agreement and disagreement
  6. Encouraging and coaching
  7. Sharing information

Exercise

(AACSB) Analysis

One student, a veteran of team-based assignments, has some good advice to offer students who are following in her footsteps. Don't start, she advises, until you've drawn up a *team charter*. This charter (or contract) should include the following: the goals of the group; information on meeting times and places; ways to ensure that each member's ideas are considered and respected; methods for resolving conflicts; a "kick-out" clause—a statement of what will happen if a team member skips meetings or fails to do his or her share of the work.[40]

Now assume that you've just been assigned to a team in one of your classes. Prepare a first-draft charter in which you spell out rules of conduct for the team and its members.

The Business of Communication

Learning Objectives

1. Discuss the role of communication in the design of the RAZR cell phone.
2. Define *communication* and discuss the ways in which organizations benefit from effective communication.

Communication by Design

As the chief designer assigned to the "thin-clam" team at Motorola, Chris Arnholt was responsible for some of the phone's distinctive physical features, including its sleek aluminum finish and backlit keyboard. In fact, it was he who pushed the company's engineers and marketers to buck an industry trend toward phones that were getting fatter because of many add-ons such as cameras and stereo speakers. For Arnholt had a vision. He called it "rich minimalism," and his goal was to help the Motorola cell phone team realize a product that embodied that profile.

But what exactly did Arnholt mean by rich minimalism? "Sometimes," he admits, "my ideas are tough to communicate," but as a veteran in his field, he also understands that "design is really about communication".[41][42] His chief (and ongoing) task, then, was communicating to the cell phone team what he meant by rich minimalism. Ultimately, of course, he had to show them what rich minimalism looked like when it appeared in tangible form in a fashionable new cell phone. In the process, he also had to be sure that the cell phone included certain key benefits that prospective consumers would want. As always, the physical design of the finished product had to be right for its intended market.

We'll have much more to say about the process of developing new products in Chapter 10 "Product Design and Development". Here, however, let's simply highlight two points about the way successful companies approach the challenges of new-product design and development (which you will likely recognize from reading the first part of this chapter):

1. In contributing to the new-product design and development process, industrial designers like Chris Arnholt must effectively communicate both ideas and practical specifications.
2. The design and development process usually succeeds only when the assigned team integrates input from every relevant area of the organization.[43]

The common denominator in both facets of the process is effective communication. The designer, for example, must communicate not only his vision of the product but also certain specifications for turning it into something concrete. Chris Arnholt sculpted models out of cornstarch and then took them home at night to refashion them according to suggestions made by the product team. Then he'd put his newest ideas on paper and hand the drawings over to another member of his design team, who'd turn them into 3D computer graphics from which other specialists would build plastic models. Without effective communication at every step in this process, it isn't likely that a group of people with different skills would produce plastic models bearing a practical resemblance to Arnholt's original drawings. On top of everything else, Arnholt's responsibility as chief designer required him to communicate his ideas not only about the product's visual and physical features but also about the production processes and manufacturing requirements for building it.[44]

Thus Arnholt's job—which is to say, his responsibility on the cell phone team—meant that he had to do a lot more than merely design the product. Strictly speaking, the designer's function is to understand a product from the consumer's point of view; develop this understanding into a set of ideas and specifications that will satisfy not only consumer needs but producer requirements; and make recommendations through drawings, models, and verbal communications (IDSA, 2008). Even our condensed version of the RAZR story, however, indicates that Arnholt's job was far broader. Why? Because new-product design is an integrative process: contributions must come from all functions within an organization, including *operations* (which includes research and development, engineering and manufacturing), *marketing*, *management*, *finance*, and *accounting*.[45]

Our version of the RAZR story has emphasized operations (which includes research and development, engineering, and manufacturing) and touched on the role of marketing (which collects data about consumer needs). Remember, though, that members from several areas of management were recruited for the team. Because the project required considerable investment of Motorola's capital, finance was certainly involved, and the decision to increase production in late 2004 was based on numbers crunched by the accounting department. At every step, Arnholt's drawings, specs, and recommendations reflected his collaboration with people from all these functional areas.

Figure 7.5 Motorola Razor

The explosion of text messaging has changed the way people use their cell phones and created new design needs for manufacturers like Motorola. [46]

What all this interactivity amounts to is *communication.*[47] As for what Arnholt meant by rich minimalism, you'll need to take a look at the picture of the RAZR at the beginning of the chapter. Among other things, it means a blue electroluminescent panel and a 22 kHz polyphonic speaker.

What Is Communication?

Let's start with a basic (and quite practical) definition of **communication** as the process of transferring information from a sender to a receiver. When you call up a classmate to inform him that your Introduction to Financial Accounting class has been canceled, you're sending information and your classmate is receiving it. When you go to your professor's Web site to find out the assignment for the next class, your professor is sending information and you're receiving it. When your boss e-mails you the data you need to complete a sales report and tells you to e-mail the report back to her by 4 o'clock, your boss is sending information and, once again, you're receiving it; later in the day, the situation will be reversed.

Your Ticket In (or Out)

Obviously, you participate in dozens of "informational transfers" every day. (In fact, they take up about 70 percent of your waking hours—80 percent if you have some sort of managerial position.[48][49] In any case, it wouldn't make much sense for us to pursue the topic much further without assuming that you've gained *some* experience and mastered *some* skills in the task of communicating. At the same time, though, we'll also venture to guess that you're much more comfortable having casual conversations with friends than writing class assignments or giving speeches in front of classmates. That's why we're going to resort to the same plain terms that we used when we discussed the likelihood of your needing teamwork skills in an organizational setting: The question is not whether you'll need communication skills (both written and verbal). You will. The question is whether you'll develop the skills to communicate effectively in a variety of organizational situations.

Once again, the numbers back us up. In a recent survey by the Association of Colleges and Employers, the ability to communicate well topped the list of skills that business recruiters want in potential hires.[50] A College Board survey of 120 major U.S. companies concludes that writing is a "threshold skill" for both employment and promotion. "In most cases," volunteered one human resources director, "writing ability could be your ticket in—or your ticket out." Applicants and employees who can't write and communicate clearly, says the final report, "will not be hired and are unlikely to last long enough to be considered for promotion".[51]

Why Are Communication Skills Important?

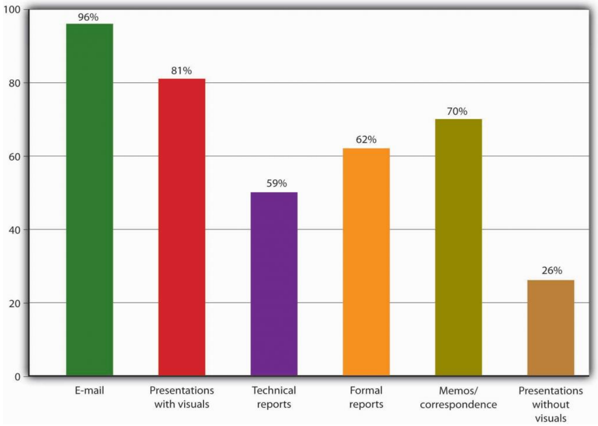
They're important to you because they're important to prospective employers. And why do employers consider communication skills so important? Because they're good for business. Research shows that businesses benefit in several ways when they're able to foster effective communication among employees:[52][53]

- Decisions are more convincing and certain, and problem solving is faster.
- Warning signs of potential problems appear earlier.
- Workflow moves more smoothly and productivity increases.
- Business relationships are stronger.
- Marketing messages are more persuasive.
- The company's professional image is enhanced.
- Employee satisfaction goes up and turnover goes down.
- The firm and its investors enjoy better financial results.

What Skills Are Important?

Figure 7.6 "Required Skills" reveals some further findings of the College Board survey that we mentioned previously—namely, the percentage of companies that identified certain communication skills as being "frequently" or "almost always" necessary in their workplaces. As you can see, ability in using e-mail is a nearly universal requirement (and in many cases this includes the ability to adapt messages to different receivers or compose persuasive messages when necessary). The ability to make presentations (with visuals) also ranks highly.

Figure 7.6 Required Skills



Key Takeaways

- Effective communication is needed in several facets of the new-product design and development process:
  1. Designers must effectively communicate both ideas and practical specifications.
  2. The process usually succeeds only when the assigned team integrates input from every relevant area of the organization.
- **Communication** is the process of transferring information from a sender to a receiver.
- Businesses benefit in several ways when they're able to foster effective communication among employees:
  1. Decisions are more assured and cogent, and problem solving is faster.
  2. Warning signs of potential problems appear earlier.
  3. Workflow moves more smoothly and productivity increases.
  4. Business relationships are stronger.
  5. Marketing messages are more persuasive.
  6. The company's professional image is enhanced.
  7. Employee satisfaction goes up and turnover goes down.
  8. The firm and its investors enjoy better financial results.

Exercise

(AACSB) Analysis

Pick a company you're interested in working for when you graduate from college. For this company, identify the following:

1. A starting position you'd like to obtain on graduation
2. A higher-level position you'd like to be promoted to in five years.

For each of these positions, describe the skills needed to get the job and those needed to be successful in the position.

Communication Channels

Learning Objectives

1. Discuss the nature of communications in an organizational setting, including communication flows, channels, and networks.
2. Explain barriers to communication, and discuss the most common types of barriers to group communication.

What Is *Organizational* Communication?

Clearly, the task of preparing and submitting a finished sales report doesn't require the same kinds of communication skills as talking on the phone with a classmate. No matter what your "workstation" happens to be—whether your workplace office or your kitchen table—you're performing the task of preparing that sales report in an *organizational setting*. You're still a sender transferring information to a receiver, but the organizational context of the task requires you to consider different factors for success in communicating effectively (including barriers to success). A report, for example, must be targeted for someone in a specific position and must contain the information necessary to make a specific set of decisions.[54]

Communication Flows

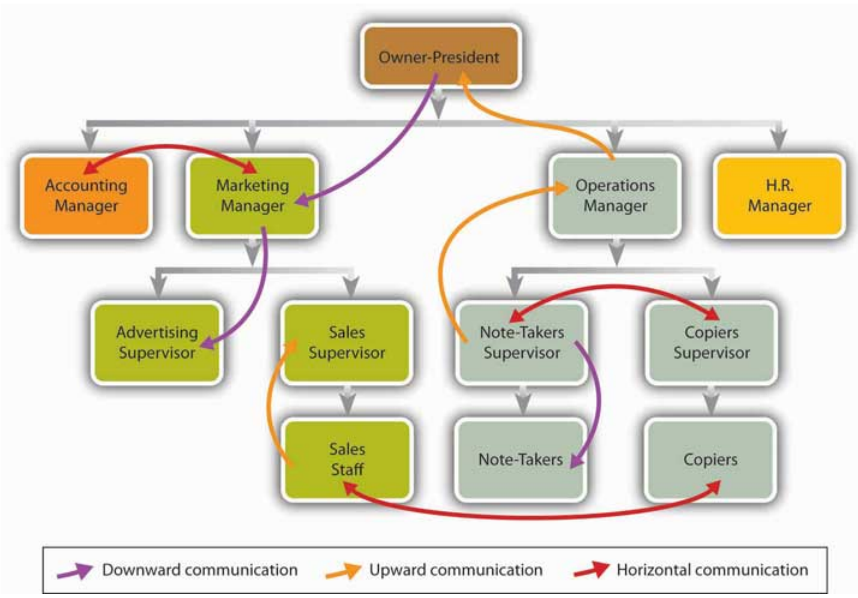
Here's another way of thinking about communication in an organizational setting. Let's assume that you and the classmate you called on the phone are on roughly equal footing—you're both juniors, your grades in the class are about the same, and so forth. Your phone conversation, therefore, is "lateral": You belong to the same group (your accounting class), and your group activities take place on the same level.

Communication may also flow laterally in organizational settings (as it does between you and your classmate), but more often it flows up or down. Take a look at Figure 7.7 "Formal Communication Flows". As you can see, we've added a few lines to show the three directions in which communications can flow in a typical organization:[55]:

- As the term suggests, downward communication flows from higher organizational levels (supervisors) to lower organizational levels (subordinates).
- Upward communication flows from lower to higher organizational levels.
- Lateral (or horizontal) communication flows across the organization, among personnel on the same level.

Your boss's request for a sales report is an instance of downward communication, and when you've finished and submitted it, you will have completed a task of upward communication.

Figure 7.7 Formal Communication Flows



Advantages of Communication Flows

Naturally, each of these different directional flows has its functions and advantages. Downward communication, for example, is appropriate for giving instructions or directions—telling people what to do. (As a goal of communication, by the way, giving orders isn't as one-sided as it may seem. One of the things that employees—the receivers—most want to know is: What, exactly, does my job entail?)[56] Like a sales report, upward communication usually provides managers with information that they need for making decisions, but it's also the vehicle for new ideas, suggestions, and complaints. Horizontal communication supports efforts to coordinate tasks and otherwise help people work together.

Disadvantages of Communication Flows

And, of course, each type of flow has its disadvantages. As information seeps downward, for instance, it tends to lose some of its original clarity and often becomes distorted or downright wrong. (This is especially true when it's delivered orally.) In addition, unlike Donald Trump, most people who are responsible for using downward communication don't like delivering bad news (such as "You're fired" or, more commonly, "Your job is being phased out"); as a result, bad news—including bad news that happens to be important news—is often ignored or disguised. The same thing may happen when bad news—say, a negative status report—must be sent upward.

Finally, while horizontal flows are valuable for promoting cooperation, they can also be used to engage in conflict—for instance, between two departments competing for the same organizational resources. The problem is especially bad when such horizontal communications breach official upward or downward lines of communication, thus bypassing managers who might be able to resolve the conflict.

Channels of Communication

Figure 7.8 "Channels of Communication" summarizes two additional sets of characteristics of organizational communication—*internal and external channels* and *formal and informal* channels.[57] Internal communication is shared by people at all levels within a company. External communication occurs between parties inside a company and parties outside the company, such as suppliers, customers, and investors. Both internal and external forms of communication include everything from formal e-mail and official reports to face-to-face conversations and casual phone calls. External communication also takes such forms as customer and supplier Web sites, news releases, and advertising.

FORMAL	**Planned communications following the company's chain of command among people inside the organization** — *e-mail, memos, conference calls, reports, presentations, executive blogs*	**Planned communications with people outside the organization** — *letters, instant messages, reports, speeches, news releases, advertising, Web sites executive blogs*
INFORMAL	**Casual communications among employees that do not follow the company's chain of command** — *e-mail, instant messages, phone calls, face-to-face conversations, team blogs*	**Casual communications with outsiders (e.g., suppliers, customers, investors)** — *e-mail, instant messages, phone calls, face-to-face conversations, customer-support blogs*

Note that Figure 7.8 "Channels of Communication" takes the form of a grid, thus creating four dimensions in which communication can take place. Informal communication, for example, can take place either among people within the company (internally) or between insiders and outsiders (externally). By and large, though you can use the same set of tools (memos, reports, phone calls) to communicate in any of these four situations, some tools (team blogs, news releases, supplier Web sites) are useful only in one or two.

The Formal Communication Network

An organization's formal communication network consists of all communications that flow along its official lines of authority. Look again at Figure 7.7 "Formal Communication Flows". Because it incorporates the *organization chart* for Notes-4-You, it shows the company's lines of authority—what we called *reporting relationships*. Here we can see that the reporting relationships in question consist of *upward communication* from subordinates to superiors. In reporting to the operations manager, for example, the notetakers' supervisor communicates upward. Conversely, when the notetakers' manager needs to give direction to notetakers, she will use *downward communication*. If the notetakers' manager and the copiers' manager must get together to prepare a joint report for the operations manager, they'll engage in *lateral communication*. In short, an organization's formal communication network is basically the same thing as its network of reporting relationships and lines of authority.[58]

The Informal Communication Network

Every company also has an informal communication network (or grapevine), which goes to work whenever two or more employees get together and start talking about the company and their jobs. Informal communication can take place just about anywhere (in one person's cubicle, in the cafeteria, on the golf course) and by just about any means (phone, e-mail, instant messaging, face-to-face conversation).

Though it's sometimes called the *grapevine*, an informal network is an extremely important communication channel. Why? For the simple reason that it's typically widespread and can rarely be prevented, even if it's not officially sanctioned by the company—indeed, even when the company tries to discourage or bypass it. Unofficial information crosses virtually every boundary drawn by a firm's organization chart, reaching out and touching everyone in the organization, and what's more, it travels a lot faster than official information.

Problems with the Flow of Information through Informal Channels

The downside of "unofficial" information should be obvious. Because much of it is communicated orally, it's likely to get distorted and often degenerates into outright misinformation. Say, for example, that a rumor about layoffs gets started in your workplace. As more than one manager will verify, such rumors can do more damage than the reality. Morale may plummet and productivity won't be far behind. Valuable employees may abandon ship (needlessly, if the rumors are false).[59]

And imagine what can happen if informal information gets outside the organization. In the 1970s, Chicago-area McDonald's outlets found themselves fighting rumors about worms in their hamburgers. Over the years, Coca-Cola has had to fight rumors about terrorists joining its organization, subversive messages concealed in its label, and hyperacidity (false rumors that Coke causes osteoporosis and makes a good pesticide and an equally good spermicide).[60][61]

What to Do about Informal Information Flows

On the upside, savvy managers can tap into the informal network, either to find out what sort of information is influencing employee activities or to circulate more meaningful information, including new ideas as well as corrective information. In any case, managers have to deal with the grapevine, and one manager has compiled a list of suggestions for doing so effectively:[62]

- *Learn to live with it*. It's here to stay.
- *Tune into it*. Pay attention to the information that's circulating and try to learn something from it. Remember: The more you know about grapevine information, the better you can interact with employees (who, in turn, will probably come to regard you as someone who keeps in touch with the things that concern them).
- *Don't participate in rumors*. Resist the temptation to add your two cents' worth, and don't make matters worse.
- *Check out what you hear*. Because it's your job to replace bad information with good information, you need to find out what's really going on.
- *Take advantage of the grapevine*. Its only function is to carry information, so there's no reason why you can't pump some useful information through it.

Perhaps most importantly, when alert managers notice that the grapevine is particularly active, they tend to reach a sensible twofold conclusion:

1. The organization's formal lines of communication aren't working as well as they should be.
2. The best way to minimize informal communication and its potential damage is to provide better formal communication from the outset—or, failing that, to provide whatever formal communication will counteract misinformation as thoroughly as possible.

Let's go back to our example of a workplace overwhelmed by layoff rumors. In a practical sense, what can a manager—say, the leader of a long-term product-development team—do to provide better communication? One manager suggests at least three specific responses:[63]

1. Go to your supervisor or another senior manager and try to find out as much as you can about the organization's real plans.
2. Ask a senior manager or a human resources representative to meet with your team and address members' concerns with accurate feedback.
3. Make it a priority to keep channels open—both between yourself and your team members and between team members and the human resources department.

Because actions of this sort send a message, they can legitimately be characterized as a form of formal communication. They also reflect good leadership: Even though the information in this case relates only indirectly to immediate team tasks, you're sharing information with people who need it, and you're demonstrating integrity (you're being honest, and you're following through on a commitment to the team).

Overcoming Barriers to Communication

What Are Barriers to Communication?

By *barriers* we mean anything that prevents people from communicating as effectively as possible. Noise, for example, can be a barrier to communication; if you and other team members are mumbling among yourselves while your team leader is trying to explain task assignments, you're putting up a barrier to group communication. As a matter of fact, you're putting up two barriers: In addition to *creating noise*, you're *failing to listen*. About 80 percent of top executives say that learning to listen is the most important skill in getting things done in the workplace,[64][65] and as President Calvin Coolidge once remarked, "No man ever listened himself out of a job." Business people who don't listen risk offending others or misinterpreting what they're saying.

Two Types of Barriers

Figure 7.9 Barriers to Communication

Though developed to improve communication, in some cases cell phones can create a barrier. [66]

As for creating unnecessary verbal noise and failing to listen, we can probably chalk them up to poor communication habits (or maybe the *same* habit, for as legendary management expert Peter Drucker argues, "Listening is not a skill; it is a discipline. All you have to do is keep your mouth shut"). In the rest of this section, we'll overlook personal barriers to communication and concentrate instead on two types of barriers that are encountered by groups of people, sometimes large and sometimes small, working toward organizational goals.

Cultural Barriers

Cultural barriers, which are sometimes called cultural filters, are the barriers that result from differences among people of different cultures.[67] Experts and managers agree that cultural diversity in the workplace can and should be a significant asset: It broadens the perspectives from which groups approach problems, gives them fresh ideas, and sparks their creativity; it also gives organizations an advantage in connecting with diverse customer bases. None of these advantages, though, magically appears simply because workplace diversity increases. To the contrary: As diversity increases, so does the possibility that a group will be composed of people who have different attitudes and different ways of expressing them.

If it hasn't happened already, for example, one of these days you'll find yourself having a work-related conversation with a member of the opposite sex. If the conversation doesn't go as smoothly as you'd expected, there's a good reason: Men and women in the workplace don't communicate the same way. According to American linguist Deborah Tannen, men tend to assert their status, to exert confidence, and to regard asking questions as a sign of weakness. Women, in contrast, tend to foster positive interrelationships, to restrain expressions of confidence, and to ask questions with no trouble.[68][69]

It really doesn't matter which "style" (if either) is better suited to making a conversation more productive. Two points, however, are clear:

1. Even if two people of the opposite sex enter a conversation with virtually identical viewpoints, their different styles of expressing themselves might very well present a barrier to their reaching an agreement. Much the same can be said of differences in style arising from other cultural filters, such as ethnicity, education, age, and experience.
2. Workplace conversations can be tricky to negotiate, yet there's no escaping them. Like life in the outside world, observes Tannen, life in the workplace "is a matter of dealing with people…and that means a series of conversations." That's also why surveys continue to show that managers regard the ability to communicate face to face as a key factor in an employee's promotability.[70]

Functional Barriers

Let's return for a moment to Figure 7.7 "Formal Communication Flows". Recall that when we introduced the organizational structure, we characterized it as a *functional organization*—one that groups together people who have comparable skills and perform similar tasks. Note, however, that in setting up this form of organization for our hypothetical company, we found it necessary to insert two layers of management (four functional managers and two job supervisors) between our owner/president and our lowest-level employees. In this respect, our structure shares certain characteristics with another form of organization—

divisional, which groups people into units that are more or less self-contained and that are largely accountable for their own performance.

What does all this have to do with barriers to communication? Simply this: The more "divisionalized" an organization becomes, the more likely it will be to encounter communication barriers. Not surprisingly, communication gets more complicated, for the same reason that an organization comes to rely on more levels of management.[71] Notes-4-You, for instance, needs two supervisors because its notetakers don't do the same work as its copiers. In addition, because their groups don't perform the same work, the two supervisors don't call on the same resources from the company's four functional managers. (Likewise, Notes-4-You also has four functional-area managers because none of them does the same work as any of the others.)

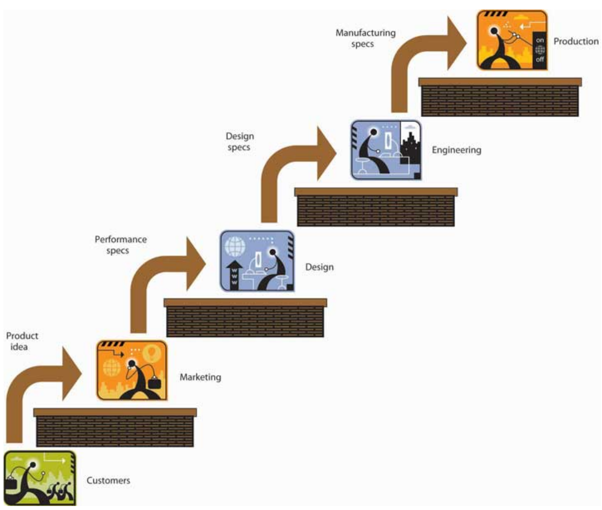
Officially, then, the operations of the two work groups remain distinct or specialized. At the same time, each group must contribute to the company-wide effort to achieve common goals. Moreover, certain organizational projects, like Motorola's cell phone project, may require the two groups to work together more closely than usual. When that happens, employees from each of the two groups may find themselves working together on the same team, but even so, one crucial fact remains: Information that one group possesses and the other doesn't must still be exchanged among team members. It may not be quite as apparent as the *cultural diversity* among men and women in many workplace situations, but there is in fact a *functional diversity* at Notes-4-You among notetakers and copiers.[72]

Figure 7.10 "Functional Barriers to Communication" illustrates the location of barriers that may be present when a team-based project must deal with a certain degree of functional diversity. As you can see, we've modeled our process on the process of the Motorola ultratrim phone project.[73] We don't need to describe the entire process in detail, but we will focus on two aspects of it that we've highlighted in the drawing:

1. The company has assigned team members from different functional areas, notably marketing and operations (which, as at Motorola, includes design, engineering, and production).
2. Information (which we've characterized as different types of "specs") must be transferred from function to function, and at the key points where this occurs, we've built in communication barriers (symbolized by brick walls).

If, for example, marketing specs called for the new Motorola phone to change colors with the user's mood, someone in engineering might have to explain the difficulties in designing the software. If design specs called for quadraphonic sound, production might have to explain the difficulties in procuring sufficiently lightweight speaker components.

Figure 7.10 Functional Barriers to Communication



Each technical problem—each problem that arises because of differences in team members' knowledge and expertise—becomes a problem in communication. In addition, communicating as a member of a team obviously requires much more than explaining the limitations of someone else's professional expertise. Once they've surfaced, technical and other problems have to be resolved—a process that will inevitably require even more communication. As we've seen in this part of the chapter, improving communication is a top priority for most organizations (for one thing, developing a team-based environment is otherwise impossible), and the ongoing task of improving communication is pretty much the same thing as the ongoing task of overcoming barriers to it.

Key Takeaways

- In a typical organizational setting, *communication flows* may take three directions:
  1. **Downward communication** flows from higher organizational levels (supervisors) to lower organizational levels (subordinates).
  2. **Upward communication** flows from lower to higher organizational levels.
  3. **Lateral** (or **horizontal**) **communication** flows across the organization, among personnel on the same level.
- Organizational communication flows through two different *channels*. **Internal communication** is shared by people at all levels within a company. **External communication** occurs between parties inside a company and parties outside the company, such as suppliers, customers, and investors.
- Organizational communication also flows through two different *networks*. Its **formal communication network** consists of all communications that flow along an organization's official lines of authority. The **informal communication network**, sometimes called the *grapevine*, goes to work whenever two or more employees get together and start talking about the company and their jobs.
- *Barriers to communication* include anything that prevents people from communicating as effectively as possible. Among groups, two types of barriers are common. *Cultural barriers*, sometimes called *cultural filters*, are the barriers that result from differences among people of different cultures. *Functional barriers* arise when communication must flow among individuals or groups who work in different functional areas of an organization.

Exercise

(AACSB) Analysis

Write three messages (you decide which communication channel to use):

1. To a coworker asking her for a report on this quarter's sales for your division
2. To your manager telling him what the sales were for the quarter and whether sales improved (or got worse), and why
3. To the vice president of the company recommending a new system for tracking sales in your division

Forms of Communication

Learning Objectives

1. Explain the do's and don'ts of business e-mails.
2. Describe the process followed to create and deliver successful presentations.
3. Learn how to write clear, concise memos.

As mentioned previously, the College Board identified these communication skills as "frequently" or "almost always" necessary in the workplace:[74] e-mail, presentation with visuals, technical reports, formal reports, memos, and presentations without visuals. The skill ranked highest in importance was the use of e-mails, including the ability to adapt messages to different receivers or compose persuasive messages when necessary. The ability to make presentations (with visuals) ranked second in importance. Report writing came next. Given the complexity of report writing, we will not cover this topic here. Instead, we will look at the remaining three forms of communication: e-mail, presentations with visuals, and memos.

Tips for Writing Business E-Mails

Dennis Jerz and Jessica Bauer created the following list of the top 10 tips for writing effective e-mail messages:[75]

1. *Write a meaningful subject line.* Recipients use the subject line to decide whether to open or delete a message and sometimes where to store it. Write a subject line that describes the content.
2. *Keep the message focused.* Avoid including multiple messages or requests in one e-mail. Try to focus on only one topic. Use standard capitalization and spelling; none of this "thx 4 ur help 2day ur gr8."
3. *Avoid attachments.* Extract the relevant text from a large file and ask the recipient if he or she wants to see the full document.
4. *Identify yourself clearly. Identify yourself in the first few lines*—otherwise your message might be deleted quickly.
5. *Be kind. Don't flame.* Avoid writing e-mails when you are upset. Always think before you hit the "send" button. Once it's gone, you can't get it back. If you're mad, write the e-mail, but don't send it. Keep it in your "save" or "draft" folder and reread it the next day.
6. *Proofread.* Use spell check and read the memo carefully before sending it.

7. *Don't assume privacy.* Don't send anything you wouldn't want posted on the office bulletin board (with your name on it). Remember, employers can read your e-mails!
8. *Distinguish between formal and informal situations*. When writing to a coworker with whom you are friends, you can be less formal than when you are writing to your manager or a client.
9. *Respond promptly*. Get back quickly to the person who sent you the e-mail. If you're too busy to answer, let the person know you got the message and will respond as soon as you can.
10. *Show respect and restraint*. Watch out: Don't use the "reply to all" button in error. Don't forward an e-mail before getting permission from the sender.

Planning, Preparing, Practicing, and Presenting

For some, the thought of making a presentation is traumatic. If you're one of those people, the best way to get over your fear is to get up and make a presentation. With time, it will get easier, and you might even start enjoying it. As you progress through college, you will have a number of opportunities to make presentations. This is good news—it gives you practice, lets you make your mistakes in a protected environment (before you hit the business world), and allows you to get fairly good at it. Your opportunities to talk in front of a group will multiply once you enter the business world. Throughout your business career, you'll likely be called on to present reports, address groups at all levels in the organization, represent your company at various events, run committee meetings, lead teams, or make a sales pitch.[76] In preparing and delivering your presentation, you can follow a four-step process (plan, prepare, practice, and present) designed by Dale Carnegie, a global training company named after its famed founder.[77]

Plan

Plan your presentation based on your purpose and the knowledge level and interest of your audience. Use words and concepts your audience can understand, and stay focused. If your audience is knowledgeable about your topic, you can skim over the generalities and delve into the details. On the other hand, if the topic is new to them, you need to move through it slowly. As you plan your presentation, ask yourself these questions: What am I trying to accomplish? Am I trying to educate, inform, motivate, or persuade my audience? What does my audience know about the topic? What do I want them to know? How can I best convey this information to them?

Prepare

Once you have planned your presentation, you're ready to prepare. It might be easier to write your presentation if you divide it into three sections: opening, body, close. Your opening should grab your audience's attention. You can do this by asking a question, telling a relevant story, or even announcing a surprising piece of information. About 5 to 10 percent of your time can be spent on the opening. The body covers the bulk of the material and consumes about 80 to 85 percent of your time. Cover your key points, stay focused, but do not overload your audience. It has been found that an audience can absorb only about four to six points. Your close, which uses about 5 to 10 percent of your time, should leave the audience with a positive impression of you and your presentation. You have lots of choices for your close: You can either summarize your message or relate your closing remarks to your opening remarks or do both.

Practice

This section should really be called "Practice, Practice, Practice" (and maybe another Practice for emphasis). The saying "practice makes perfect" is definitely true with presentations, especially for beginners. You might want to start off practicing your presentation by yourself, perhaps in front of a mirror. You could even videotape yourself and play it back (that should be fun). As you get the hang of it, ask a friend or a group of friends to listen to and critique your talk. When you rehearse, check your time to see whether it's what you want. Avoid memorizing your talk, but know it well.

Present

Figure 7.11 Presentations

Preparation is key to a successful presentation. [78]

Now you're ready for the big day—it's time to present. Dress for the part—if it's a professional talk, dress like a professional. Go early to the location where you'll present, check out the room, and be sure any equipment you'll need is there and works. Try to connect with your audience as soon as you start your presentation. Take your time delivering your opening. Act as natural as you can, and try to relax. Slow your speech down, as you'll likely have a tendency to speed up if you get nervous. Pause before and after your main point for emphasis. If you put brief notes on index cards, avoid reading from the cards. Glance down at them when needed, but then look up at your audience as you speak. Involve your audience in your presentation by asking them questions. Not only will they feel included, but it will help you relax. When you're close to finishing, let your audience know this (but don't announce it too early in the talk or your audience might start packing up prematurely). Remember to leave some time for questions and answers.

Visual Aids

It's very common to use visual aids (generally PowerPoint slides) in business presentations. The use of visual aids helps your audience remember your main points and keeps you focused. If you do use PowerPoint slides, follow some simple (but important) rules:[79]

- Avoid wordiness: use key words and phrases only.
- Don't crowd your slide: include at most four to five points per slide.
- Use at least an eighteen-point font (so that it can be seen from the back of the room).
- Use a color font that contrasts with the background (for example, blue font on white background).
- Use graphs rather than just words.
- Proof your slides and use spell check.

And most important: The PowerPoint slides are background, but you are the show. Avoid turning around and reading the slides. The audience wants to see *you* talk; they are not interested in seeing the back of your head.

How to Write an Effective Memo

Memos are effective at conveying fairly detailed information. To help you understand how to write a memo, read the following sample memorandum.

Memorandum

TO	
FROM	
DATE	
RE	

As college students, you'll be expected to analyze real-world situations, research issues, form opinions, and provide support for the conclusions that you reach. In addition to engaging in classroom discussions of business issues, you'll be asked to complete a number of written assignments. For these assignments, we'll give you a business situation and ask you to analyze the issues, form conclusions, and provide support for your opinions.

In each assignment, you'll use the *memo format*, which is the typical form of written communication used in business. Writing in memo format means providing a *complete but concise response* to the issues at hand. Good memo writing demands time and effort. Because the business world expects you to possess this skill, we want to give you an opportunity to learn it now.

Guidelines

Here are a few helpful hints to get you started on the right track:

- **The format should follow the format of this memo**. Note the **guide headings**—"TO," "FROM," "DATE," and "RE" (which, by the way, stands for "regarding" or "reference"). We also include a line across the page to signal the beginning of the body of the memo.
- Keep **paragraphs** short and to the point. The trick is being concise yet complete—summarizing effectively. Paragraphs should be single-spaced, flush against the left margin, and separated by a single blank line.
- Accent or highlight **major points**. Use underlining, bullets, or bold type for desired effect (taking care not to overdo it).
- Use *short* **headings** to distinguish and highlight vital information. Headings keep things organized, provide structure, and make for smooth reading. Headings (and, as appropriate, subheadings) are an absolute *must*.
- Your **title** (the "Re" line) should reflect the contents of your memo: It should let the reader know why he or she should read it. Keep the title short—a phrase of a few words, not a sentence.
- Be persuasive and convincing in your narrative. You have limited space in which to get your **key points** across. State your positions clearly. And again, be concise (a memo is not a term paper).
- If you have any additional information in the form of **exhibits**—charts, tables, illustrations, and so forth—put them in an **attachment**. Label each item "Exhibit 1," "Exhibit 2," and the like. Give each one a title, and be sure to reference them in your narrative ("As shown in Exhibit 1, the annual growth rate in sales has dropped from double-digit to single-digit levels").
- Finally, *staple* multiple pages for submission. Needless to say, be sure to proofread for correct spelling and punctuation. Don't scribble in changes by hand: They're sloppy and leave a bad impression.

Final Comment

Now that you've read our memo, we expect you to follow the simple guidelines presented in it. This form of communication is widely practiced in business, so take advantage of this opportunity to practice your memo-writing skills.

Nonverbal Communication

Sometimes it's not what you say or how you say it that matters, but what your body language communicates about you and how you feel. When a good friend who's in a bad mood walks into a room, you don't need to hear a word from her to know she's having an awful day. You can read her expression. In doing this, you're picking up on her nonverbal communication—"nonword" messages communicated through facial expressions, posture, gestures, and tone of voice. People give off nonverbal cues all the time. So what effect do these cues have in the business setting? Quite a bit—these cues are often better at telling you what's on a person's mind than what the person actually says. If an employee is meeting with his supervisor and frowns when she makes a statement, the supervisor will conclude that he disapproved of the statement (regardless of what he claims). If two employees are discussing a work-related problem and one starts to fidget, the other will pick this up as disinterest.

Given the possible negative effect that nonverbal cues can have in business situations, how can you improve your body language? The best approach is to become aware of any nonverbal cues you give out, and then work to eliminate them. For example, if you have a habit of frowning when you disapprove of something, recognize this and stop doing it. If the tone of your voice changes when you are angry, try to maintain your voice at a lower pitch.

Key Takeaways

- Here are ten tips for writing an e-mail:
  1. Write a meaningful subject line.
  2. Keep the message focused and readable.
  3. Avoid attachments.
  4. Identify yourself clearly in the first few lines.
  5. Be kind. Don't flame. Always think before hitting the "send" button.
  6. Proofread.
  7. Don't assume privacy.
  8. Distinguish between formal and informal situations.
  9. Respond promptly.
  10. Show respect and restraint.
- In preparing and delivering your presentation, you can follow a four-step process: plan, prepare, practice and present.

- You should **plan** your presentation based on your purpose and the knowledge level and interest of your audience.
- In **preparing** your presentation, it helps to divide it into three sections: opening, body and close.
  1. Your **opening**, which uses about 5–10 percent of your time, should grab your audience's attention.
  2. The **body** covers your main points and uses about 80 to 85 percent of your time.
  3. Your **close**, which uses about 5 to 10 percent of your time, should leave the audience with a positive impression of you and your presentation.
- The saying "**practice** makes perfect" is definitely true when giving presentations (especially for beginners).
- When you **present**, dress professionally, connect with your audience, try to relax and pause before and after your main points for emphasis.
  1. Visual aids, such as PowerPoint slides, can aid your presentation if they are used properly.
- Memos are effective at conveying fairly detailed information. Here are some tips:
  1. Keep paragraphs short and to the point.
  2. Accent or highlight **major points**.
  3. Use **short** headings.
  4. Your **title** should reflect the contents of your memo.
  5. Be persuasive and convincing in your narrative.

Exercise

(AACSB) Reflection

1. Ask a friend or a family member to tell you which nonverbal cues you frequently transmit. Identify those that would be detrimental to you in a business situation. Indicate how you could eliminate or reduce the impact of these cues. Ask the same person (or someone else) whether you are a good listener. If the answer is no, indicate how you could improve your listening skills.
2. Prepare a presentation on "planning, preparing, practicing, and presenting." Divide your presentation into three parts: opening, body, and closing. Prepare visual aids. Pretend that your audience is made up of recent college graduates hired by Nike.

Cases and Problems

Learning on the Web (AACSB)

Factors Contributing to Nike's Success

This writing assignment solicits your opinion on factors contributing to Nike's success. To complete it, you should go to http://www.nikebiz.com/company_overview/timeline to learn about Nike's history by reviewing the company's time line.

Memo Format

Use the memo format described in the chapter for this assignment. Your memo should not exceed two pages. It should be single spaced (with an extra space between paragraphs and bulleted items).

Scenario

You're one of the fortunate college students selected to participate in Nike's summer internship program. The program is quite competitive, and you still can't believe that you were chosen. You arrived in Beaverton, Oregon, yesterday morning and have been busy ever since. Last night, you attended a dinner for new interns where you were welcomed to Nike by CEO Mark Parker.

You were lucky to be sitting next to a personable, well-informed Nike veteran named Simon Pestridge. Pestridge joined Nike about twelve years ago. He was telling you about a past assignment he had as director of marketing for Australia. (You were impressed with his status at Nike, not just because he doesn't look much older than you, but also because you've always wanted to travel to Australia.) The dinner conversation turned to a discussion of the reasons for Nike's success. Others at the table were giving their opinions on the subject when Pestridge turned to you and said, "As a new intern, give us an outsider's point of view. Why do you think Nike's been so successful?" You were about to venture an opinion when Pestridge was called away for a phone call. As he got up, however, he quickly said, "Send me a memo telling me what factors you think have contributed to Nike's success. Keep it simple. Three factors are plenty." Though you were relieved to have a little time to think about your answer, you were also a bit nervous about the prospect of writing your first official memo.

As everyone else headed for the Bo Jackson gym, you went back to your room to think about Pestridge's question and to figure out how to go about writing your memo. You want to be sure to start by telling him that you enjoyed talking with him. You also need to remind him that you're responding to his question about three factors in Nike's success, and must be sure to explain why you believe they're important. You'll end by saying that you hope the information is helpful and that he can contact you if he has any further questions.

So far, so good, but you're still faced with the toughest part of your task—identifying the three factors that you deem important to Nike's success. Fortunately, even at Nike there's always tomorrow to get something done, so you decide to sleep on it and write your memo in the morning.

Ethics Angle (AACSB)

The Goof-Off

You and three other students have been working on a group project all semester in your Introduction to Business class. One of the members of the team did very little work; he failed to attend almost all the meetings, took no responsibility for any of the tasks, didn't attend the practice session before your presentation, and in general was a real goof-off. But he happens to be friends with two of the team members. You and your other team members have been asked to complete the attached team member evaluation. You want to give the student what he deserves—almost no credit. But your other two team members don't agree. They argue that it is "unsocial and mean" to tell the truth about this student's lack of contribution. Instead, they want to report that everyone shared the work equally. The evaluation will be used in determining grades for each team member. Those who contributed more will get a higher grade than those who did not. Prepare an argument that you can advance to the other team members on the ethics of covering for this student. Assuming that your two teammates won't change their minds, what would you do?

Attachment to Ethics Angle Problem

Introduction to Business

Team Member Evaluation

(To be given to your faculty member during the last week of class)

TEAM ___________________

You have a total of $100,000. You can use this to reward your team members (including yourself) for their contributions to the team project.

Fill in each team member's name below (including your own), and show beside each name how much of the $100,000 you would give that member for his or her contributions to the preparation and presentation of the team project. Do not share your recommendations with your team members.

Your recommendations will be confidential.

Team Members (including yourself)	Amount to be given for efforts on team project
___________________________________	$________________________
___________________________________	$________________________
___________________________________	$________________________
___________________________________	$________________________
___________________________________	$________________________
___________________________________	$________________________
TOTAL (MUST EQUAL $100,000)	$________________________

YOUR NAME ____

Team-Building Skills (AACSB)

Team Skills and Talents

Team projects involve a number of tasks that are handled by individual team members. These tasks should be assigned to team members based on their particular skills and talents. The next time you work on a team project, you should use the following table to help your team organize its tasks and hold its members responsible for their completion.

Here is how you should use this document:

1. Identify all tasks to be completed.
2. Assign each task to a member (or members) of your team based on their skills, talents, and time available.
3. Determine a due date for each task.
4. As a task is completed, indicate its completion date and the team member (or members) who completed the task. If more than one team member works on the assignment, indicate the percentage of time each devoted to the task. You can add tasks that surface as your team works its way through the project.
5. If the assigned person fails to complete the task, or submits poor quality work, add a note to the report explaining what happened and how the situation was corrected (for example, another team member had to redo the task).
6. Submit the completed form (with all columns completed) to your faculty member at the class after your team project is due. Include a cover sheet with your team's name (or number) and the name of each team member.

Tasks to Be Completed	Initials of Team Member(s) Who Will Complete Task	Date to Be Completed	Date Completed	Initials of Team Member(s) Who Completed Task (Add a Note Below the Table Explaining Any Problems with Completion or Quality of Work)
________	________	________	________	________
________	________	________	________	________
________	________	________	________	________
________	________	________	________	________
________	________	________	________	________

The Global View (AACSB)

A Multicultural Virtual Team

You work for Nike, a global company. You just learned that you were assigned to a virtual team whose mission is to assess the feasibility of Nike's making an inexpensive shoe that can be sold in Brazil. The team consists of twelve members. Three of the members work in the United States (two in Beaverton, Oregon, and one in New York City). Two work in England, two in China, two in India, and three in Brazil. All are Nike employees and all were born in the country in which they work. All speak English, though some speak it better than others. What challenges do you anticipate the team will face because of its multicultural makeup?. How could these challenges be overco

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2.5: Chapter 8- Operations Management in Manufacturing and Service Industries

Learning Objectives

1. Define operations management, and discuss the role of the operations manager in a manufacturing company.
2. Describe the decisions made in planning the production process in a manufacturing company.

Like PowerSki, every organization—whether it produces goods or provides services—sees Job 1 as furnishing customers with quality products. Thus, to compete with other organizations, a company must convert resources (materials, labor, money, information) into goods or services as efficiently as possible. The upper-level manager who directs this transformation process is called an *operations manager*. The job of operations management (OM), then, consists of all the activities involved in transforming a product idea into a finished product, as well as those involved in planning and controlling the systems that produce goods and services. In other words, operations managers manage the process that transforms inputs into outputs. Figure 8.1 "The Transformation Process" illustrates this traditional function of operations management.

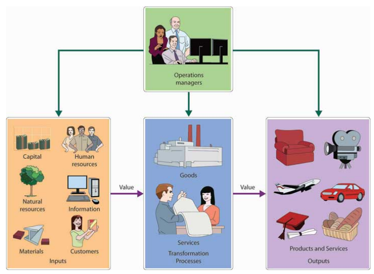


Figure 8.1 The Transformation Process

In the rest of this chapter, we'll discuss the major activities of operations managers. We'll start by describing the role that operations managers play in the various processes designed to produce goods and offer services. Next, we'll look at the production of goods in manufacturing firms; then, we'll describe operations management activities in companies that provide services. We'll wrap up the chapter by explaining the role of operations management in such processes as quality control and outsourcing.

Operations Management in Manufacturing

Like PowerSki, all manufacturers set out to perform the same basic function: *to transform resources into finished goods*. To perform this function in today's business environment, manufacturers must continually strive to improve operational efficiency. They must fine-tune their production processes to focus on quality, to hold down the costs of materials and labor, and to eliminate all costs that add no value to the finished product. Making the decisions involved in the effort to attain these goals is the job of the operations manager. That person's responsibilities can be grouped as follows:

- *Production planning*. During production planning, managers determine how goods will be produced, where production will take place, and how manufacturing facilities will be laid out.
- *Production control*. Once the production process is under way, managers must continually schedule and monitor the activities that make up that process. They must solicit and respond to feedback and make adjustments where needed. At this stage, they also oversee the purchasing of raw materials and the handling of inventories.
- *Quality control*. Finally, the operations manager is directly involved in efforts to ensure that goods are produced according to specifications and that quality standards are maintained.

Let's take a closer look at each of these responsibilities.

Planning the Production Process

The decisions made in the planning stage have long-range implications and are crucial to a firm's success. Before making decisions about the operations process, managers must consider the goals set by marketing managers. Does the company intend to be a low-cost producer and to compete on the basis of price? Or does it plan to focus on quality and go after the high end of the market? Perhaps it wants to build a reputation for reliability. What if it intends to offer a wide range of products? To make things even more complicated, all these decisions involve trade-offs. Upholding a reputation for reliability isn't necessarily compatible with offering a wide range of products. Low cost doesn't normally go hand in hand with high quality.

With these factors in mind, let's look at the specific types of decisions that have to be made in the production planning process. We've divided these decisions into those dealing with production methods, site selection, facility layout, and components and materials management.

Production-Method Decisions

The first step in production planning is deciding which type of production process is best for making the goods that your company intends to manufacture. In reaching this decision, you should answer such questions as the following:

- How much input do I receive from a particular customer before producing my goods?
- Am I making a one-of-a-kind good based solely on customer specifications, or am I producing high-volume standardized goods to be sold later?
- Do I offer customers the option of "customizing" an otherwise standardized good to meet their specific needs?

One way to appreciate the nature of this decision is by comparing three basic types of processes or methods: *make-to-order, mass production*, and *mass customization*. The task of the operations manager is to work with other managers, particularly marketers, to select the process that best serves the needs of the company's customers.

Make-to-Order

At one time, most consumer goods, such as furniture and clothing, were made by individuals practicing various crafts. By their very nature, products were *customized* to meet the needs of the buyers who ordered them. This process, which is called a make-to-order strategy, is still commonly used by such businesses as print or sign shops that produce low-volume, high-variety goods according to customer specifications.

Mass Production

Figure 11.2 Mass Production; Dawn Endico – Dealer Prep – CC BY-SA 2.0.

Automakers produce a high volume of cars in anticipation of future demand.

By the early twentieth century, however, a new concept of producing goods had been introduced: mass production (or make-to-stock strategy) is the practice of producing high volumes of identical goods at a cost low enough to price them for large numbers of customers. Goods are made in anticipation of future demand (based on forecasts) and kept in inventory for later sale. This approach is particularly appropriate for standardized goods ranging from processed foods to electronic appliances.

Mass Customization

But there's a disadvantage to mass production: customers, as one contemporary advertising slogan puts it, can't "have it their way." They have to accept standardized products as they come off assembly lines. Increasingly, however, customers are looking for products that are designed to accommodate individual tastes or needs but can still be bought at reasonable prices. To meet the demands of these consumers, many companies have turned to an approach called mass customization, which (as the term suggests) combines the advantages of customized products with those of mass production.

This approach requires that a company interact with the customer to find out exactly what the customer wants and then manufacture the good, using efficient production methods to hold down costs. One efficient method is to mass-produce a product up to a certain cut-off point and then to customize it to satisfy different customers.

The list of companies devoting at least a portion of their operations to mass customization is growing steadily. One of the best-known mass customizer is Nike, which has achieved success by allowing customers to configure their own athletic shoes, apparel, and equipment through Nike's iD program. The Web has a lot to do with the growth of mass customization. Levi's, for instance, lets a woman find a pair of perfect fitting jeans by going through an online fitting process that first identifies her "curve" type:

slight (straight figure), *demi* (evenly proportioned), *bold* (curvy figure, which experiences waist gapping in the back), and supreme (curviest shape, which needs a higher rise in the back). Oakley offers customized sunglasses, goggles, watches, and backpacks, while Mars, Inc. can make M&M's in any color the customer wants (say, school colors) as well as add text and pictures to the candy.[1]

Naturally, mass customization doesn't work for all types of goods. Most people don't care about customized detergents or paper products (although a customized Kleenex tissue box with your picture on it and a statement that says, "go ahead…cry over me!" might come in handy after a relationship breakup with your significant other).[2] And while many of us like the idea of customized clothes, footwear, or sunglasses from Levi's, Nike, or Oakley, we often aren't willing to pay the higher prices they command.

Facilities Decisions

After selecting the best production process, operations managers must then decide where the goods will be manufactured, how large the manufacturing facilities will be, and how those facilities will be laid out.

Site Selection

In choosing a location, managers must consider several factors:

- To minimize shipping costs, both for raw materials coming into the plant and for finished goods going out, managers often want to locate plants close to suppliers, customers, or both.
- They generally want to locate in areas with ample numbers of skilled workers.
- They naturally prefer locations where they and their families will enjoy living.
- They want locations where costs for resources and other expenses—land, labor, construction, utilities, and taxes—are low.
- They look for locations with a favorable business climate—one in which, for example, local governments might offer financial incentives (such as tax breaks) to entice them to do business in their locales.

Managers rarely find locations that meet all these criteria. As a rule, they identify the most important criteria and aim at satisfying them. In deciding to locate in San Clemente, California, for instance, PowerSki was able to satisfy three important criteria: (1) proximity to the firm's suppliers, (2) availability of skilled engineers and technicians, and (3) favorable living conditions. These factors were more important than operating in a low-cost region or getting financial incentives from local government. Because PowerSki distributes its products throughout the world, proximity to customers was also unimportant.

Capacity Planning

Now that you know *where* you're going to locate, you have to decide on the quantity of products that you'll produce. You begin by *forecasting* demand for your product. Forecasting isn't easy, to estimate the number of units that you're likely to sell over a given period, you have to understand the industry that you're in and estimate your likely share of the market by reviewing industry data and conducting other forms of research.

Once you've forecasted the demand for your product, you can calculate the capacity requirements of your production facility—the maximum number of goods that it can produce over a given time under normal working conditions. In turn, having calculated your capacity requirements, you're ready to determine how much investment in plant and equipment you'll have to make, as well as the number of labor hours required for the plant to produce at capacity.

Like forecasting, capacity planning is difficult. Unfortunately, failing to balance capacity and projected demand can be seriously detrimental to your bottom line. If you set capacity too low (and so produce less than you should), you won't be able to meet demand, and you'll lose sales and customers. If you set capacity too high (and turn out more units than you should), you'll waste resources and inflate operating costs.

Key Takeaways

- The job of **operations management** is to oversee the process of transforming resources into goods and services.
- The role of operations managers in the manufacturing sector includes production planning, production control, and quality control.
- During production planning, managers determine how goods will be produced (production process), where production will take place (site selection), and how manufacturing facilities will be laid out (layout planning).
- In selecting the appropriate production process, managers compare three basic methods: **make-to-order strategy** (goods are made to customer specifications), **mass production** or **make-to-stock strategy** (high volumes of goods are made and held in

inventory for later sale), and **mass customization** (high volumes of customized goods are made).

- In choosing the site for a company's manufacturing operations, managers look for locations that minimize shipping costs, have an ample supply of skilled workers, provide a favorable community for workers and their families, offer resources at low cost, and have a favorable business climate.
- Managers estimate the quantity of products to be produced by forecasting demand for their product and then calculating the capacity requirements of the production facility—the maximum number of goods that it can produce over a given period under normal working conditions.

Exercises

1. **(AACSB) Analysis**
2. **(AACSB) Analysis**

Facility Layouts

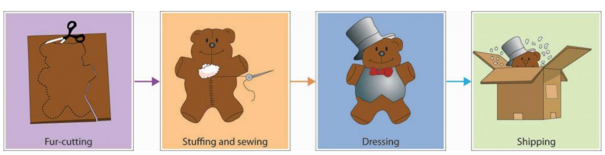
Learning Objective

1. Describe four major types of facility layouts: process, product, cellular, and fixed position.

The next step in production planning is deciding on plant layout—how equipment, machinery, and people will be arranged to make the production process as efficient as possible. In this section, we'll examine four common types of facility layouts: process, product, cellular, and fixed position.

The process layout groups together workers or departments that perform similar tasks. *Goods in process* (goods not yet finished) move from one workstation to another. At each position, workers use specialized equipment to perform a particular step in the production process. To better understand how this layout works, we'll look at the production process at the Vermont Teddy Bear Company. Let's say that you just placed an order for a personalized teddy bear—a "hiker bear" with khaki shorts, a white T-shirt with your name embroidered on it, faux-leather hiking boots, and a nylon backpack with sleeping bag. Your bear begins at the fur-cutting workstation, where its honey-brown "fur" coat is cut. It then moves to the stuffing and sewing workstation to get its insides and have its sides stitched together. Next, it moves to the dressing station, where it's outfitted with all the cool clothes and gear that you ordered. Finally, it winds up in the shipping station and starts its journey to your house. For a more colorful "Online Mini-Tour" of this process, log on to the Vermont Teddy Bear Web site at http://www.vermontteddybear.com/Static/Tour-Welcomestation.aspx (or see Figure 8.3 "Process Layout at Vermont Teddy Bear Company").

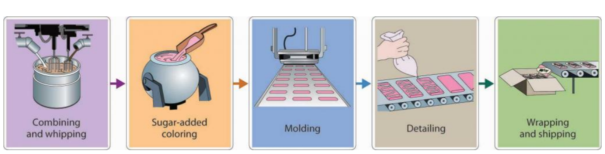
Figure 8.3 Process Layout at Vermont Teddy Bear Company



Stuffing and sewing -> Dressing -> Shipping->

In a product layout, high-volume goods are produced efficiently by people, equipment, or departments arranged in an *assembly line* —that is, a series of workstations at which already-made parts are *assembled*. Just Born, a candy maker located in Bethlehem, Pennsylvania, makes a product called Marshmallow Peeps on an assembly line. First, the ingredients are combined and whipped in huge kettles. Then, sugar is added for color. At the next workstation, the mixture—colored warm marshmallow—is poured into baby-chick–shaped molds carried on conveyor belts. The conveyor-belt parade of candy pieces then moves forward to stations where workers add eyes or other details. When the finished candy reaches the packaging area, it's wrapped for shipment to stores around the world. To take an online tour of the Marshmallow Peeps production process, log on to the Just Born Web site at http://www.justborn.com/get-to-know-us/our-factory (or see Figure 8.4 "Product Layout at Just Born, Inc.").

Figure 8.4 Product Layout at Just Born, Inc.

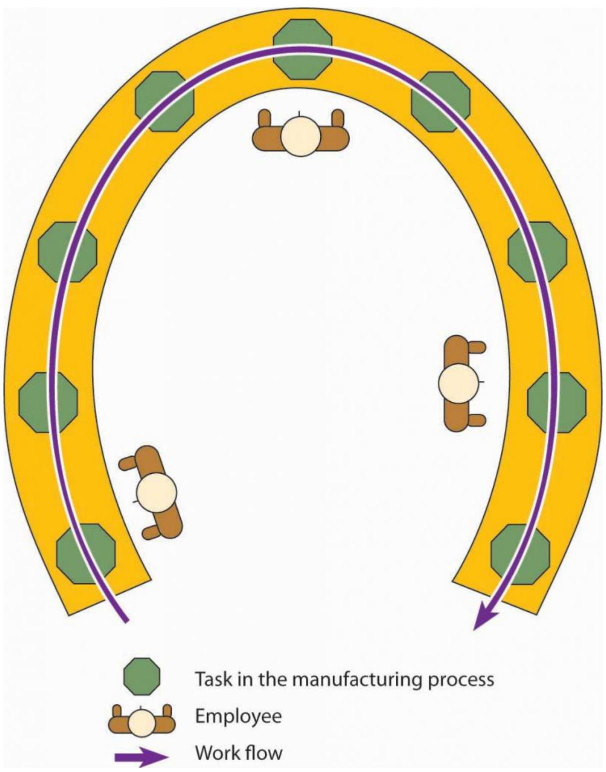


Sugar-added coloring -> Molding -> Detailing -> Wrapping and shipping->

Both product and process layouts arrange work by *function*. At the Vermont Teddy Bear Company, for example, the cutting function is performed in one place, the stuffing-and-sewing function in another place, and the dressing function in a third place. If you're a cutter, you cut all day; if you're a sewer, you sew all day: that's your function. The same is true for the production of Marshmallow Peeps at Just Born: if your function is to decorate peeps, you stand on an assembly line and decorate all day; if your function is packing, you pack all day.

Arranging work by function, however, isn't always efficient. Production lines can back up, inventories can build up, workers can get bored with repetitive jobs, and time can be wasted in transporting goods from one workstation to another. To counter some of these problems, many manufacturers have adopted a cellular layout, in which small teams of workers handle all aspects of building a component, a "family" of components, or even a finished product. Each team works in a small area, or cell, equipped with everything that it needs to function as a self-contained unit. Machines are sometimes configured in a U-shape, with people working inside the U. Because team members often share duties, they're trained to perform several different jobs. Teams monitor both the quantity and the quality of their own output. This arrangement often results in faster completion time, lower inventory levels, improved quality, and better employee morale. Cellular manufacturing is used by large manufacturers, such as Boeing, Raytheon, and Pratt & Whitney,[3] as well as by small companies, such as Little Enterprise, which makes components for robots.[4][5]Figure 8.5 "Cellular Layout" illustrates a typical cellular layout.

Figure 8.5 Cellular Layout



It's easy to move teddy bears and marshmallow candies around the factory while you're making them, but what about airplanes or ships? In producing large items, manufacturers use fixed-position layout in which the product stays in one place and the workers (and equipment) go to the product. This is the arrangement used by General Housing Corporation in constructing modular homes. Each house is constructed at the company's factory in Bay City, Michigan, according to the customer's design. Because carpenters, electricians, plumbers, and others work on each building inside the climate-controlled factory, the process can't be hindered by weather. Once it's done, the house is transported in modules to the owner's building site and set up in one day. For a closer view of General Housing Corporation's production process, go to the General Housing Web site at http://www.genhouse.com.

Key Takeaways

- Managers have several production **layout** choices, including process, product, cellular, and fixed-position.

- The **process layout** groups together workers or departments that perform similar tasks. At each position, workers use specialized equipment to perform a particular step in the production process.
- In a **product layout**, high-volume goods are produced in assembly-line fashion—that is, a series of workstations at which already-made parts are assembled.
- In a **cellular layout**, small teams of workers handle all aspects of building a component, a “family of components,” or even a finished product.
- A **fixed-position layout** is used to make large items (such as ships or buildings) that stay in one place while workers and equipment go to the product.

Exercise

(AACSB) Analysis

As purchasing manager for a company that flies corporate executives around the world, you’re responsible for buying everything from airplanes to onboard snacks. You plan to visit all the plants that make the things you buy: airplanes, passenger seats, TV/DVDs that go in the back of the passenger seats, and the specially designed uniforms (with embroidered company logos) worn by the flight attendants. What type of layout should you expect to find at each facility—process, product, or fixed-position? What will each layout look like? Why is it appropriate for the company’s production process? Could any of these plants switch to a cellular layout? What would this type of layout look like? What would be its advantages?

Managing the Production Process in a Manufacturing Company

Learning Objective

1. Identify the activities undertaken by the operations manager in overseeing the production process in a manufacturing company.

Once the production process is in place, the attention of the operations manager shifts to the daily activities of materials management, which encompass the following activities: purchasing, inventory control, and work scheduling.

Purchasing and Supplier Selection

The process of acquiring the materials and services to be used in production is called purchasing (or *procurement*). For many products, the costs of materials make up about 50 percent of total manufacturing costs. Not surprisingly, then, materials acquisition gets a good deal of the operations manager’s time and attention.

As a rule, there’s no shortage of vendors willing to supply parts and other materials, but the trick is finding the *best* suppliers. In selecting a supplier, operations managers must consider such questions as the following:

- Can the vendor supply the needed quantity of materials at a reasonable price?
- Is the quality good?
- Is the vendor reliable (will materials be delivered on time)?
- Does the vendor have a favorable reputation?
- Is the company easy to work with?

Getting the answers to these questions and making the right choices—a process known as supplier selection—is a key responsibility of operations management.

E-Purchasing

Technology is changing the way businesses buy things. Through *e-purchasing* (or *e-procurement*), companies use the Internet to interact with suppliers. The process is similar to the one you’d use to find a consumer good—say, a forty-two-inch LCD high-definition TV—over the Internet. You might start by browsing the Web sites of TV manufacturers, such as Sony or Samsung, or electronics retailers, such as Best Buy. To gather comparative prices, you might go to a comparison-shopping Web site, such as Amazon.com, the world’s largest online retailer. You might even consider placing a bid on eBay, an online marketplace where sellers and buyers come together to do business through auctions. Once you’ve decided where to buy your TV, you’d complete your transaction online, even paying for it electronically.

If you were a purchasing manager using the Internet to buy parts and supplies, you’d follow basically the same process. You’d identify potential suppliers by going directly to private Web sites maintained by individual suppliers or to public Web sites that collect information on numerous suppliers. You could do your shopping through online catalogs, or you might participate in an online marketplace by indicating the type and quantity of materials you need and letting suppliers bid on prices. (Some of these e-marketplaces are quite large. Covisint, for example, which was started by automakers to coordinate online transactions in the auto industry, is used by more than two hundred and fifty thousand suppliers in the auto industry, as well as suppliers in the health care field.)[6] Finally, just as you paid for your TV electronically, you could use a system called electronic data interchange (EDI) to process your transactions and transmit all your purchasing documents.

The Internet provides an additional benefit to purchasing managers by helping them communicate with suppliers and potential suppliers. They can use the Internet to give suppliers specifications for parts and supplies, encourage them to bid on future materials needs, alert them to changes in requirements, and give them instructions on doing business with their employers. Using the Internet for business purchasing cuts the costs of purchased products and saves administrative costs related to transactions. And it's faster for procurement and fosters better communications.

Inventory Control

If a manufacturer runs out of the materials it needs for production, then production stops. In the past, many companies guarded against this possibility by keeping large inventories of materials on hand. It seemed like the thing to do at the time, but it often introduced a new problem—wasting money. Companies were paying for parts and other materials that they wouldn't use for weeks or even months, and in the meantime, they were running up substantial storage and insurance costs.

Most manufacturers have since learned that to remain competitive, they need to manage inventories more efficiently. This task requires that they strike a balance between two threats to productivity: losing production time because they've run out of materials, and wasting money because they're carrying too much inventory. The process of striking this balance is called inventory control, and companies now regularly rely on a variety of inventory-control methods.

Just-in-Time Production

One method is called just-in-time (JIT) production: the manufacturer arranges for materials to arrive at production facilities *just in time* to enter the manufacturing process. Parts and materials don't sit unused for long periods, and the costs of "holding" inventory are significantly cut. JIT, however, requires considerable communication and cooperation between the manufacturer and the supplier. The manufacturer has to know what it needs, and when. The supplier has to commit to supplying the right materials, of the right quality, at exactly the right time.

Material Requirements Planning

Another method, called material requirements planning (MRP), relies on a computerized program both to calculate the quantity of materials needed for production and to determine when they should be ordered or made. Let's say, for example, that you and several classmates are planning a fund-raising dinner for the local animal shelter. First, you estimate how many people will attend—say, fifty. Next, you plan the menu—lasagna, garlic bread, salad, and cookies. Then, you determine what ingredients you'll need to make the food. Next, you have to decide when you'll need your ingredients. You don't want to make everything on the afternoon of the dinner; some things—like the lasagna and cookies—can be made ahead of time. Nor do you want to buy all your ingredients at the same time; in particular, the salad ingredients would go bad if purchased too far in advance. Once you've made all these calculations and decisions, you work out a schedule for the production of your dinner that indicates the order and timing of every activity involved. With your schedule in hand, you can determine when to buy each ingredient. Finally, you do your shopping.

Figure 8.6 Lasagna

Making lasagna requires decision making and calculations to ensure a yummy final product. [7]

Though the production process at most manufacturing companies is a lot more complex than planning a dinner (even for fifty), an MRP system is designed to handle similar problems. The program generates a production schedule based on estimated output (your food-preparation timetable for fifty guests), prepares a list of needed materials (your shopping list), and orders the materials (goes shopping).

The basic MRP focuses on material planning, but there's a more sophisticated system—called manufacturing resource planning (MRP II)—that goes beyond material planning to help monitor resources in all areas of the company. Such a program can, for instance, coordinate the production schedule with HR managers' forecasts for needed labor.

Work Scheduling

As we've seen, manufacturers make profits by transforming inputs (materials and other resources) into outputs (finished goods). We know, too, that production activities, like all business activities, have to be *controlled*: they have to be monitored to ensure that actual performance satisfies planned performance. In production, the control process starts when operations managers decide not only *which* goods and *how many* will be produced, but *when*. This detailed information goes into a master production schedule (MPS). To draw up an MPS, managers need to know where materials are located and headed at every step in the production process. For this purpose, they determine the *routing* of all materials—that is, the work flow of each item based on the sequence of operations in which it will be used.

Key Takeaways

- Once the production process is under way, the attention of the operations manager shifts to the daily activities of **materials management**, which encompasses materials **purchasing**, **inventory control**, and work scheduling.
- Because material costs often make up about 50 percent of total manufacturing costs, vendor selection and material acquisition gets a good deal of the operations manager's time and attention.
- In recent years, the purchasing function has been simplified through technology advances, including e-purchasing and **electronic data interchange (EDI)**, which process transactions and transmit purchasing documents.
- Commonly used inventory control methods include **just-in-time (JIT) production**, by which materials arrive just in time to enter the manufacturing process, and **material requirements planning (MRP)**, which uses computer programming to determine material needs.
- To schedule jobs, managers create a **master production schedule (MPS)**.

Exercise

What is e-purchasing (or e-procurement)? How does it work? What advantages does it give a purchasing manager? How does it benefit a company? How does it change the relationship between purchasing managers and vendors?

Graphical Tools: PERT and Gantt Charts

Learning Objective

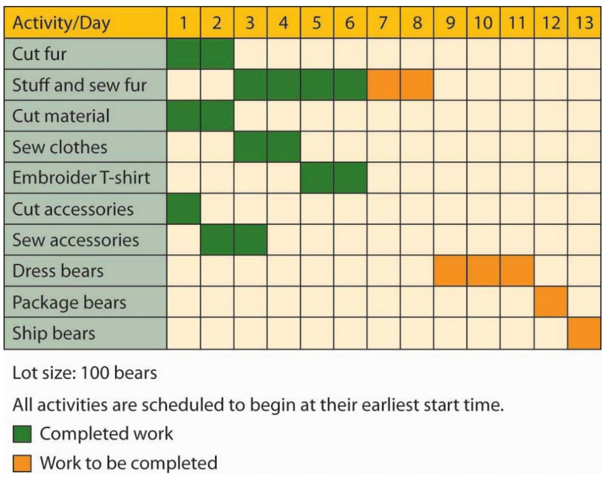
1. Explain how to create and use both PERT and Gantt charts.

Because they also need to control the timing of all operations, managers set up *schedules*: They select jobs to be performed during the production process, assign tasks to work groups, set timetables for the completion of tasks, and make sure that resources will be available when and where they're needed. There are a number of scheduling techniques. We'll focus on two of the most common—*Gantt* and PERT *charts*.

Gantt Charts

A Gantt chart, named after the designer, Henry Gantt, is an easy-to-use graphical tool that helps operations managers determine the status of projects. Let's say that you're in charge of making the "hiking bear" that we ordered earlier from the Vermont Teddy Bear Company. Figure 8.7 "Gantt Chart for Vermont Teddy Bear" is a Gantt chart for the production of one hundred of these bears. As you can see, it shows that several activities must be completed before the bears are dressed: the fur has to be cut, stuffed, and sewn; and the clothes and accessories must be made. Our Gantt chart tells us that by day six, all accessories and clothing have been made. The stuffing and sewing, however (which must be finished before the bears are dressed), isn't scheduled for completion until the end of day eight. As operations manager, you'll have to pay close attention to the progress of the stuffing and sewing operations to ensure that finished products are ready for shipment by their scheduled date.

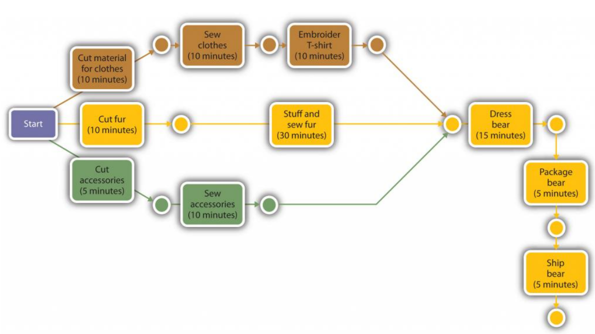
Figure 8.7 Gantt Chart for Vermont Teddy Bear



PERT Charts

Gantt charts are useful when the production process is fairly simple and the activities aren't interrelated. For more complex schedules, operations managers may use PERT charts. PERT (which stands for *Program Evaluation and Review Technique*) is designed to diagram the activities required to produce a good, specify the time required to perform each activity in the process, and organize activities in the most efficient sequence. It also identifies a *critical path*: the sequence of activities that will entail the greatest amount of time. Figure 8.8 "PERT Chart for Vermont Teddy Bear" is a PERT diagram showing the same process for producing one "hiker" bear at Vermont Teddy Bear.

Figure 8.8 PERT Chart for Vermont Teddy Bear



Our PERT chart shows how the activities involved in making a single bear are related. It indicates that the production process begins at the cutting station. Next, the fur that's been cut for this particular bear moves first to the stuffing and sewing stations and then to the dressing station. At the same time that its fur is moving through this sequence of steps, the bear's clothes are being cut and sewn and its T-shirt is being embroidered. Its backpack and tent accessories are also being made at the same time. Note that fur, clothes, and accessories all meet at the dressing station, where the bear is dressed and outfitted with its backpack. Finally, the finished bear is packaged and shipped to the customer's house.

What was the critical path in this process? The path that took the longest amount of time was the sequence that included cutting, stuffing, dressing, packaging, and shipping—a sequence of steps taking sixty-five minutes. If you wanted to produce a bear more quickly, you'd have to save time on this path. Even if you saved the time on any of the other paths—say, the sequence of steps involved in cutting, sewing, and embroidering the bear's clothes—you still wouldn't finish the entire job any sooner: the finished clothes would just have to wait for the fur to be stuffed and sewn and moved to the dressing station. In other words, we can gain efficiency only by improving our performance on one or more of the activities along the critical path.

Key Takeaways

- Gantt and PERT charts are two of the most common graphical tools used by operations managers to diagram the activities involved in producing goods.
- A Gantt chart is an easy-to-use graphical tool that helps operations managers determine the status of projects.
- PERT charts are used to diagram the activities required to produce a good, specify the time required to perform each activity in the process, and organize activities in the most efficient sequence.
- A PERT chart identifies a critical path—the sequence of activities that will entail the greatest amount of time.

Exercise

(AACSB) Analysis

Earning a college degree requires not only a lot of hard work but also, as you know, a lot of planning. You must, for example, complete a specified number of credits and take many required courses, particularly in your major. Deciding which courses to take and when to take them can be complicated when some of them have prerequisites. A PERT chart—which diagrams the activities required to complete a goal—might help you determine the order in which you should take courses for your major. Pick a major that interests you and find out what courses you'd need to complete it. Then prepare a PERT chart showing all the courses you'd plan to take each semester to complete your major. (For example, if you select the accounting major, include only accounting courses; don't include your other business courses or your elective courses.) Identify the critical path laid out in your chart. What happens if you fail to take one of your critical-path courses on time?

The Technology of Goods Production

Learning Objective

1. Explain how manufacturing companies use technology to produce and deliver goods in an efficient, cost-effective manner.

PowerSki founder and CEO Bob Montgomery spent sixteen years designing the Jetboard and bringing it to production. At one point, in his efforts to get the design just right, he'd constructed thirty different prototypes. Needless to say, this process took a very long time, but even so, Montgomery thought that he could handle the designing of the engine without the aid of a computer. Before long, however, he realized that it was impossible to keep track of all the changes.

Computer-Aided Design

That's when Montgomery turned to computer technology for help and began using a computer-aided design (CAD) software package to design not only the engine but also the board itself and many of its components. The CAD program enabled Montgomery and his team of engineers to test the product digitally and work out design problems before moving to the prototype stage.

The sophisticated CAD software allowed Montgomery and his team to put their design paper in a drawer and to start building both the board and the engine on a computer screen. By rotating the image on the screen, they could even view the design from every angle. Having used their CAD program to make more than four hundred design changes, they were ready to test the Jetboard in the water. During the tests, onboard sensors transmitted data to portable computers, allowing the team to make adjustments from the shore while the prototype was still in the water. Nowadays, PowerSki uses *collaboration software* to transmit design changes to the suppliers of the 340 components that make up the Jetboard.

Computer-Aided Manufacturing

For many companies, the next step is to link CAD to the manufacturing process. A computer-aided manufacturing (CAM) software system determines the steps needed to produce the component and instructs the machines that do the work. Because CAD and CAM programs can "talk" with each other, companies can build components that satisfy exactly the requirements set by the computer-generated model. CAD/CAM systems permit companies to design and manufacture goods faster, more efficiently, and at a lower cost, and they're also effective in helping firms monitor and improve quality. CAD/CAM technology is used in many industries, including the auto industry, electronics, and clothing.

Computer-Integrated Manufacturing

By automating and integrating all aspects of a company's operations, computer-integrated manufacturing (CIM) systems have taken the integration of computer-aided design and manufacturing to a higher level—and are in fact revolutionizing the production process. CIM systems expand the capabilities of CAD/CAM. In addition to design and production applications, they handle such functions as order entry, inventory control, warehousing, and shipping. In the manufacturing plant, the CIM system controls the functions of industrial robots —computer-controlled machines used to perform repetitive tasks that are also hard or dangerous for human workers to perform.

Flexible Manufacturing Systems

Finally, a CIM system is a common element in flexible manufacturing systems (FMS), in which computer-controlled equipment can easily be adapted to produce a variety of goods. An FMS has immense advantages over traditional production lines in which machines are set up to produce only one type of good. When the firm needs to switch a production line to manufacture a new product, substantial time and money are often spent in modifying equipment. An FMS makes it possible to change equipment setups merely by reprogramming computer-controlled machines. Such flexibility is particularly valuable to companies that produce customized products.

Key Takeaways

- In addition to creating high-quality products, companies must produce and deliver goods and services in an efficient, cost-effective manner.
- Sophisticated software systems, including **computer-aided design (CAD)**, **computer-aided manufacturing (CAM)**, **computer-integrated manufacturing (CIM)**, and **flexible manufacturing systems (FMS)**, are becoming increasingly important in this area.
- Computer-aided design software (CAD) is used to create models representing the design of a product.
- Many companies link CAD systems to the manufacturing process through computer-integrated manufacturing (CIM) systems that not only determine the steps needed to produce components but also instruct machines to do the necessary work.
- A CAD/CAM system can be expanded by means of computer-integrated manufacturing (CIM), which integrates various operations (from design through production) with functional activities ranging from order taking to shipping.
- A CIM system is a common element in a flexible manufacturing system (FMS), in which computer-controlled equipment can easily be adapted to produce a variety of goods.

Exercise

(AACSB) Analysis

The design and production of both goods and services can be facilitated by various high-tech tools, including CAD, CAM, CIM, and FMS. What does CAD software do, and how does it improve a design process? What is CAM, and why is it beneficial to integrate CAD and CAM programs? How do CIM systems expand the capabilities of CAD/CAM? What is an FMS, and what are its advantages over traditional manufacturing systems?

Operations Management for Service Providers

Learning Objectives

1. List the characteristics that distinguish service operations from manufacturing operations.
2. Describe the decisions made in planning the product delivery process in a service company.
3. Identify the activities undertaken to manage operations in a service organization.

As the U.S. economy has changed from a goods producer to a service provider, the predominance of the manufacturing sector has declined substantially over the last sixty years. Today, only about 9 percent of U.S. workers are employed in manufacturing, in contrast to 30 percent in 1950.[8][9] Most of us now hold jobs in the service sector, which accounts for 77 percent of U.S. gross domestic product.[10][11] Wal-Mart is now America's largest employer, followed by IBM, United Parcel Service (UPS), McDonald's, and Target. Not until we drop down to the seventh-largest employer—Hewlett Packard—do we find a company with even a manufacturing component.[12]

Figure 8.9 Walmart Sign

Wal-Mart employs more than a million people in the United States. [13]

Though the primary function of both manufacturers and service providers is to satisfy customer needs, there are several important differences between the two types of operations. Let's focus on three of them:

- *Intangibility*. Manufacturers produce tangible products—things that can be touched or handled, such as automobiles and appliances. Service companies provide intangible products, such as banking, entertainment, or education.
- *Customization*. Manufactured goods are generally standardized; one twelve-ounce bottle of Pepsi is the same as any other twelve-ounce bottle of Pepsi. Services, by contrast, are often customized to satisfy the specific needs of a customer. When you go to the barber or the hairdresser, you ask for a haircut that looks good on you because of the shape of your face and the texture of your hair. When you go to the dentist, you ask him or her to fill or pull the tooth that's bothering you.
- *Customer contact*. You could spend your entire working life assembling cars in Detroit and never meet a customer who bought a car that you helped to make. But if you were a waitress, you'd interact with customers every day. In fact, their satisfaction with your product would be determined in part by the service that you provided. Unlike manufactured goods, many services are bought and consumed at the same time.

Figure 8.10 Burger King

Here is just one of the over twelve thousand Burger King restaurants across the globe. [14]

Not surprisingly, operational efficiency is just as important in service industries as it is in manufacturing. To get a better idea of the role of operations management in the service sector, we'll look closely at Burger King (BK), home of the Whopper, and the world's second-largest restaurant chain.[15] BK has grown substantially since selling the first Whopper (for $0.37) almost half a century ago. The instant success of the fire-grilled burger encouraged the Miami founders of the company to expand by selling franchises. Today, there are 12,200 BK company- and independently-owned franchised restaurants in seventy-three countries (seven thousand of which are in the United States), and they employ almost forty thousand people.[16] More than eleven million customers visit BK each day.[17]

Operations Planning

When starting or expanding operations, businesses in the service sector must make a number of decisions quite similar to those made by manufacturers:

- What services (and perhaps what goods) should they offer?
- How will they provide these services?
- Where will they locate their business, and what will their facilities look like?
- How will they forecast demand for their services?

Let's see how service firms like BK answer questions such as these.[18]

Operations Processes

Service organizations succeed by providing services that satisfy customers' needs. Companies that provide transportation, such as airlines, have to get customers to their destinations as quickly and safely as possible. Companies that deliver packages, such as FedEx, must pick up, sort, and deliver packages in a timely manner. Colleges must provide quality educations. Companies that provide both services and goods, such as Domino's Pizza, have a dual challenge: they must produce a quality good and deliver it satisfactorily.

Service providers that produce goods can, like manufacturers, adopt either a *make-to-order* or a *make-to-stock* approach to manufacturing them. BK, which encourages patrons to customize burgers and other menu items, uses a make-to-order approach. BK can customize products because it builds sandwiches one at a time rather than batch-process them. Meat patties, for example, go from the grill to a steamer for holding until an order comes in. Then the patty is pulled from the steamer and requested condiments are added. Finally, the completed sandwich chutes to a counter worker, who gives it to the customer. In contrast, many of BK's competitors, including McDonald's, rely on a make-to-stock approach in which a number of sandwiches are made at the same time with the same condiments. If a customer wants, say, a hamburger without onions, he or she has to wait for a new batch of patties to be grilled. The procedure could take up to five minutes, whereas BK can process a special order in thirty seconds.

Like manufacturers, service providers must continuously look for ways to improve operational efficiency. Throughout its sixty-year history, BK has introduced a number of innovations that have helped make the company (as well as the fast-food industry itself) more efficient. BK, for example, was the first to offer drive-through service (which now accounts for 70 percent of its sales.[19]

It was also a BK vice president, David Sell, who came up with the idea of moving the drink station from behind the counter so that customers could take over the time-consuming task of filling cups with ice and beverages. BK was able to cut back one employee per day at every one of its more than eleven thousand restaurants. Material costs also went down because customers usually fill cups with more ice, which is cheaper than a beverage. Moreover, there were savings on supply costs because most customers don't bother with lids, and many don't use straws. On top of everything else, most customers liked the system (for one thing, it allowed them to customize their own drinks by mixing beverages), and as a result, customer satisfaction went up, as well. Overall, the new process was a major success and quickly became the industry standard.

Facilities

When starting or expanding a service business, owners and managers must invest a lot of time in selecting a location, determining its size and layout, and forecasting demand. A poor location or a badly designed facility can cost customers, and inaccurate estimates of demand for products can result in poor service, excessive costs, or both.

Site Selection

People in the real estate industry often say that the three most important factors to consider when you're buying a home are location, location, location. The same principle applies when you're trying to locate a service business. To be successful in a service industry, you need to be accessible to your customers. Some service businesses, such as cable-TV providers, package-delivery services, and e-retailers, go to their customers. Many others, however—hotels, restaurants, stores, hospitals, and airports—

have to attract customers to their facilities. These businesses must locate where there's a high volume of available customers. Let's see how BK decides where to place a restaurant.

"Through the light and to the right." This is a favorite catchphrase among BK planners who are looking for a promising spot for a new restaurant (at least in the United States). In picking a location, BK planners perform a detailed analysis of demographics and traffic patterns, yet the most important factor is usually *traffic count*—the number of cars or people that pass by a specific location in the course of a day. In the United States, where we travel almost everywhere by car, BK looks for busy intersections, interstate interchanges with easy off and on ramps, or such "primary destinations" as shopping malls, tourist attractions, downtown business areas, or movie theaters. In Europe, where public transportation is much more common, planners focus on subway, train, bus, and trolley stops.

Once planners find a site with an acceptable traffic count, they apply other criteria. It must, for example, be easy for vehicles to enter and exit the site, which must also provide enough parking to handle projected dine-in business. Local zoning must permit standard signage, especially along interstate highways. Finally, expected business must be high enough to justify the cost of the land and building.

Size and Layout

Because manufacturers do business out of plants rarely visited by customers, they base the size and layout of their facilities solely on production needs. In the service sector, however, most businesses must design their facilities with the customer in mind: they must accommodate the needs of their customers while keeping costs as low as possible. Performing this twofold task isn't easy. Let's see how BK has met the challenge.

For its first three decades, almost all BK restaurants were pretty much the same. They all sat on one acre of land (located "through the light and to the right"), had about four thousand square feet of space, and held seating for seventy customers. All kitchens were roughly the same size. As long as land was cheap and sites were readily available, this system worked well enough. By the early 1990s, however, most of the prime sites had been taken, if not by BK itself, then by one of its fast-food competitors or other businesses needing a choice spot, including gas stations and convenience stores. With everyone bidding on the same sites, the cost of a prime acre of land had increased from $100,000 to over $1 million in a few short years.

To continue growing, BK needed to change the way it found and developed its locations. Planners decided that they had to find ways to reduce the size of a typical BK restaurant. For one thing, they could reduce the number of seats, because the business at a typical outlet had shifted over time from 90 percent inside dining and 10 percent drive-through to a 50-50 split. BK customers tended to be in a hurry, and more customers preferred the convenience of drive-through "dining."

David Sell (the same executive who had recommended letting customers fill their own drink cups) proposed to save space by wrapping Whoppers in paper instead of serving them in the cardboard boxes that took up too much space in the back room of every restaurant. So BK switched to a single paper wrapper with the label "Whopper" on one side and "Cheese Whopper" on the other. To show which product was inside, employees just folded the wrapper in the right direction. Ultimately, BK replaced pallets piled high with boxes with a few boxes full of wrappers.

Ideas like these helped BK trim the size of a restaurant from four thousand square feet to as little as one thousand. In turn, smaller facilities enabled the company to enter markets that were once cost prohibitive. Now BK could locate profitably in airports, food courts, strip malls, center-city areas, and even schools. The company even designed 10-foot-by-10-foot kiosks that could be transported to special events, stadiums, and concerts.

Capacity Planning

Estimating capacity needs for a service business isn't the same thing as estimating those of a manufacturer. A manufacturer can predict overall demand, produce the product, store it in inventory, and ship it to a customer when it's ordered. Service providers, however, can't store their products for later use: hairdressers can't "inventory" haircuts, hospitals can't "inventory" operations, and amusement parks can't "inventory" roller-coaster rides. Service firms have to build sufficient capacity to satisfy customers' needs on an "as-demanded" basis. Like manufacturers, service providers must consider many variables when estimating demand and capacity:

- How many customers will I have?
- When will they want my services (which days of the week, which times of the day)?
- How long will it take to serve each customer?

- How will external factors, such as weather or holidays, affect the demand for my services?

Figure 8.11 Walmart Store

Retailers have to be prepared to accommodate much heavier traffic than normal during the holiday season. [20]

Forecasting demand is easier for companies like BK, which has a long history of planning facilities, than for brand-new service businesses. BK can predict sales for a new restaurant by combining its knowledge of customer-service patterns at existing restaurants with information collected about each new location, including the number of cars or people passing the proposed site and the effect of nearby competition.

Managing Operations

Overseeing a service organization puts special demands on managers, especially those running firms, such as hotels, retail stores, and restaurants, that have a high degree of contact with customers. Service firms provide customers with personal attention and must satisfy their needs in a timely manner. This task is complicated by the fact that demand can vary greatly over the course of any given day. Managers, therefore, must pay particular attention to employee work schedules and (in some cases) inventory management. Let's see how BK deals with these problems.

Scheduling

In manufacturing, managers focus on scheduling the *activities* needed to transform raw materials into finished goods. In service organizations, they focus on scheduling *workers* so that they're available to handle fluctuating customer demand. Each week, therefore, every BK store manager schedules employees to cover not only the peak periods of breakfast, lunch, and dinner, but also the slower periods in between. If he or she staffs too many people, labor cost per sales dollar will be too high. If there aren't enough employees, customers have to wait in lines. Some get discouraged, and even leave, and many may never come back.

Scheduling is made easier by information provided by a point-of-sale device built into every BK cash register. The register keeps track of every sandwich, beverage, and side order sold by the hour, every hour of the day, every day of the week. Thus, to determine how many people will be needed for next Thursday's lunch hour, the manager reviews last Thursday's data, using sales revenue and a specific BK formula to determine the appropriate staffing level. Each manager can adjust this forecast to account for other factors, such as current marketing promotions or a local sporting event that will increase customer traffic.

Inventory Control

Businesses that provide both goods and services, such as retail stores and auto-repair shops, have the same inventory-control problems as manufacturers: keeping levels too high costs money, while running out of inventory costs sales. Technology, such as the point-of-sale registers used at BK, makes the job easier. BK's system tracks everything sold during a given time and lets each store manager know how much of everything should be kept in inventory. It also makes it possible to count the number of burgers and buns, bags and racks of fries, and boxes of beverage mixes at the beginning or end of each shift. Because there are fixed numbers of supplies—say, beef patties or bags of fries—in each box, employees simply count boxes and multiply. In just a few minutes, the manager knows whether the inventory is correct (and should be able to see if any theft has occurred on the shift).

Key Takeaways

- Though the primary function of both manufacturers and service providers is to satisfy customer needs, there are several important differences between the two types of operations.
- While manufacturers produce tangible, generally standardized products, service firms provide intangible products that are often customized to satisfy specific needs. Unlike manufactured goods, many services are bought and consumed at the same time.
- Operational efficiency is just as important in service industries as it is in manufacturing.
- Operations managers in the service sector make many decisions that are similar to those made by manufacturers: they decide which services to offer, how to provide these services, where to locate their businesses, what their facilities will look like, and what the demand will be for their services.
- Service providers that produce goods can, like manufacturers, adopt either a make-to-order approach (in which products are made to customer satisfaction) or make-to-stock approach (in which products are made for inventory) to manufacturing them.
- Estimating **capacity** needs for a service business is more difficult than for a manufacturer. Service providers can't store their services for later use: services must be delivered on an as-needed basis.
- Overseeing a service organization puts special demands on managers, especially services requiring a high degree of contact with customers.
- Given the importance of personalized service, scheduling workers is more complex in the service industry than in manufacturing. In manufacturing, operations managers focus on scheduling the *activities* needed to produce goods; in service organizations, they focus on scheduling *workers* to ensure that enough people are available to handle fluctuating customer demand.

Exercise

(AACSB) Analysis

Starting a new business can be an exciting adventure. Here's your chance to start a "pretend" business. Select a service business that you'd like to open, and answer these questions. Provide an explanation for each answer:

1. What services (and perhaps goods) will I provide?
2. How will I provide these services?
3. Where will I locate my business?
4. What will the facilities look like (how large will the facilities be and what will the layout look like)?
5. How many customers will I serve each day?
6. When will my customers want my services (which days of the week, which times of the day)?
7. How long will it take to serve each customer?
8. Why will my business succeed? Why will my customers return?

Producing for Quality

Learning Objective

1. Explain how manufacturing and service companies alike use total quality management and outsourcing to provide value to customers.

What do you do if you get it home and your brand-new DVD player doesn't work? What if you were late for class because it took you twenty minutes to get a burger and order of fries at the drive-through window of a fast-food restaurant? Like most people, you'd probably be more or less disgruntled. As a customer, you're constantly assured that when products make it to market, they're of the highest possible quality, and you tend to avoid brands that have failed to live up to your expectations or to producers' claims. You're told that workers in such businesses as restaurants are there to serve you, and you probably don't go back to establishments where you've received poor-quality service.

But what is *quality*? According to the American Society for Quality, quality refers to "the characteristics of a product or service that bear on its ability to satisfy stated or implied needs".[21] When you buy a DVD player, you expect it to play DVDs. When it doesn't, you question its quality. When you go to a drive-through window, you expect to be served in a reasonable amount of time. If you're forced to wait, you conclude that you're the victim of poor-quality service.

Quality Management

To compete today, companies must deliver quality goods and services that satisfy customers' needs. This is the objective of quality management. Total quality management (TQM), or quality assurance, includes all the steps that a company takes to ensure that its goods or services are of sufficiently high quality to meet customers' needs. Generally speaking, a company adheres to TQM principles by focusing on three tasks:

1. Customer satisfaction
2. Employee involvement
3. Continuous improvement

Let's take a closer look at these three principles.

Customer Satisfaction

Companies that are committed to TQM understand that the purpose of a business is to generate a profit by satisfying customer needs. Thus, they let their customers define *quality* by identifying and offering those product features that satisfy customer needs. They encourage customers to tell them how to make the right products, both goods and services, that work the right way.

Armed with this knowledge, they take steps to make sure that providing quality is a factor in every facet of their operations—from design, to product planning and control, to sales and service. To get feedback on how well they're doing, many companies routinely use surveys and other methods to monitor customer satisfaction. By tracking the results of feedback over time, they can see where they need to improve.

Employee Involvement

Successful TQM requires that everyone in the organization, not simply upper-level management, commits to satisfying the customer. When customers wait too long at a drive-through window, it's the responsibility of a number of employees, not the manager alone. A defective DVD isn't solely the responsibility of the manufacturer's quality control department; it's the responsibility of every employee involved in its design, production, and even shipping. To get everyone involved in the drive for quality assurance, managers must communicate the importance of quality to subordinates and motivate them to focus on customer satisfaction. Employees have to be properly trained not only to do their jobs but also to detect and correct quality problems.

In many companies, employees who perform similar jobs work as teams, sometimes called quality circles, to identify quality, efficiency, and other work-related problems, to propose solutions, and to work with management in implementing their recommendations.

Continuous Improvement

An integral part of TQM is continuous improvement: the commitment to making constant improvements in the design, production, and delivery of goods and services. Improvements can almost always be made to increase efficiency, reduce costs, and improve customer service and satisfaction. Everyone in the organization is constantly on the lookout for ways to do things better.

Statistical Process Control

Companies can use a variety of tools to identify areas for improvement. A common approach in manufacturing is called statistical process control. This technique monitors production quality by testing a sample of output to see whether goods in process are being made according to predetermined specifications.

Assume for a moment that you work for Kellogg's, the maker of Raisin Bran cereal. You know that it's the company's goal to pack two scoops of raisins in every box of cereal. How can you test to determine whether this goal is being met? You could use a statistical process control method called a *sampling distribution*. On a periodic basis, you would take a box of cereal off the production line and measure the amount of raisins in the box. Then you'd record that amount on a *control chart* designed to compare actual quantities of raisins with the desired quantity (two scoops). If your chart shows that several samples in a row are low on raisins, you'd shut down the production line and take corrective action.

Benchmarking

Sometimes it also helps to look outside the organization for ideas on how to improve operations and to learn how your company compares with others. Companies routinely use benchmarking to compare their performance on a number of dimensions with the performance of other companies that excel in particular areas. Frequent benchmark targets include L.L. Bean, for its superior performance in filling orders; 3M, for its record of introducing innovative products; Motorola, for its success in maintaining consistent quality standards; and Mary Kay Cosmetics, for its skills in inventory control.[22]

International Quality Standards

As a consumer, wouldn't you like to know which companies ensure that their products meet quality specifications? Some of us would like to know which companies take steps to protect the environment. Some consumers want to know which companies continuously improve their performance in both of these areas—that is, practice both quality management and environmental management. By the same token, if you were a company doing a good job in these areas, wouldn't you want potential customers to know? It might be worth your while to find out whether your suppliers were also being conscientious in these areas—and even your suppliers' suppliers.

ISO 9000 and ISO 14000

Through the International Organization for Standardization (ISO), a nongovernmental agency based in Switzerland, it's possible to find this kind of information. The resources of this organization will enable you to identify those organizations that have people and processes in place for delivering products that satisfy customers' quality requirements. You can also find out which organizations work to reduce the negative impact of their activities on the environment. Working with representatives from various countries, the organization has established the ISO 9000 family of international standards for quality management and the <ISO 14000 family of international standards for environmental management.

ISO standards focus on the way a company does its work, not on its output (though there's certainly a strong correlation between the way in which a business functions and the quality of its products). Compliance with ISO standards is voluntary, and the certification process is time-consuming and complex. Even so, hundreds of thousands of organizations around the world are ISO 9000 and ISO 14000 certified.[23] ISO certification has become an internationally recognized symbol of quality management and is almost essential to be competitive in the global marketplace.

Outsourcing

PowerSki's Web site states that "PowerSki International has been founded to bring a new watercraft, the PowerSki Jetboard, and the engine technology behind it, to market".[24] That goal was reached in May 2003, when the firm emerged from a lengthy design period. Having already garnered praise for its innovative product, PowerSki was ready to begin mass-producing Jetboards. At this juncture, the management team made a strategic decision that's not uncommon in manufacturing today. Rather than producing Jetboards in-house, they opted for outsourcing: having outside vendors manufacture the engines, fiberglass hulls, and associated parts. Assembly of the final product took place in a manufacturing facility owned by All American Power Sports in Moses Lake, Washington. This decision doesn't mean that the company relinquished control over quality; in fact, every component that goes into the PowerSki Jetboard is manufactured to exact specifications set by PowerSki. One advantage of outsourcing its production function is that the management team can thereby devote its attention to refining its product design and designing future products.

Outsourcing in the Manufacturing Sector

Outsourcing the production of its engines, hulls, and other components enables PowerSki to reduce the cost of producing each Jetboard through manufacturing efficiencies and lower labor costs. All components that go into the Jetboard are made to PowerSki's specifications and are inspected upon arrival to ensure that they meet the company's high-quality standards.

Understandably, outsourcing is becoming an increasingly popular option among manufacturers. For one thing, few companies have either the expertise or the inclination to produce everything needed to make a product. Today, more firms, like PowerSki, want to specialize in the processes that they perform best—and outsource the rest. Like PowerSki, they also want to take advantage of outsourcing by linking up with suppliers located in regions with lower labor costs.

Outsourcing in the Service Sector

Outsourcing is by no means limited to the manufacturing sector. Service companies also outsource many of their noncore functions. Your school, for instance, probably outsources such functions as food services, maintenance, bookstore sales, printing, groundskeeping, security, information-technology (IT) support, and even residence operations.

Key Takeaways

- Today, companies that compete in both the manufacturing and service sectors must deliver **quality** goods and services that satisfy customers' needs. Many companies achieve this goal by adhering to principles of **total quality management (TQM)**.
- Companies using a TQM approach focus on customer satisfaction, engage all members of the organization in quality efforts, and strive for **continuous improvement** in the design, production, and delivery of goods and services. They also **benchmark** other companies to find ways to improve their own performance.
- To identify areas for improvement, companies can use a technique called **statistical process control (SPC)**, which monitors quality by testing to see whether a sample of output is being made to predetermined specifications.
- Another cost-saving approach is **outsourcing**—having outside vendors manufacture components or even entire products or provide services, such as information-technology support or service center operations.
- Outsourcing is an appealing option for companies without the expertise in producing everything needed to make a product or those that want to take advantage of low labor costs in developing countries.

Exercises

1. **(AACSB) Analysis**
2. **(AACSB) Analysis**

Cases and Problems

Learning on the Web (AACSB)

How to Build a BMW

How'd you like to own a Series 3 BMW? How about a convertible priced at $48,000 for those warm summer days? Or maybe a less expensive coupe for $39,000? Or, if you need more space for hauling camping equipment, dogs, or kids, maybe you would prefer a wagon at $37,000? We can't help you finance a BMW, but we can show you how they're made. Go to http://www.bmw-plant-munich.com/ to link to the BMW Web site for a virtual tour of the company's Munich, Germany, plant.

First, click on "Location" and then on "The Plant in Figures." Before going any further, answer the following questions:

1. How many associates (employees) work in the plant?
2. How many apprentices (trainees) work there? Why does the plant have trainees?
3. How many cars are made in the plant each day? How many engines?

Next, click on "Production" to open a drop-down list that looks like this:

Fascination Production
Press Shop
Body Shop
Paint Shop
Engine Assembly
Assembly

Click on "Fascination Production," and watch a video that zips you through the production steps needed to make a BMW. Continue your tour by clicking on each progressive step taken to build a quality car: press shop, body shop, paint shop, engine assembly and final assembly. After reading about and watching the brief video describing the work done in a particular area of the plant, pause and answer the following questions (you will answer this set of questions five times—once for each of these areas of the factory: press shop, body shop, paint shop, engine assembly, and final assembly):

1. What production steps occurred in this area of the plant?
2. What technology does BMW use in the production process?
3. Approximately what percentage of the work was done by people?
4. What procedures were followed to ensure the production of high-quality vehicles?

Career Opportunities

Wanted: Problem Solvers and Creative Thinkers

If you had a time machine plus a craving for a great hamburger, you could return to the early 1950s and swing by Dick and Mac McDonald's burger stand in San Bernardino, California. Take a break from eating and watch the people in the kitchen. You'll see an early application of operations management in the burger industry. Dick and Mac, in an effort to sell more burgers in less time, redesigned their kitchen to use assembly-line procedures. As the number of happy customers grew, word spread about their speedy system, and their business thrived. Curiously, it wasn't Dick and Mac who made McDonald's what it is today, but rather a traveling milkshake-mixer salesman named Ray Kroc. He visited the hamburger stand to learn how they could sell twenty thousand shakes a year. When he saw their operations and the lines of people walking away with bags filled with burgers, fries, and shakes, he knew he had a winner. In cooperation with the McDonald brothers, he started selling franchises around the country, and the rest is history.

So, what does this story have to do with a career in operations management? If you're a problem solver like Dick and Mac (who discovered a way to make burgers faster and cheaper) or a creative thinker like Ray Kroc (who recognized the value in an assembly-line burger production system), then a career in operations management might be for you. The field is broad and offers a variety of opportunities. To get a flavor of the choices available, go to http://www.wetfeet.com/Careers-and-Industries/Careers/Operations.aspx to link to the WetFeet Web site and review the dozen or so operations management positions listed. Provide a brief description of each position. Indicate how interesting you find each position by rating it using a five-point scale (with 1 being uninteresting and 5 being very interesting). Based on your assessment, pick the position you find most interesting and the one you find least interesting. Explain why you made your selections.

Ethics Angle (AACSB)

In many ways, Eastman Kodak (a multinational manufacturer and distributor of photographic equipment and supplies) is a model corporate citizen. *Fortune* magazine has ranked it as one of the country's most admired companies, applauding it in particular for its treatment of minorities and women. Its community-affairs programs and contributions have also received praise, but Eastman Kodak remains weak in one important aspect of corporate responsibility: it has consistently received low scores on environmental practices. For example, the watchdog group Scorecard rated Eastman Kodak's Rochester, New York, facility as the third-worst emitter of airborne carcinogens in the United States. Other reports have criticized the company for dumping cancer-causing chemicals into the nation's waters.

Go to http://www.kodak.com/US/en/corp/HSE/homepage.jhtml?pd-path=2879/7196 to link to the Eastman Kodak Web site and read its own assessment of its environmental practices. Then answer the following questions:

- Based on the information provided on its Web site, how favorable do you feel about Eastman Kodak's environmental practices?
- In what ways is the company responding to criticisms of its environmental practices and improving them?
- Do the statements on the Web site mesh with the criticism that the company has received? If not, what accounts for the differences?

Team-Building Skills (AACSB)

Growing Accustomed to Your Fit

Instead of going to the store to try on several pairs of jeans that may or may not fit, wouldn't it be easier to go online and order a pair of perfect-fitting jeans? Lands' End has made this kind of shopping possible through mass-customization techniques and some sophisticated technology.

To gain some firsthand experience at shopping for mass-customized goods, have each member of your team go to Nike's iD site at http://nikeid.nike.com. Each team member should go through the process of customizing a different Nike product but stop right before placing an order. After everyone has gone through the process, get together and write a report in which the team explains exactly what's entailed by online mass customization and details the process at Nike. Be sure to say which things impressed you and which didn't. Explain why Nike developed this means of marketing products and, finally, offer some suggestions on how the process could be improved.

The Global View (AACSB)

What's the State of Homeland Job Security?

Over the past several decades, more and more U.S. manufacturers began outsourcing production to such low-wage countries as Mexico and China. The number of U.S. manufacturing jobs dwindled, and the United States became more of a service economy.

People who were directly affected were understandably unhappy about this turn of events, but most people in this country didn't feel threatened. At least, not until service jobs also started going to countries that, like India, have large populations of well-educated, English-speaking professionals. Today, more technology-oriented jobs, including those in programming and Internet communications, are being outsourced to countries with lower wage rates. And tech workers aren't alone: the jobs of accountants, analysts, bankers, medical technicians, paralegals, insurance adjusters, and even customer-service representatives have become candidates for overseas outsourcing.

Many U.S. workers are concerned about job security (though the likelihood of a particular individual's losing a job to an overseas worker is still fairly low). The issues are more complex than merely deciding where U.S. employers should be mailing paychecks, and politicians, economists, business executives, and the general public differ about the causes and consequences of foreign outsourcing. Some people think it's a threat to American quality of life, while others actually think that it's a good thing.

Spend some time researching trends in outsourcing. Formulate some opinions, and then answer the following questions:

1. About what percentage of U.S. jobs have left the country in the last five years? What percentage will probably leave in the next five years?
2. What kinds of jobs are being outsourced, and where are they going? What kinds of jobs can't be outsourced?
3. How does global outsourcing help U.S. businesses? How does it hinder them?
4. How has the trend in outsourcing manufacturing and service operations to foreign countries helped average Americans? How has it harmed them?
5. Does overseas outsourcing help or hurt the U.S. economy? In what ways?

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2.6: Chapter 9- Product Design and Development

To see the PowerSki Jetboard in action, visit the company's Web site at http://www.powerski.com. Watch the streaming videos that demonstrate what the Jetboard can do.

Have you ever wanted to go surfing but couldn't find a body of water with decent waves? You no longer have a problem: the PowerSki Jetboard makes its own waves. This innovative product combines the ease of waterskiing with the excitement of surfing. A high-tech surfboard with a forty-five-horsepower, forty-five-pound watercraft engine, the PowerSki Jetboard has the power of a small motorcycle. Experienced surfers use it to get to the top of rising ocean waves, but if you're just a weekend water-sports enthusiast, you can get your adrenaline going by skimming across the surface of a local lake at forty miles an hour. All you have to do is submerge the tail of the board, slide across on your belly, and stand up (with the help of a flexible pole). To innocent bystanders, you'll look like a very fast water-skier without a boat.

Where do product ideas like the PowerSki Jetboard come from? How do people create products that meet customer needs? How are *ideas* developed and turned into actual *products*? How do you forecast demand for a product? How do you protect your product ideas? These are some of the questions that we'll address in this chapter.

What Is a Product?

Learning Objectives

1. Define *product*.
2. Describe the four major categories of product developments: new-to-the-market, new-to-the-company, improvement of existing product, and extension of product line.

Basically, a product is something that can be marketed to customers because it provides them with a benefit and satisfies a need. It can be a physical *good*, such as the PowerSki Jetboard, or a *service*, such as a haircut or a taxi ride. The distinction between goods and services isn't always clear-cut. Say, for example, that a company hires a professional to provide an in-house executive training program on "netiquette" (e-mail etiquette). Off the top of our heads, most of us would say that the company is buying a service. What if the program is offered online? We'd probably still argue that the product is a service. But what if the company buys training materials that the trainer furnishes on DVD? Is the customer still buying a service? Probably not: we'd have to say that when it buys the DVD, the company is buying a tangible good.

In this case, the product that satisfies the customer's need has both a tangible component (the training materials on DVD) and an intangible component (the educational activities performed by the seller). Not surprisingly, many products have both tangible and intangible components. If, for example, you buy a Hewlett-Packard computer, you get not only the computer (a tangible good) but certain promises to answer any technical questions that you might have and certain guarantees to fix your computer if it breaks within a specified time period (intangible services).

Types of Product Developments

New product developments can be grouped into four major categories: new-to-the-company, improvement of existing product, extension of product line, and new-to-the-market.

Figure 9.1 Peeps Milk Chocolate

Holiday decorating kits have extended Just Born's product line beyond Peeps[1]

For examples of the first three types of new product developments, we'll take a look at Just Born. The company is known for its famous "Marshmallow Peeps," and consequently its management is very interested in marshmallows. It conducted research that revealed that families use marshmallows in lots of ways, including crafts and decorating. This led Just Born to develop an Easter decorating kit that used Peeps marshmallows. It was such a hit that the company followed by creating decorating kits for Halloween and the Christmas season. Because similar products are made by other companies, the decorating kits are not "new to the market" but are "new to the company." Now, let's look at another product development involving Just Born's also famous Mike & Ike's. The marketing people at Just Born discovered that teenagers prefer to buy candies that come in pouches (which fit into their pants pockets) rather than in small boxes. In response, the company reduced the piece size, added some new ingredients, and put the Mike & Ike's in pouches. This "improvement in an existing product" resulted in a 20 percent annual sales jump for Mike & Ike's. Our last look at Just Born demonstrates an approach used by the company to "extend its existing product line." Most of us like chocolate and most of us also like marshmallow, so how about putting them together? This is just what Just Born did—the company extended its Peeps product line to include "Peeps in a chocolate egg." Consumers loved the combination, and its success prompted the company to extend its product line again and launch a chocolate crispy version for Easter.

New-to-the-Market Products

The PowerSki Jetboard is a "new-to-the-market product." Before it was invented, no comparable product existed. Launching a new-to-the-market product is very risky, and only about 10 percent of products created fall into this category. On a positive note, introducing a new product to the market can be very profitable, because the product often enjoys a temporary monopolistic position.

Entreprenerial Start-Ups

Inventors of new-to-the-market products often form entrepreneurial start-ups to refine their product idea and bring it to market. This was the path taken by Bob Montgomery, inventor of the PowerSki Jetboard. As is typical of entrepreneurial start-ups, the company that Montgomery founded has these characteristics:[2]

- *It's characterized by innovative products and/or practices*. Before the PowerSki Jetboard was invented, no comparable product existed.
- *Its goals include profitability and growth*. Because the patented Jetboard enjoys a temporary monopolistic position, PowerSki potentially could be very profitable.
- *It focuses on new opportunities*. Bob Montgomery dreamed of creating the first motorized surfboard. This dream began when he and a few of his surfer friends (all around age twelve) missed a wave because it was too far down the beach for them to catch. He imagined that if he was on a motorized surfboard (instead of an ordinary one that you had to paddle), he would have been able to catch that wave. His dream became the mission of his company: "PowerSki International Corp. was founded to deliver the patented PowerSki Jetboard, the world's only motorized surfboard, and its engine technology to the world market. It's PowerSki's goal to bring the experience of surfing to everyone on lakes, rivers, seas, and the ocean. 'Now everybody has an ocean, and can ride an endless wave'".[3]

- *Its owners are willing to take risks*. *Anybody* who starts *any* business is taking a risk of some kind. The key to *entrepreneurial* risk is related to the idea of innovation: as Woody Allen once put it, “If you’re not failing every now and again, it’s a sign you’re not doing anything very innovative”. [4]

How to Take a Calculated Risk

As Montgomery learned, the introduction of an *innovative* product to the market is more unpredictable, and thus more risky, than the introduction of a market-tested product. Starting up a store to sell an improved version of an existing surfboard entails one level of risk; starting up a business to market the first motorized surfboard entails quite another. Even though the introduction of new-to-the-market products are more risky, some of this risk can be avoided. What if, for example, Montgomery had brought the Jetboard to market only to discover that many of the buyers in his target market—water-sports enthusiasts—couldn’t easily maneuver the Jetboard? We could then say that he took an unnecessarily risky step in bringing his product to market, but we could also say that he simply attempted to market his product without adequate information. Surely a little research would have alerted Montgomery to the probable consequences of his decision to go to market when he did and with his product in its current state of development.

A couple of final words, therefore, about introducing an entirely new product to the market. First, this type of product introduction is about carefully *calculated* risks, not *unnecessary* risks. Second, though little is certain in the entrepreneurial world, most decision making can be improved with input from one or both of two sources:

1. Information gathered from research
2. Knowledge gained from personal experience

Again, you can’t be *certain* about any results, but remember that *uncertainty* reflects merely the lack of complete knowledge or information; thus, the more knowledge and information that you can bring to bear on a situation, the less uncertain—and the less risky—the decision becomes.[5] In short, always do your homework, and if you’re new to entrepreneurship or to your market, make it a point to work with people who know from experience what they’re talking about.

Key Takeaways

- A **product** is something that can be marketed to customers because it provides them with a benefit and satisfies a need. Products can be goods or services or a combination of both.
- A “new-to-the-company product” is a good or a service that is new to the company but has been sold by a competitor in the past—for example, Peeps marshmallow Easter decorating kits.
- An “improvement in an existing product” is an enhancement of a product already on the market—for example, a change of ingredients and packaging for Mike & Ike’s.
- An “extension to an existing product line” is a new product developed as a variation of an already existing product—for example, Peeps chocolate eggs.
- A “new-to-the-market product” is a good or a service that has not been available to consumers or manufacturers in the past—for example, the PowerSki Jetboard.
- Four characteristics of the entrepreneurial start-up are:
    1. It’s characterized by innovative products and/or practices.
    2. Its goals include profitability and growth.
    3. It focuses on new opportunities.
    4. Its owners are willing to take risks.
- Entrepreneurship is about carefully *calculated* risks, not *unnecessary* risks. Most entrepreneurial decision making can be improved with input from one or both of two sources:
    1. Information gathered from research
    2. Knowledge gained from personal experience

Exercise

(AACSB) Analysis

Identify a good or a service for each of the following product development categories: new-to-the-market, new-to-the-company, improvement of existing product, and extension of product line. To come up with the products, you might visit a grocery store or a mall. Don’t use the Just Born examples presented in the chapter.

Where Do Product Ideas Come From?

Learning Objective

1. Explain where product ideas come from.

For some people, coming up with a great product idea is a gratifying adventure. For most, however, it's a daunting task. The key to coming up with a product idea is identifying something that customers want—or, perhaps more important, filling an unmet customer need. In coming up with a product idea, ask not "what do I want to sell?" but rather "what does the customer want to buy?"[6] With this piece of advice in mind, let's get back to the task of coming up with a product idea. Nobel Prize–winning chemist Linus Pauling suggested that "the best way to have a good idea is to have lots of ideas," and though this notion might seem a little whimsical at first, it actually makes a lot of sense, especially if you're trying to be innovative in the entrepreneurial sense. Every year, for example, companies launch about thirty thousand new food, beverage, and beauty products, and up to 90 percent fail within a year.[7][8] You might need ten good ideas just to have one that stands a chance.

Purple Cow Ideas

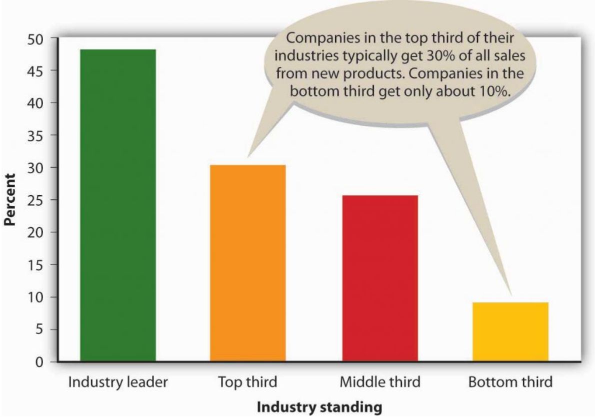
So where do these ideas come from? Product ideas can originate from almost anywhere. How many times have you looked at a product that just hit the market and said, "I could have thought of that"? Just about anybody can come up with a product *idea*; basically, you just need a little imagination. Success is more likely to result from a truly remarkable product—something that grabs the attention of consumers. Entrepreneur and marketing consultant Seth Godin refers to truly remarkable products as "purple cows".[9] He came up with the term while driving through the countryside one day. As he drove along, his interest was attracted by the hundreds of cows dotting the countryside. After a while, however, he started to ignore the cows because looking at them had become tedious. For one thing, they were all brown, and it occurred to him that a glimpse of a *purple* cow would be worth writing home about. People would tend to remember a purple cow; in fact, they might even want one.

Who thinks up "purple cow" ideas? Where do the truly remarkable business ideas come from? As we pointed out in an earlier chapter, entrepreneurs and small business owners are a rich source of new product ideas (according to the Small Business Administration, 55 percent of all new product innovations come from small businesses). Take Dean Kamen, inventor of the Segway Human Transporter, a battery-operated vehicle that responds to the rider's movements: lean forward and you can go straight ahead at 12.5 miles per hour; to stop, just tilt backward. This revolutionary product is only one of Kamen's many remarkable business ideas. He invented his first product—a wearable infusion pump for administering chemotherapy and other drugs—while he was still a college undergraduate.[10][11] Jacob Dunnack is also getting an early entrepreneurial start. At *age six*, Jacob became frustrated one day when he took his baseball bat to his grandmother's house but forgot to take some baseballs as well. His solution? A hollow baseball bat that holds baseballs. Dunnack's invention, now called the JD Batball, was quickly developed and sold in stores such as Toys "R" Us.[12][13]

Why do so many entrepreneurs and small businesspeople come up with so many purple cows? For one thing, entrepreneurs are often creative people; moreover, they're often willing to take risks. This is certainly true of Bob Montgomery, inventor of the PowerSki Jetboard (which undoubtedly qualifies as a purple cow). With more than twenty years' experience in the water-sports industry and considerable knowledge of the personal-watercraft market, Montgomery finally decided to follow his long-cherished dream of creating an entirely new and conceptually different product—one that would offer users ease of operations, high performance, speed, and quality. His creative efforts have earned him the prestigious *Popular Science* "Best of What's New" award.[14]

To remain competitive, medium and large organizations alike must also identify product development opportunities. Many companies actively solicit product ideas from people inside the organization, including marketing, sales, research, and manufacturing personnel, and some even establish internal "entrepreneurial" units. Others seek product ideas from outside the organization by talking to customers and paying attention to what the competition is doing. In addition to looking out for new product ideas, most companies constantly seek out ways to make incremental improvements in existing products by adding features that will broaden their consumer appeal. As you can see from Figure 9.2 "Sales from New Products", the market leaders in most industries are the firms that are most successful at developing new products.

Figure 9.2 Sales from New Products



A novel approach to generating new-to-the-world product ideas is hiring "creativity" consultants. One of the best is Doug Hall, who's been called "America's Number 1 Idea Guru." At a Cincinnati idea factory called Eureka!Ranch, Hall and other members of his consulting firm specialize in helping corporate executives get their creative juices flowing.[15] Hall's job is getting people to invent products that make a real difference to consumers, and his strategies are designed to help corporate clients become more innovative—to jump-start their brains. As Hall puts it, "You have to swing to hit home runs".[16] Eureka!Ranch's client list includes Disney, Kellogg, Johnson & Johnson, and Procter & Gamble, as well as a number of budding entrepreneurs. Hall boasts that the average home uses eighteen goods or services that the Ranch helped shape, and if he's right, you yourself have probably benefited from one of the company's idea-generating sessions.[17]

Key Takeaways

- The majority of product ideas come from entrepreneurs and small business owners, though medium and large organizations also must identify product-development opportunities in order to remain competitive.
- Firms seek product ideas from people inside the organization, including those in marketing, sales, research, and manufacturing, as well as from customers and others outside the organization.

Exercise

(AACSB) Analysis

The "Strange New Products" Web site brags that it displays the "weirdest, funniest, stupidest, and [most] ingenious new products entering the marketplace." This seems to be an accurate statement. Visit the site (http://www.strangenewproducts.com) and do the following:

1. Pick your favorite new product.
2. Describe the idea.
3. Explain how the product works.
4. Indicate whether you believe the product fills an unmet need. Explain why or why not.
5. Rate the product's likelihood of success on a scale from 1 (extremely unlikely) to 10 (very likely). Explain your rating.

Identifying Business Opportunities

Learning Objectives

1. Explain how an idea turns into a business opportunity.
2. Describe the four types of utility provided by a product: time, place, ownership, and form.

An idea turns into a business opportunity when it has commercial potential—when you can make money by selling the product. But needless to say, not all ideas generate business opportunities. Consider these products that made the list of the "Top 25 Biggest Product Flops of All Time":[18]

- *Bic underwear*. When you think of Bic you think of inexpensive pens and disposable razors and lighters. But disposable underwear? Women didn't find the idea of buying intimate attire from a pen manufacturer appealing, and the disposability factor was just plain weird.

Figure 9.3 Bic Lighter

There might be many creative ways for Bic to extend its product lines, aside from the disposable underwear idea. Can you think of a product idea that might be more successful for Bic? [19]

- *Harley Davidson perfume*. Even its loyal fans found the idea of Harley-Davidson perfume peculiar (and they weren't terribly fond of the Harley-Davidson aftershave, either). Perhaps they were afraid they would end up smelling like a motorcycle.
- *Bottled water for pets*. OK, so people love their pets and cater to them, but does it really make sense to serve Thirsty Cat! and Thirsty Dog! bottled water to your four-legged friends? Even though the water came in tantalizing flavors such as Crispy Beef and Tangy Fish, it never caught on. Do you wonder why?
- *Colgate kitchen entrees*. Colgate's entrance into food products wasn't well received. Maybe the company believed customers would buy into the idea of eating one of its prepared meals and then brushing their teeth with Colgate toothpaste. For most of us, the name Colgate doesn't get our taste buds tingling.

Utility

Remember: being in business is not about you—it's about the customer. Successful businesspeople don't ask themselves "What do I want to sell?" but rather "What does the customer want to buy?" *Customers buy products to fill unmet needs and because they expect to derive some value or utility from them*. People don't buy Alka-Seltzer because they like the taste or even because the price is right: they buy it because it makes their indigestion go away. They don't shop at Amazon.com because the Web site is entertaining: they shop there because they want their purchases delivered quickly. The realization that this kind of service would meet customer needs made Amazon.com a genuine business opportunity.

Products provide customers with four types of utility or benefit:

1. *Time utility*. The value to a consumer of having a good or a service available at a convenient time. A concessionaire selling bottled water at a summer concert is making liquid refreshment available when it's needed.
2. *Place utility*. The value to a consumer of having a product available in a convenient location. A street vendor selling hotdogs outside an office building is making fast food available where it's needed.
3. *Ownership utility*. Value created by transferring a product's ownership. A real estate agent helping a young couple buy a home is transferring ownership from someone who doesn't need it to someone who does.
4. *Form utility*. The value to consumers from changing the composition of a product. A company that makes apparel is turning raw material (fabric) into a form (clothing) that people need. A company that produces liquid detergent, rather than powdered detergent, is adding form utility for some consumers.

How can you decide whether an idea provides utility and has the potential to become a business opportunity? You should start by asking yourself the questions in Figure 9.4 "When Is an Idea a Business Opportunity?": if you can't come up with good answers to these questions, you probably don't have a highly promising product. On the other hand, if you conclude that you have a potential product for which people would pay money, you're ready to take the next step: analyze the market to see whether you should go forward with the development of the product.

Figure 9.4 When Is an Idea a Business Opportunity?

Key Takeaways

- An idea turns into a business opportunity when it has commercial potential—when you can make money by selling the product.
- Time utility provides value by having a product available at a convenient time.
- Place utility provides value by having a product available in a convenient location.
- Ownership utility provides value by transferring a product's ownership.
- Form utility provides value by changing the composition of a product.

Exercise

(AACSB) Analysis

Provide two examples of each of the four types of utility: time, place, ownership, and form. Don't use the examples given in the book.

Understand Your Industry

Learning Objective

1. Explain how to research an industry.

Before you invest a lot of time and money to develop a new product, you need to understand the industry in which it's going to be sold. As inventor of the PowerSki Jetboard, Bob Montgomery had the advantage of being quite familiar with the industry that he proposed to enter. With more than twenty years' experience in the water-sports and personal-watercraft industry, he felt at home in this business environment. He knew who his potential customers were, and he knew who his competitors were. He had experience in marketing similar products, and he was familiar with industry regulations.

Most people don't have the same head start as Montgomery. So, how does the average would-be businessperson learn about an industry? What should you want to know about it? Let's tackle the first question first.

Evaluating Your Industry

Before you can study an industry, you need to know what industry to study. An industry is a group of related businesses: they do similar things and they compete with each other. In the footwear industry, for example, firms make footwear, sell it, or both. Players in the industry include Nike and Adidas, both of which specialize in athletic footwear; but the industry is also sprinkled with companies like Candies (which sells young women's fashion footwear) and Florsheim (quality men's dress shoes).

Let's say that you want to know something about the footwear industry because your potential purple cow is a line of jogging shoes designed specifically for older people (those over sixty-five) who live in the Southeast. You'd certainly need a broad understanding of the footwear industry, but would general knowledge be enough? Wouldn't you feel more comfortable about pursuing your idea if you could focus on a smaller segment of the industry—namely, the segment that specializes in products similar to the one you plan to sell? Here's a method that will help you narrow your focus.[20]

Segmenting Your Market

Begin with the overall industry—in this case, the footwear industry. Within this industry, there are several groups of customers, each of which is a market. You're interested in the *consumer market*—retail customers. But this, too, is a fairly broad market; it includes everybody who buys shoes at retail. Your next step, then, is to subdivide this market into smaller market segments—groups of potential customers with common characteristics that influence their buying decisions. You can use a variety of standard characteristics, including *demographics* (age, sex, income), *geography* (region, climate, city size), and *psychographics* (lifestyle, activities, interests). The segment you're interested in consists of older people (a demographic variable) living in the Southeast (a geographic variable) who jog (a psychographic variable). Within this market segment, you might want to subdivide further and find a niche—an unmet need. Your niche might turn out to be providing high-quality jogging shoes to active adults living in retirement communities in Florida.

The goal of this process is to identify progressively narrower sectors of a given industry. You need to become familiar with the whole industry—not only with the footwear industry but also with the retail market for jogging shoes designed for older people. You also need to understand your niche market, which consists of older people who live active lives in Florida.

Now that we know something about the process of focusing in on an industry, let's look at another example. Suppose that your product idea is offering dedicated cruises for college students. You'd begin by looking at the recreational-activities *industry*. Your *market* would be people who travel for leisure, and within that market, you'd focus on the *market segment* consisting of people who take cruises. Your *niche* would be college students who want to take cruises.

Assessing Your Competition

Now that you've identified your industry and its various sectors, you're ready to consider such questions as the following:[21]

- Is the industry growing or contracting? Are sales revenues increasing or decreasing?
- Who are your major competitors? How does your product differ from those of your competitors?
- What opportunities exist in the industry? What threats?
- Has the industry undergone recent changes? Where is it headed?
- How important is technology to the industry? Has it brought about changes?
- Is the industry mature, or are new companies successfully entering it?
- Do companies in the industry make reasonable profits?

Where do you find answers to questions such as these? A good place to start is by studying your competitors: Who are their customers? What products do they sell? How do they price their products? How do they market them? How do they treat their customers? Do they seem to be operating successfully? Observe their operations and buy their goods and services. Search for published information on your competitors and the industry. For example, there's a great deal of information about companies on the Internet, particularly in company Web sites. The Internet is also a good source of industry information. Look for the site posted by the industry trade association. Find out whether it publishes a magazine or other materials. Talk with people in the industry—business owners, managers, suppliers; these people are usually experts. And talk with customers. What do they like or dislike about the products that are currently available? What benefits are they looking for? What benefits are they getting?

Key Takeaways

- Before developing a new product, you need to understand the industry in which it will be sold.
- An **industry** is a group of related businesses that do similar things and compete with each other.
- To research an industry, you begin by studying the overall industry and then progressively narrow your search by looking at smaller sectors of the industry, including **markets** (or groups of customers) and **market segments** (smaller groups of customers with common characteristics that influence their buying decisions).
- Within a market segment, you might want to subdivide further to isolate a **niche**, or unmet need.

Exercise

(AACSB) Analysis

To introduce a successful new service, you should understand the industry in which you'll be offering the service. Select a service business that you'd like to run and explain what information you'd collect on its industry. How would you find it?

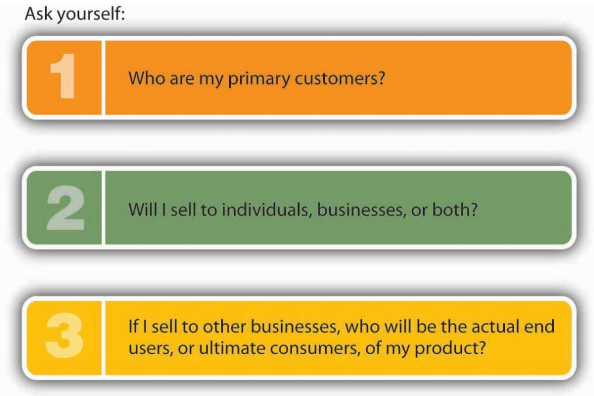
Forecasting Demand

Learning Objective

1. Forecast demand for a product.

It goes without saying, but we'll say it anyway: without enough customers, your business will go nowhere. So, before you delve into the complex, expensive world of developing and marketing a new product, ask yourself questions like those in Figure 9.5 "When to Develop and Market a New Product". When Bob Montgomery asked himself these questions, he concluded that he had two groups of customers for the PowerSki Jetboard: (1) the dealerships that would sell the product and (2) the water-sports enthusiasts who would buy and use it. His job, therefore, was to design a product that dealers would want to sell and enthusiasts would buy. When he was confident that he could satisfy these criteria, he moved forward with his plans to develop the PowerSki Jetboard.

Figure 9.5 When to Develop and Market a New Product



After you've identified a group of potential customers, your next step is finding out as much as you can about what they think of your product idea. Remember: because your ultimate goal is to roll out a product that satisfies customer needs, you need to know ahead of time what your potential customers want. Precisely what are their unmet needs? Ask them questions such as these:[22][23]

- What do you like about this product idea? What don't you like?
- What improvements would you make?
- What benefits would you get from it?
- Would you buy it? Why, or why not?
- What would it take for you to buy it?

Before making a substantial investment in the development of a product, you need to ask yourself yet another question: are there enough customers willing to buy my product at a price that will allow me to make a profit? Answering this question means performing one of the hardest tasks in business: forecasting demand for your proposed product. There are several possible approaches to this task that can be used alone or in combination.

People in Similar Businesses

Though some businesspeople are reluctant to share proprietary information, such as sales volume, others are willing to help out individuals starting new businesses or launching new products. Talking to people in your prospective industry (or one that's similar) can be especially helpful if your proposed product is a service. Say, for example, that you plan to open a pizza parlor with a soap opera theme: customers will be able to eat pizza while watching reruns of their favorite soap operas on personal TV/DVD sets. If you visited a few local restaurants and asked owners how many customers they served every day, you'd probably learn enough to estimate the number of pizzas that you'd serve during your first year. If the owners weren't cooperative, you could just hang out and make an informal count of the customers.

Potential Customers

You can also learn a lot by talking with potential customers. Ask them how often they buy products similar to the one you want to launch. Where do they buy them and in what quantity? What factors affect demand for them? If you were contemplating a frozen yogurt store in Michigan, it wouldn't hurt to ask customers coming out of a bakery whether they'd buy frozen yogurt in the winter.

Published Industry Data

To get some idea of the total market for products like the one you want to launch, you might begin by examining pertinent industry research. For example, to estimate demand for jogging shoes among consumers sixty-five and older, you could look at data published on the industry association's Web site, National Sporting Goods Association, http://www.nsga.org/i4a/pages/index.cfm?pageid=1[24][25] Here you'd find that forty million jogging/running shoes were sold in the United States in 2008 at an average price of $58 per pair. The Web site also reports that the number of athletes who are at least forty and who participate in road events increased by more than 50 percent over a ten year period.[26] To find more specific information—say, the number of joggers older than sixty-five—you could call or e-mail USA Track and Field. You might find this information in an eighty-seven-page statistical study of retail sporting-goods sales published by the National Sporting Goods Association (2011).[27] If you still don't get a useful answer, try contacting organizations that sell industry data. American Sports Data, for instance, provides demographic information on no fewer than twenty-eight fitness activities, including jogging.[28] You'd want to ask them for data on the number of joggers older than sixty-five living in Florida. There's a lot of valuable and available industry-related information that you can use to estimate demand for your product.

Now, let's say that your research turns up the fact that there are three million joggers older than sixty-five and that six hundred thousand of them live in Florida, which attracts 20 percent of all people who move when they retire.[29] How do you use this information to estimate the number of jogging shoes that you'll be able to sell during your first year of business? First, you have to estimate your market share: your portion of total sales in the older-than-sixty-five jogging shoe market in Florida. Being realistic (but having faith in an excellent product), you estimate that you'll capture 2 percent of the market during your first year. So you do the math: 600,000 pairs of jogging shoes sold in Florida × 0.02 (a 2 percent share of the market) = 12,000, the estimated first-year demand for your proposed product.

Granted, this is just an estimate. But at least it's an educated guess rather than a wild one. You'll still want to talk with people in the industry, as well as potential customers, to hear their views on the demand for your product. Only then would you use your sales estimate to make financial projections and decide whether your proposed business is financially feasible. We'll discuss this process in a later chapter.

Key Takeaways

- After you've identified a group of potential customers, your next step is finding out as much as you can about what they think of your product idea.
- Before making a substantial investment in the development of a product, you need to ask yourself: are there enough customers willing to buy my product at a price that will allow me to make a profit?
- Answering this question means performing one of the hardest tasks in business: forecasting demand for your proposed product.
- There are several possible approaches to this task that can be used alone or in combination.
- You can obtain helpful information about product demand by talking with people in similar businesses and potential customers.
- You can also examine published industry data to estimate the total market for products like yours and estimate your **market share**, or portion of the targeted market.

Exercise

(AACSB) Analysis

Your friends say you make the best pizzas they've ever eaten, and they're constantly encouraging you to set up a pizza business in your city. You have located a small storefront in a busy section of town. It doesn't have space for an eat-in restaurant, but it will allow customers to pick up their pizzas. You will also deliver pizzas. Before you sign a lease and start the business, you need to estimate the number of pizzas you will sell in your first year. At this point you plan to offer pizza in only one size.

Before arriving at an estimate, answer these questions:

1. What factors would you consider in estimating pizza sales?
2. What assumptions will you use in estimating sales (for example, the hours your pizza shop will be open)?
3. Where would you obtain needed information to calculate an estimate?

Then, estimate the number of pizzas you will sell in your first year of operations.

Breakeven Analysis

Learning Objective

1. Learn how to use breakeven analysis to estimate the number of sales units at which net income is zero.

Forecasting sales of shoes has started you thinking. Selling twelve thousand pair of shoes the first year you run the business sounds great, but you still need to find an answer to the all-important question: are there enough customers willing to buy my jogging shoes at a price that will allow me to make a profit? Is there some way to figure out the level of sales I would need to avoid *losing* money—to "break even"? Fortunately, an accountant friend of yours informs you that there is. Not surprisingly, it's called breakeven analysis, and here's how it works: to break even (have no profit or loss), *total sales revenue must exactly equal all your expenses (both variable and fixed)*. To determine the level of sales at which this will occur, you need to do the following:

1. Fixed costs = $210,000 salaries + $60,000 rent + $10,000 advertising + $8,000 insurance + 12,000 other fixed costs = $300,000
2. Variable cost per unit = $40 (cost of each pair of shoes) + $5 sales commission = $45
3. Contribution margin per unit = $80 selling price minus $45 variable cost per unit = $35
4. Breakeven in units = $300,000 fixed costs ÷ $35 contribution margin per unit = 8,571 units

Your calculation means that if you sell 8,571 pairs of shoes, you will end up with zero profit (or loss) and will exactly break even.

If your sales estimate is realistic (a big "if"), then you should be optimistic about starting the business. All your fixed costs will be covered once you sell 8,571 pairs of shoes. Any sales above that level will be pure profit. So, if you sell your expected level of twelve thousand pairs of shoes, you'll make a profit of $120,015 for the first year. Here's how we calculated that profit:

- 12,000 expected sales level – 8,571 breakeven sales level = 3,429 units × $35 contribution margin per unit = $120,015 first-year profit

As you can see, breakeven analysis is pretty handy. It allows you to determine the level of sales that you must reach to avoid losing money and the profit you'll make if you reach a higher sales goal. Such information will help you plan for your business.

Key Takeaways

- Breakeven analysis is a method of determining the level of sales at which the company will break even (have no profit or loss).
- The following information is used in calculating the breakeven point: fixed costs, variable costs, and contribution margin per unit.
- Fixed costs are costs that don't change when the amount of goods sold changes. For example, rent is a fixed cost.
- Variable costs are costs that vary, in total, as the quantity of goods sold changes but stay constant on a per-unit basis. For example, sales commissions paid based on unit sales are a variable cost.
- Contribution margin per unit is the excess revenue per unit over the variable cost per unit.
- The breakeven point in units is calculated with this formula: fixed costs divided by contribution margin per unit (selling price per unit less variable cost per unit).

Exercise

(AACSB) Analysis

For the past ten years, you've worked at a PETCO Salon as a dog groomer. You're thinking of starting your own dog grooming business. You found a place you could rent that's right next to a popular shopping center, and two of your friends (who are also dog groomers) have agreed to work for you. The problem is that you need to borrow money to start the business and your banker has asked for a breakeven analysis. You have prepared the following cost estimates for your first year of operations:

Fixed Costs	
Salaries	$105,000
Rent and utilities	$36,000
Advertising	$2,000
Equipment	$3,000

Variable Cost per Dog	
Shampoo	$2.00
Coat conditioner	$1.50
Pet cologne	$0.75

Variable Cost per Dog	
Dog treats	$1.25
Hair ribbons	$0.50

You went online and researched grooming prices in your area. Based on your review, you have decided to charge $32 for each grooming.

- Part 1:
  - What's the breakeven point in units—how many dogs will you need to groom in the first year to break even?
  - If you and your two employees groomed dogs five days a week, seven hours a day, fifty weeks a year, how many dogs would each of you need to groom each day? Is this realistic given that it takes one hour to groom a dog?
- Part 2:
  - If you raised your grooming fee to $38, how many dogs would you need to groom to break even?
  - At this new price, how many dogs will each of you have to groom each day (assuming, again, that the three of you groom dogs fifty weeks a year, five days a week, seven hours a day)?
- Part 3:
  - Would you start this business?
  - What price would you charge to groom a dog?
  - How could you lower the breakeven point and make the business more profitable?

Product Development

Learning Objective

1. Describe the process of developing a product that meets customer needs.

Like PowerSki, every organization—whether it produces goods or provides services—sees Job 1 as furnishing customers with quality products. The success of a business depends on its ability to identify the unmet needs of consumers and to develop products that meet those needs at a low cost.[30] In other words, effective product development results in goods and services that can be sold at a profit. In addition, it results in high-quality products that not only satisfy consumer needs but also can be developed in a timely, cost-efficient manner. Accomplishing these goals entails a collaborative effort by individuals from all areas of an organization: operations management (including representatives from engineering, design, and manufacturing), marketing, accounting, and finance. In fact, companies increasingly assign representatives from various functional areas who work together as a project team throughout the product development processes. This approach allows individuals with varied backgrounds and experience to provide input as the product is being developed.

Product Development Is a Risky Proposition

Not surprisingly, developing profitable products is difficult, and the success rate is low. On average, for every successful product, a company has twelve failures. At this rate, the firms on the *Fortune* 1000 list waste over $60 billion a year in research and development.[31] There are several reasons why product development is such a risky proposition:

- *Trade-offs*. You might, for instance, be able to make your jogging shoes lighter than your competitors', but if you do, they probably won't wear as well. They could be of higher quality, but that will make them more costly (they might price themselves out of the market).
- *Time pressure*. Developing a product can require hundreds of decisions that must be made quickly and with imperfect information.
- *Economics*. Because developing a product requires a lot of time and money, there's always pressure to make sure that the project not only results in a successful product but also gets it to market at the most opportune time. Failure to be first to market with an otherwise desirable new product can cost a company a great deal of money.

Even so, organizations continue to dedicate immense resources to developing new products. Your supermarket, for example, can choose from about one hundred thousand items to carry on its shelves—including twenty thousand *new* products every year. Unfortunately, the typical supermarket can stock only thirty thousand products.[32]

Video Clip 9.1 10 Worst Product Flops

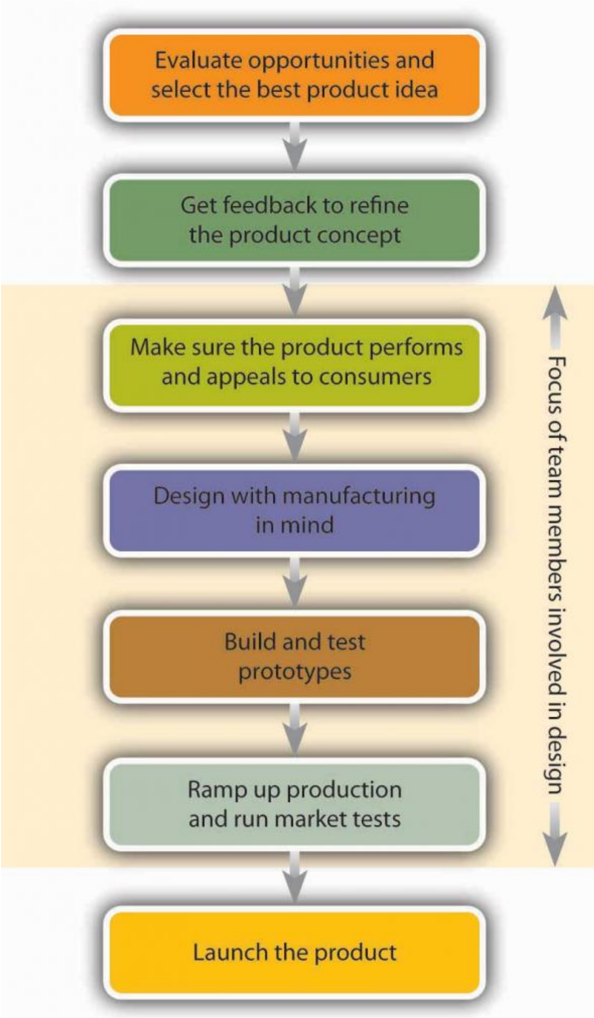
A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=97

Even the mighty Coca-Cola has had its share of failures—New Coke, anyone?

The Product Development Process

The product development process is a series of activities by which a product idea is transformed into a final product. It can be broken down into the seven steps summarized in Figure 9.6 "The Product Development Process".

Figure 9.6 The Product Development Process



Evaluate Opportunities and Select the Best Product Idea

If you're starting your first business, you might have only one product idea. But existing organizations often have several ideas for new products, as well as improvements to existing ones. Where do they come from? They can come from individuals within the organization or from outside sources, such as customers. Typically, various ideas are reviewed and evaluated by a team of individuals, who identify the most promising ideas for development. They may rely on a variety of criteria: Does the proposed product fill an unmet need of our customers? Will enough people buy our product to make it commercially successful? Do we have the resources and expertise to make it?

Get Feedback to Refine the Product Concept

From the selected product idea, the team generates an initial product concept that describes what the product might look like and how it might work. Members talk both with other people in the organization and with potential buyers to identify customer needs and the benefits that consumers will get from the product. They study the industry in which the product will be sold and investigate competing products. They brainstorm various *product designs*—that is, the specifications for how the product is to be made, what it's to look like, and what performance standards it's to meet.

Based on information gathered through this process, the team will revise the product concept, probably pinpointing several alternative models. Then they'll go back to potential customers and get their feedback on both the basic concept and the various alternatives. Based on this feedback, the team will decide what the product will look like, how it will work, and what features it will have.

Make Sure the Product Performs and Appeals to Consumers

The team then decides how the product will be made, what components it will require, and how it will be assembled. It will decide whether the product should be made in-house or outsourced to other companies. For products to be made in-house, the team determines where parts will be obtained. During this phase, team members are involved in design work to ensure that the product will be appealing, safe, and easy to use and maintain.

Design with Manufacturing in Mind

As a rule, there's more than one way to make any product, and some methods are more expensive than others. During the next phase, therefore, the team focuses its attention on making a high-quality product at the lowest possible cost, working to minimize the number of parts and simplify the components. The goal is to build both quality and efficiency into the manufacturing process.

Build and Test Prototypes

A prototype is a physical model of the product. In the next phase, prototypes are produced and tested to make sure that the product meets the customer needs that it's supposed to. The team usually begins with a preliminary prototype from which, based on feedback from potential customers, a more sophisticated model will then be developed. The process of building and testing prototypes will continue until the team feels comfortable that it has fashioned the best possible product. The final prototype will be extensively tested by customers to identify any changes that need to be made before the finished product is introduced.

Ramp Up Production and Run Market Tests

During the production ramp-up stage, employees are trained in manufacturing and assembly processes. Products turned out during this phase are carefully inspected for residual flaws. Samples are often demonstrated or given to potential customers for testing and feedback.

Launch the Product

In the final stage, the firm starts ongoing production and makes the product available for widespread distribution.

Key Takeaways

- The success of a business depends on its ability to identify the unmet needs of consumers and to develop products that meet those needs at a reasonable cost.
- Accomplishing these goals requires a collaborative effort by individuals from all areas of the organization: operations management (including representatives from engineering, design, and manufacturing), marketing, accounting, and finance.
- Representatives from these various functional areas often work together as **project teams** throughout the **product development process**, which consists of a series of activities that transform a product idea into a final product.
- This process can be broken down into seven steps:
  1. Evaluate opportunities and select the best product mix
  2. Get feedback to refine the **product concept** that describes what the product might look like and how it might work
  3. Make sure that the product performs and appeals to consumers
  4. Design with manufacturing in mind to build both quality and efficiency into the manufacturing process
  5. Build and test **prototypes**, or physical models of the product
  6. Run market tests and enter the **ramp-up stage** during which employees are trained in the production process
  7. Launch the product

Exercise

(AACSB) Analysis

Use your imagination to come up with a hypothetical product idea. Now, identify the steps you'd take to design, develop, and bring your product to market.

Protecting Your Idea

Learning Objective

1. Learn how to protect your product idea by applying for a patent.

You can protect your rights to your idea with a patent from the U.S. Patent and Trademark Office, which grants you “the right to exclude others from making, using, offering for sale, or selling” the invention in the United States for twenty years.[33]

What do you need to know about applying for a patent? For one thing, document your idea as soon as you think of it. Simply fill out a form, stating the purpose of your invention and the current date. Then sign it and get someone to witness it. The procedure sounds fairly informal, but you may need this document to strengthen your claim that you came up with the idea before someone else who also claims it. Later, you’ll apply formally for a patent by filling out an application (generally with the help of a lawyer), sending it to the U.S. Patent and Trademark Office, and waiting. Nothing moves quickly through the U.S. Patent and Trademark Office, and it takes a long time for any application to get through the process.

Will your application get through at all? There’s a good chance if your invention meets all the following criteria:

- *It’s new*. No one else can have known about it, used it, or written about it before you filed your patent application (so keep it to yourself until you’ve filed).
- *It’s not obvious*. It has to be sufficiently different from everything that’s been used for the purpose in the past (you can’t patent a new color for a cell phone).
- *It has utility*. It can’t be useless; it must have some value.

Applying for a U.S. patent is only the first step. If you plan to export your product outside the United States, you’ll need patent protection in each country in which you plan to do business, and as you’ve no doubt guessed, getting a foreign patent isn’t any easier than getting a U.S. patent. The process keeps lawyers busy: during a three-year period, PowerSki International had to take out more than eighty patents on the PowerSki Jetboard. It still has a long way to go to match the number of patents issued to some extremely large corporations. Microsoft, for example, recently obtained its ten thousandth patent.[34]

Clearly, the patent business is booming. The U.S. Patent and Trademark Office issued more than a half million patents in 2010.[35] One reason for the recent proliferation of patents is the high-tech boom: over the last decade, the number of patents granted has increased by more than 50 percent.

Key Takeaways

- You can protect your rights to your idea with a **patent** from the U.S. Patent and Trademark Office.
- A patent grants you “the right to exclude others from making, using, offering for sale, or selling” the invention in the United States for twenty years.
- To be patentable, an invention must meet all the following criteria: it’s new (no one else can have known about it, used it, or written about it before you filed your patent application); it’s not obvious (it’s sufficiently different from everything that’s been used for the purpose in the past); and it has utility (it must have some value; it can’t be useless).

Exercise

(AACSB) Analysis

A friend of yours described a product idea she had been working on. It is a child’s swing set with a sensor to stop the swing if anyone walks in front of it. She came to you for advice on protecting her product idea. What questions would you need to ask her to determine whether her product idea is patentable? How would she apply for a patent? What protection would the patent give her? How long would the patent apply?

Cases and Problems

Learning on the Web (AACSB)

Breaking Even on Burgers

You and your business partner plan to open a gourmet burger restaurant. Your partner estimated the new business will sell a hundred fifty thousand burgers during its first year and a half of operations. You want to determine the number of burgers you must sell to break even during this period.

Here are the figures you know so far:

- The variable cost for each burger is $0.97 each.
- The fixed cost of making burgers for eighteen months is $140,000 (this includes costs such as rent, utilities, insurance).
- You will sell your burgers for $1.99 each.
- At the $1.99 per-unit selling price, how many burgers will you have to sell to break even?

Part 1: Using the previous information, manually calculate the breakeven number of burgers. How close is the breakeven number of burgers to your partner's sales estimate of one hundred fifty thousand burgers? How confident are you that your restaurant will be profitable?

Part 2: Now, recalculate the breakeven number of burgers using a higher selling price. Pretend that your likely customers are burger fanatics and will pay $2.79 for a burger (rather than $1.99). Also pretend that the variable cost for each burger and your fixed costs won't change (variable cost per burger is still $0.97 and fixed costs are still $140,000). Manually calculate the number of burgers you must sell to break even at this higher selling price. Are you now more confident that the business will succeed?

Part 3: Without recalculating breakeven, answer these two questions:

1. If the variable cost for each burger went down from $0.97 to $0.80 per burger (and your selling price stayed at $1.99), would you need to sell more or fewer burgers to break even?
2. If fixed costs went down from $140,000 to $100,000 (and your selling price stayed at $1.99 and variable cost per burger returned to $0.97), would you need to sell more or fewer burgers to break even?

Career Opportunities

Being a "Big Idea" Person

Imagine a career in which you design the products people use every day. If you're a "big idea" person, have an active imagination, have artistic flair, and possess the ability to understand how products function, then a career in product design and development might be for you. To learn what opportunities are available in this field, go to the Job Bank section of the Product Development and Management Association's Web site (http://www.pdma.org/job_bank.cfm) and click on "View Posted Jobs." Explore the various job openings by clicking on a position (to highlight it); and then clicking on the "View Job Details" button at the bottom of the screen. Find a position that interests you and look for answers to these questions:

1. What's the job like?
2. What educational background, work experience, and skills are needed for the job?
3. What aspects of the job appeal to you? What aspects are unappealing?
4. Are you cut out for a career in product design and development? Why, or why not?

Ethics Angle (AACSB)

Who's Getting Fat from Fast Food?

Product liability laws cover the responsibility of manufacturers, sellers, and others for injuries caused by defective products. Under product liability laws, a toy manufacturer can be held liable if a child is harmed by a toy that's been marketed with a design flaw. The manufacturer can also be held liable for defects in marketing the toy, such as giving improper instructions on its use or failing to warn consumers about potential dangers. But what if the product isn't a toy, but rather a fast-food kid's meal? And what if the harm isn't immediately obvious but emerges over time?

These questions are being debated in the legal and health professions (and the media). Some people believe that fast-food restaurants should be held responsible (at least in part) for childhood obesity. They argue that fast-food products—such as kids' meals made up of high-calorie burgers, fried chicken fingers, French fries, and sugary soft drinks—are helping to make U.S. children overweight. They point out that while restaurant chains spend billions each year to advertise fast food to children, they don't do nearly enough to warn parents of the dangers posed by such foods. On the other side of the debate are restaurant owners, who argue that they're not the culprits. They say that their food can be a part of a child's diet—if it's eaten in moderation.

There's no disputing that 15 percent of American children are obese and that fast-food consumption by children has increased by 500 percent since 1970. Most observers also accept the data furnished by the U.S. Surgeon General: that obesity in the United States claims some three hundred thousand lives a year and costs $117 billion in health care. The controversy centers on the following questions:

1. Who really is to blame for the increase in obesity among U.S. children?
2. Under current consumer-protection laws, is fast-food marketing aimed at children misleading?
3. Should fast-food restaurants be held legally liable for the health problems associated with their products?

What's your opinion? If you owned a fast-food restaurant, what action (if any) would you take in response to the charges leveled by critics of your industry?

Team-Building Skills (AACSB)

The Great Idea

Get together with members of your team and brainstorm ideas for a new-to-the-market product. Begin the brainstorming session by asking each person to write an idea on a sticky note. Post the idea and repeat the process four times. After the team has evaluated and discussed the ideas, all members should vote. Each gets ten votes, which can be placed on one idea or spread over many. Once the voting ends, add up the votes received by each idea and declare one idea the winner.

Write a group report that answers the following questions:

1. What is the idea?
2. How would the idea work?
3. Who would our customers be?
4. What unmet need does it fill?

The Global View (AACSB)

What to Do When the "False" Alarm Goes Off

If someone on the street tried to sell you a "Rolex" watch for $20, you'd probably suspect that it's a fake. But what about a pair of New Balance athletic shoes? How do you know they're authentic? How can you tell? Often you can't. Counterfeiters are getting so good at copying products that even experts have trouble telling a fake from the real thing. What if the counterfeit product in question was a prescription drug? Even worse, what if it had been counterfeited with unsterile equipment or contained no active ingredients?

How likely is it that you'll buy a counterfeit product in the next year? Unfortunately, it's very likely. To learn a little more about the global counterfeiting business, go to the *BusinessWeek* and *Washington Post* Web sites. Read the *BusinessWeek* article "Fakes!" (http://www.businessweek.com/magazine/content/05_06/b3919001_mz001.htm) and the *Washington Post* article "Counterfeit Goods That Trigger the 'False' Alarm" (http://www.highbeam.com/doc/1P2-4576.html). After you read these articles, answer the following questions:

1. How has the practice of counterfeiting changed over time? What factors have allowed it to escalate?
2. What types of products are commonly counterfeited, and why might they be unsafe? What counterfeit products are particularly dangerous?
3. How do the counterfeiters get goods onto the market? How can you reduce your chances of buying fake goods?
4. Why is counterfeiting so profitable? How can counterfeiters compete on price with those making the authentic goods? How do counterfeiters harm U.S. businesses?
5. What efforts are international companies and governments (including China) making to stop counterfeiters?
6. If you know that a product is fake, is it ethical to buy it?

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CHAPTER OVERVIEW

3: Accounting and Finances

3.1: Chapter 10- Accounting and Cash Flow

Simione Consultants LLC

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Health care is the largest single industry in the US economy. Currently, health care represents nearly 17 percent of the gross domestic product, encompassing nearly 600,000 establishments and employing more than 14 million people. The health-care industry covers an extraordinary wide range of businesses and operations. It includes large hospitals, diagnostic laboratories, nursing care facilities, and the offices of doctors and dentists. Each establishment has individuals that possess considerable expertise in their respective disciplines. However, they may not possess the knowledge or the expertise that would enable them to manage their establishments in the most efficient manner. That is where firms like Simione Consultants LLC play a vital role.

Simione Consultants LLC represents the evolution of consulting companies that have spun off from many accounting firms. Accountants are no longer merely reconciling accounts or preparing tax returns for their clients. They are now offering a broad range of consulting services. Simione Consultants LLC provides expert assistance to hospital-based and hospital-affiliated home health and hospice agencies, visiting nurse associations, small proprietary agencies, and large national chains. They provide services that one might expect from a firm whose origins were in a standard accounting practice—such as assisting in accounts receivables and cash-flow management. Other accounting services that they provide include financial analysis reports and the preparation of cost reports for the federal government. They can conduct in-depth cost analyses at a detailed and a granular level so that clients can improve their operational efficiencies. The compliance division consulting services include working with health-care attorneys, corporate compliance and audit departments, and government agencies such as the Office of the Inspector General. Its clinical operations division works closely with financial consultants to improve the financial health of its clients.

What makes Simione Consultants LLC distinct is its ability to go beyond these basic accounting tasks and provide vital ancillary support for its clients in this niche market. They are in a position to conduct the valuation of businesses or assist in mergers and acquisitions. They help clients with preparing a prospectus or assisting with negotiations. Their consulting services can advise on how a client can maximize its return on an information management system by identifying system requirements and specifying possible solutions. In addition, the company has developed a software product—“The Financial Monitor”—that provides quarterly home health and hospice reports with multiple valuable benchmarks, including national, state, and profit-status norms, to help their clients and the industry make informed financial decisions.

A measure of how firms such as Simione Consultants LLC have moved beyond balance accounts is the company’s ability to support a client’s marketing function. The firm can help build comprehensive marketing plans and assist clients in developing and improving sales materials and training.

Simione Consultants LLC began its work in the home health-care industry more than forty years ago with an agency in Hamden, Connecticut. It was the vision of William J. Simione Jr., the founding member, who saw an opportunity. With his brother Robert J. Simione, the managing principal, and a dedicated team of principals, management, and staff, William Simione has helped Simione Consulting LLC become one of the leading home health and hospice consulting companies in the United States with over a thousand clients. Robert Simione says that a company is only as good as the people who work for it, and Simione Consultants LLC has the best home health and hospice consultants in the country.

Understanding the Need for Accounting Systems

Learning Objectives

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

The older I get, the more interesting I find lawyers and accountants. [1]

– Alex James

Imagine that you invite a friend from China, who is visiting the United States for the first time, to a baseball game. Your friend has never been to a baseball game before and knows nothing of the game's rules. He might notice on the scoreboard listings for runs, hits, and errors. Your friend might also see notations on the number of strikes and balls. He does not know exactly what any of those terms mean, but he notices that some people in the stands applaud when the number of runs increases. Your friend might be amused by seeing individuals periodically running from one base to another; however, without knowing the basic rules of baseball, he cannot possibly understand what is actually occurring. He certainly could not comment on how well the game is going or provide suggestions about what one of the teams should do next. Most Americans would be in the same position if they were watching a cricket match. In both cases, you and your friend are in the same position of someone who wishes to run a business without having a fundamental understanding of accounting systems.

Warren Buffett has said that accounting is, to put it simply, the language of business. Without a fundamental understanding of this language of accounting and its set of rules, you are in the same position as your Chinese friend—you really do not know what is going on with a business. If someone is considering starting a business, he or she should possess some degree of fluency in this language. One does not expect this businessperson to be as knowledgeable as a certified public accountant (CPA) or an expert in tax issues. However, such businesspeople should have a clear expectation that they will be able to look at the key elements of an accounting system and interpret how well their businesses are doing. They should be able to track some of the key tasks and elements associated with a comprehensive accounting system.

Accounting is defined by the American Institute of Certified Public Accountants (AICPA) as "the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof."[2] Put more simply, it is essentially an information system. Accounting provides critical information to potential investors and businesses managers. Accounting may, in fact, be one of the oldest information systems known to humans. Some have argued that accounting systems were the impetus for the development of writing systems in Mesopotamia.[3][4] Archaeologists have discovered clay tokens, dating back 10,000 years ago, which functioned as part of the inventory system measuring agricultural goods, such as grains and domesticated animals. By 3500 BC, these tokens were being stored in containers—known as bullae. Notations on the surface of these containers indicated the type and quantity of the tokens held within; for many, this system was the basis of an abstract system of written communication.[5]

Other ancient societies recognized the importance of carefully monitoring and recording economic transactions. The Roman Empire needed to finance its operations and employed the familiar concept of an annual budget to coordinate expenditures and taxation. It had treasury managers, known as questors, who were subject to periodic audits.[6] The most famous monograph on accounting dates to Renaissance Italy. Luca Pacioli, a Franciscan friar and polymath, wrote Summa de Arithmetica, Geometria, Proportioni et Proportionalita in 1494. Essentially this was a math textbook, but it included a section on double-entry bookkeeping. This approach to accounting had been covered by Beredetto Cotrugli a century earlier.[7] The text was immediately recognized as an important contribution and was one of the first books produced by Gutenberg. On a first reading, Pacioli's coverage appears to be remarkably "modern." It described how merchants should identify their assets and liabilities, note transitions as they occur, and identify them as either debits or credits. He pointed out that the total of debits and credits must be equal, thus his model became the basis of the balance sheet. In the intervening five hundred years, business has essentially adapted Pacioli's approach. Obvious, over the last five centuries, businesses have grown both in size and in complexity, and accounting systems have grown with them. Therefore, it is important for any business regardless of size to be able to "count" on solid accounting information.

The exact nature of accounting support will be greatly determined by the type and size of the small business. The level of accounting support required by the nonemployer business will obviously differ significantly from the level required by a business generating tens of millions of dollars of revenue and employing hundreds of workers. The level of support will also be influenced by the business owner's familiarity with accounting and the type of accounting information systems that have been determined as appropriate. Regardless of size or type, small businesses should plan on eventually acquiring the talents of an accountant. Preferably, the decision to use an accountant should occur with the creation of the business.

Hiring an accountant or an accounting firm is an important decision for a small business. Employing an accountant does not translate into this individual being a full-time employee of the business. At the start, most small businesses will use the accountant as a consultant or a contract employee. As they grow, some small businesses might benefit from acquiring the services of full-service accounting firm. Although some start-ups, particularly those that might be cash-strapped, use the services of the bookkeeper only, but this is ill-advised. Most small businesses will need the services of a CPA. Another type of accountant a small business might employ is known as an enrolled agent. These are accountants who have passed a tax test from the Internal Revenue Service (IRS).

When looking for an accountant, there are some issues that you should consider. Try to find an accountant who has some working familiarity with a particular type of business or industry. Hopefully, you will be able to find an accountant with whom you have some rapport. This is important because a good accountant is more than simply someone who balances the books. You should consult an accountant before determining what type of accounting system you intend to employ—cash versus accrual (see Section 10.1 “Understanding the Need for Accounting Systems”). Remember that an accountant will play an important role in assisting you in the creation, purchase, and development of an accounting information system for the business. This system is important in providing the appropriate information to the external community (for this audience the term ***financial accounting*** is often used)—bankers, angel investors, venture capitalists, and/or the government. The same accounting information system will also be an important component of internal controls (in this case the term **managerial accounting** is used)—the systems and policies by which you make a firm more efficient. In this role, an accountant can help develop appropriate policies with respect to cash control and inventory control. An accountant can play a critical role in developing business plans, particularly with respect to budgets and financial statements. As highlighted in Section 10.3 “Financial Ratio Analysis”, you should consult an accountant before selecting an accounting software package. Quite often, an accountant can be extremely useful in training people to use such a software package.[8]

Video Clip 10.1 Why Warren Buffett Said Accounting Is the Language of Business

This video introduces the importance of accounting.

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=108

Video Clip 10.2 Why You Need an Accountant

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

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=108

Video Clip 10.3 What CPAs Wish Every Small Business Knew

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

https://youtube.com/watch?v=R_FcOu2_SoA

Alternative Approaches to Accounting Systems

The system of double-entry bookkeeping is, perhaps, the most beautiful one in the wide domain of literature or science. If it were less known, it would be the admiration of the learned world.[9]

Edwin T. Freedley

The evolution of accounting has led to two major systems: the cash basis model and the accrual basis model. Before describing the two systems, we must identify a very important term—accounting transactions. When in business, we either receive money from a sale or spend money, such as in buying a piece of equipment. We can define these as transactions. The manner in which we record transactions defines the difference between a cash basis accounting system or an accrual accounting system.

In most cases, either system can be used by a business (there are situations under which a cash-based accounting system cannot be used, the details of which are discussed later), but regardless of the system used, a business must clearly specify which method is being employed.

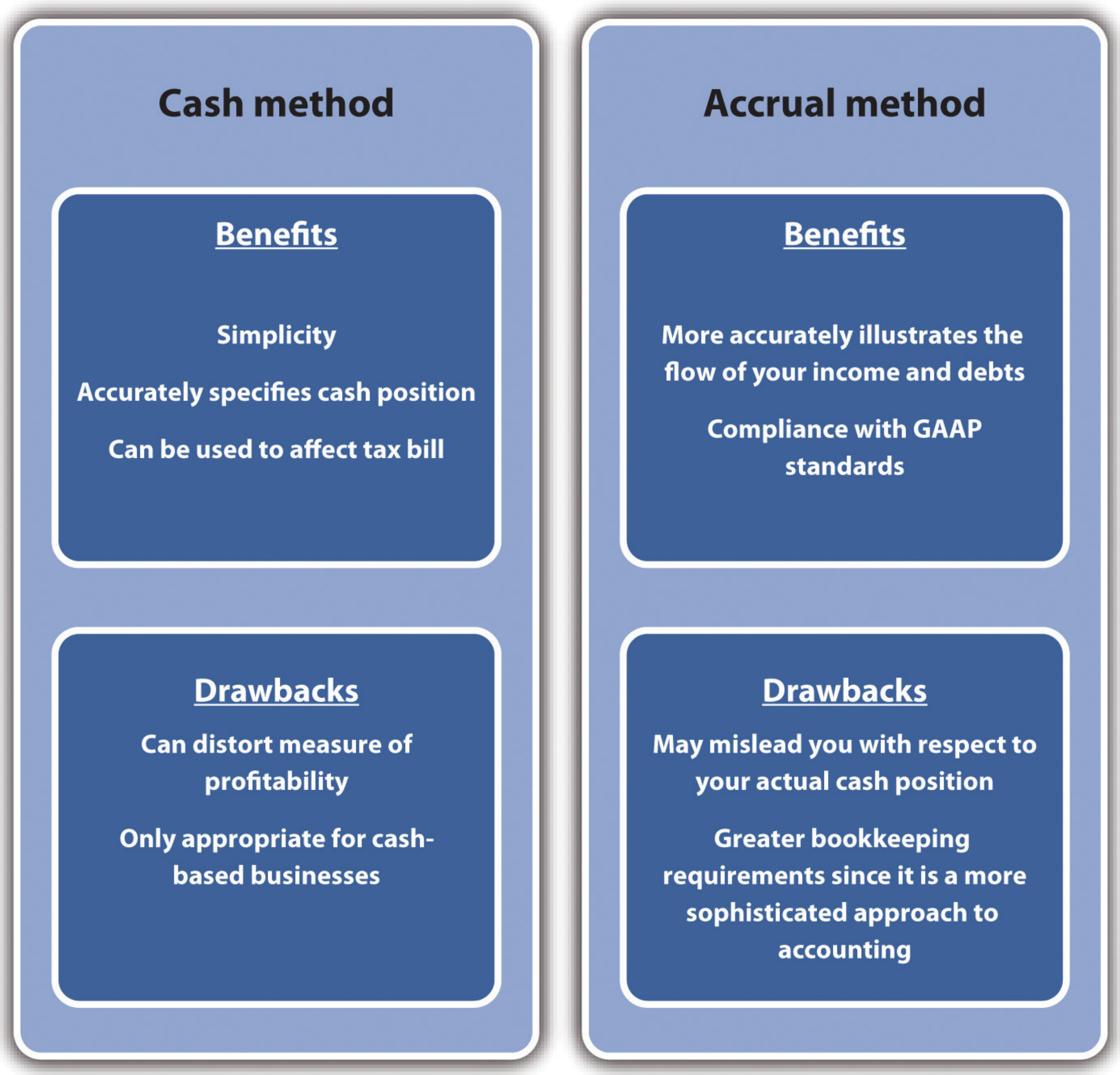
In the ***cash-based accounting*** system, a transaction is recorded when money is either received or spent. As an example, a business has three sales on June 29 of a particular year. The first sale is for $500, the second is for $1,000, and the third is for $300. However, the three customers use different methods of payment. The first customer pays for the product in cash, the second customer writes a personal check, and the third customer pays by credit card. The second customer's personal check clears on July 5, while the credit card company transfers the $300 into the business's account on July 3. Under the cash basis accounting system, the business would list the first sale of $500 as a June transaction, but it would list the second and third sales (totaling $1,300) as July transactions. The same logic is used with respect to expenditures. If the same firm purchased a laptop computer in July but did not have to pay for two months, then the transaction would be recorded in September.

Under the ***accrual accounting*** system, transactions are recorded when they occur. If the aforementioned business was functioning under the accrual basis accounting system, then all three sales (totaling $1,800) would be recorded as June transactions, and the purchase of the laptop would be designated as a July transaction.

Generally, though, with some few exceptions, businesses must use the accrual basis accounting method if they have inventory of any component of items that they sell to the public and if the sales are more than $5 million per year. Other conditions under which the cash basis accounting system may not be used include C corporations, partnerships with at least one C corporation partner, and tax shelters.[10] The major benefit of cash basis accounting is its simplicity. It greatly reduces the demand on bookkeeping. The cash basis system also provides a much more accurate indication of a company's current cash position. This approach may be used to affect taxable income, which can be done by deferring billing so that payments are received in the next year.[11] However, there are drawbacks to the cash basis approach—the most serious being that it may provide a distorted or an inaccurate indication of profitability. The reality is that cash basis accounting systems are really only appropriate for businesses with sales under $1 million and that function basically on a cash basis.

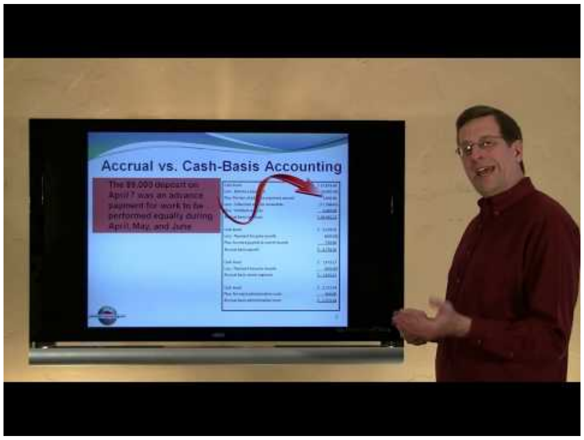
Accrual basis accounting is in conformance with IRS and generally accepted accounting principles (GAAP) regulations. Although more complex and generally requiring greater bookkeeping with a more sophisticated approach to accounting, the accrual basis provides a more accurate indication of the profitability of a business. The major drawback of the accrual basis system comes with respect to understanding the business's cash position. A firm may look profitable under this system, but if customers have not paid for the goods and services, the cash position might be dire.[12] A summary of the pros and cons of the two systems is provided in Figure 10.1 "Comparative Accounting Systems".

Figure 10.1 Comparative Accounting Systems



Video Clip 10.4 Accrual versus Cash-Basis Accounting Video Presentation

A lecture on the two accounting systems.



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Video Clip 10.5 Accrual Basis versus Cash Basis Accounting Power

A video with voice-over of a PowerPoint presentation.

https://youtube.com/watch?v=3RxJFyUPu_o

Key Takeaways

- Accounting is one of the oldest activities of human civilizations and dates back over five thousand years.
- Small businesses require accounting capabilities, which must be done either in-house or through an external service.
- The selection process for an accounting service should be carefully considered. The evaluation process should consider the following: expertise in a particular type of business or industry, rapport, availability of additional consulting services, and the ability to support computerized accounting systems.
- Accounting systems may be divided into two major types: cash basis and accrual basis.
- Cash basis systems count a transaction when the cash is received. Such systems are used by smaller businesses that have no appreciable inventory.
- Accrual basis systems count transactions when they occur. Although this system may require additional analysis to determine a business's actual cash position, it provides a more accurate measure of profitability.

Exercises

1. Identify five local businesses and talk to their owners. Ask them about how they handle their accounting needs. Do they do it *all* themselves or do they use an accountant or an accounting service? If they use an accountant or an accounting service, ask them in what way—merely to prepare taxes or do they draw on them for other advice?
2. Identify five local accountants or accounting firms. Ask them about the services that they provide to small businesses. If possible, try to determine the cost of these services.
3. Ask the five local businesses which system they use—cash or accrual—and why they use it.

Financial Accounting Statements

Learning Objectives

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

It sounds extraordinary, but it's a fact that balance sheets can make fascinating reading.[13]

Mary, Lady Archer of Weston

All business plans should contain sets of financial statements. However, even after the initial business plan is created, these financial statements provide critical information that will be required for the successful operation of the business. They not only are necessary for tax purposes but also provide critical insights for managing the firm and addressing issues such as the following:

- Are we profitable?
- Are we operating efficiently?
- Are we too heavily in debt or could we acquire more debt?
- Do we have enough cash to continue operations?
- What is this business worth?

There are three key financial statements: the balance sheet, the income statement, and the cash-flow statement. Every business owner or manager needs to be able to correctly interpret these statements if he or she expects to continue successful operations. It should be pointed out that all three financial statements follow general formats. The degree of detail or in some cases terminology may differ slightly from one business to another; as an example, some firms may wish to have an extensive list of operational expenses on their income statements, while others would group them under broad categories. Likewise, privately held businesses would not use the term *shareholders' equity* but rather use *owner's equity* in their balance sheet, and they would not list dividends. This aim of this chapter is to provide the reader with a broad overview of accounting concepts as they apply to managing small and mid-sized businesses.

The Balance Sheet Statement

One should think of the ***balance sheet*** statement as a photograph, taken at a particular point in time, which images the financial position of a firm. The balance sheet is dominated by what is known as the accounting equation. Put simply, the accounting equation separates what is owned from who owns it. Formally, the accounting equation states the following:

assets = liabilities + owner's equity.

Assets are "economic resources that are expected to produce a benefit in the future."[14] ***Liabilities*** are the amount of money owed to outside claims (i.e., money owed to people outside the business). ***Owner's equity*** —also known as stockholders' equity—represents the claims on the business by those who own the business. As specified in the accounting equation, the dollar value of assets must equal the dollar value of the business's liabilities plus the owner's equity. Before proceeding with any numerical example, let us define some important terms.

Current assets are assets that will be held for less than one year. They include *cash*, *marketable securities*, *Accounts receivables*, *Prepaid expenses*, and *inventory*. These are listed in a specific order. The order is based on the degree of liquidity of each asset. *Liquidity* measures the ease in which an asset can be converted into cash. Naturally, cash is the most liquid of all assets. All firms should have cash readily available. The exact amount of the desirable amount of cash to be held at hand will be determined by the sales level of the anticipated cash receipts and the cash needs of the business.

Marketable securities are stocks and bonds that a business may hold in the hope that they would provide a greater return to the business rather than just letting cash "sit" in a bank account. Most of these securities can be easily turned into cash—should the need arise.

Accounts receivables represent the amount of money due to a business from prior credit sales. Not all firms operate on a strictly cash sales basis. Many firms will offer customers the opportunity to purchase on a credit basis. As an example, a furniture store sells a bedroom set worth $6,000 to a newlywed couple. The couple puts down $2,500 to fix the sale and then signs a contract to pay the remaining $3,500 within the next year. That $3,500 would be listed as accounts receivable for the furniture firm.

Prepaid expense is an accrual accounting term that represents a payment that is made in advance of their actual occurrence. Insurance would be an example of a prepaid expense because a company is paying premiums to cover damages that might occur in the near future. If a year's worth of rent were paid at one time, it too would be viewed as a prepaid expense.

Inventory is the tangible goods held by a business for the production of goods and services. Inventory can fall into three categories: raw materials, work-in-process (WIP), and finished goods. Raw materials inventory represents items or commodities purchased by a firm to create products and services. WIP inventory represents "partially completed goods, part or subassemblies that are no longer part of the raw materials inventory and not yet finished goods."[15] The valuation of WIP should include the cost of direct material, direct labor, and overhead put into the WIP inventory. Finished inventory represents products that are ready for sale.

Generally accepted accounting principles (GAAP) require that a business value its inventory on either the cost price or the market price—whichever is lowest. This inherent conservative approach to valuation is due to the desire to prevent the overestimation of inventory during inflationary periods.

Total current assets are the summation of the aforementioned items and are defined as follows:

total current assets = cash + marketable securities + accounts receivable + prepaid expenses + inventory.

The next set of items in the asset section of the balance sheet is long-term assets. ***Long-term assets*** are those assets that will not be turned into cash within the next year. Long-term assets may include a category known as investments. These are items that management holds for investment purposes, and they do not intend to "cash in" within the upcoming year. They might consist of other companies' stock, notes, or bonds. In some cases, they may represent specialized forms—money put away for pension funds. The next major category of long-term assets is fixed assets. ***Fixed assets*** include plant, equipment, and land. Generally, these are valued at their original cost. The value of these assets will decline over time. As an example, you purchase a new car for $25,000. If you were to sell the same car one, two, or five years later, its value would be less than the original purchase price. This recognition is known as ***depreciation*** which is a noncash expense that specifically recognizes that assets decline in value over time. Accumulated depreciation is a running total of all depreciation on assets. Depreciation is also found on the income statement. Its presence in that financial statement enables a business to reduce its taxable income. There are many methods by which you can compute the depreciation value on fixed assets. These methods can be split into two broad categories: straight-line depreciation and accelerated depreciation. Straight-line depreciation is fairly easy to illustrate. In the example of the car, assume you purchased this car for company use. You intend to use it for five years, and at the end of the five years, you plan on scrapping the car and expect that its salvage value will be zero. This is illustrated in Table 10.1 "Depreciation Calculations".

Table 10.1 Depreciation Calculations

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Depreciation	$0	$5,000	$5,000	$5,000	$5,000	$5,000
Accumulated depreciation	$0	$5,000	$10,000	$15,000	$20,000	$25,000
Net asset value	$25,000	$20,000	$15,000	$10,000	$5,000	$0

Because the useful lifetime of the vehicle was five years, the original value of the vehicle was divided by five; therefore, the annual depreciation would equal $5,000 ($25,000/5 = $5,000 per year). The accumulated depreciation simply sums up the prior years' depreciation for that particular asset.

Accelerated depreciation methods attempt to recapture a major portion of the depreciation earlier in the life of an asset. Accelerated depreciation yields tax-saving benefits earlier in the life of any particular fixed asset. The appropriate method of depreciating an asset for tax purposes is dictated by the Internal Revenue Service (IRS). One should look at the IRS publication 946—*How to Depreciate Property*—to get a better understanding of the concept of depreciation and how to properly compute it.

The last category of long-term assets is ***intangible assets*** —assets that provide economic value to a business but do not have a tangible, physical presence. Intangible assets include items such as patents, franchises, copyrights, and goodwill. Thus the value of long-term assets can be calculated as follows:

long-term assets = investments + fixed assets − accumulated depreciation + intangible assets.

The last element on the asset side of the balance sheet is the total assets. This is the summation of current assets and long-term assets.

On the other side of the balance sheet, we have liabilities plus owner's equity. The elements of liabilities consist of current liabilities and long-term liabilities. These represent what a business owes to others. ***Current liabilities*** are debts and obligations that are to be paid within a year. These include ***notes payable***, ***Accounts payable***, other items payable (e.g., taxes, wages, and rents), dividends payable, and the current portion of long-term debt. In equation form,

current liabilities = notes payable + accounts payable + other items payable + dividends payable + the current portion of long-term debt.

Notes payable represents money that is owed and which must be repaid within a year. It is fairly inclusive because it may include lines of credit from banks that have been used, short-term bank loans, mortgage obligations, or payments on specific assets that are due within a year.

Accounts payable are short-term obligations that a business owes to suppliers, vendors, and other creditors. It may consist of all the supplies and materials that were purchased on credit.

Other items payable can include items such as the payroll and tax withholdings owed to employees or the government but which have not as of yet been paid.

Dividends payable is a term that is appropriate for businesses structured as corporations. This category represents the amount that a business plans to pay its shareholders.

The current portion of long-term debt represents how much of the long-term debt must be repaid within the upcoming fiscal year. This would include the portion of the principal that is due in this fiscal year.

The other portion of liabilities is represented by long-term liabilities. These are debts payable over a period greater than one year and include long-term debt, pension fund liability, and long-term lease obligations. In equation form,

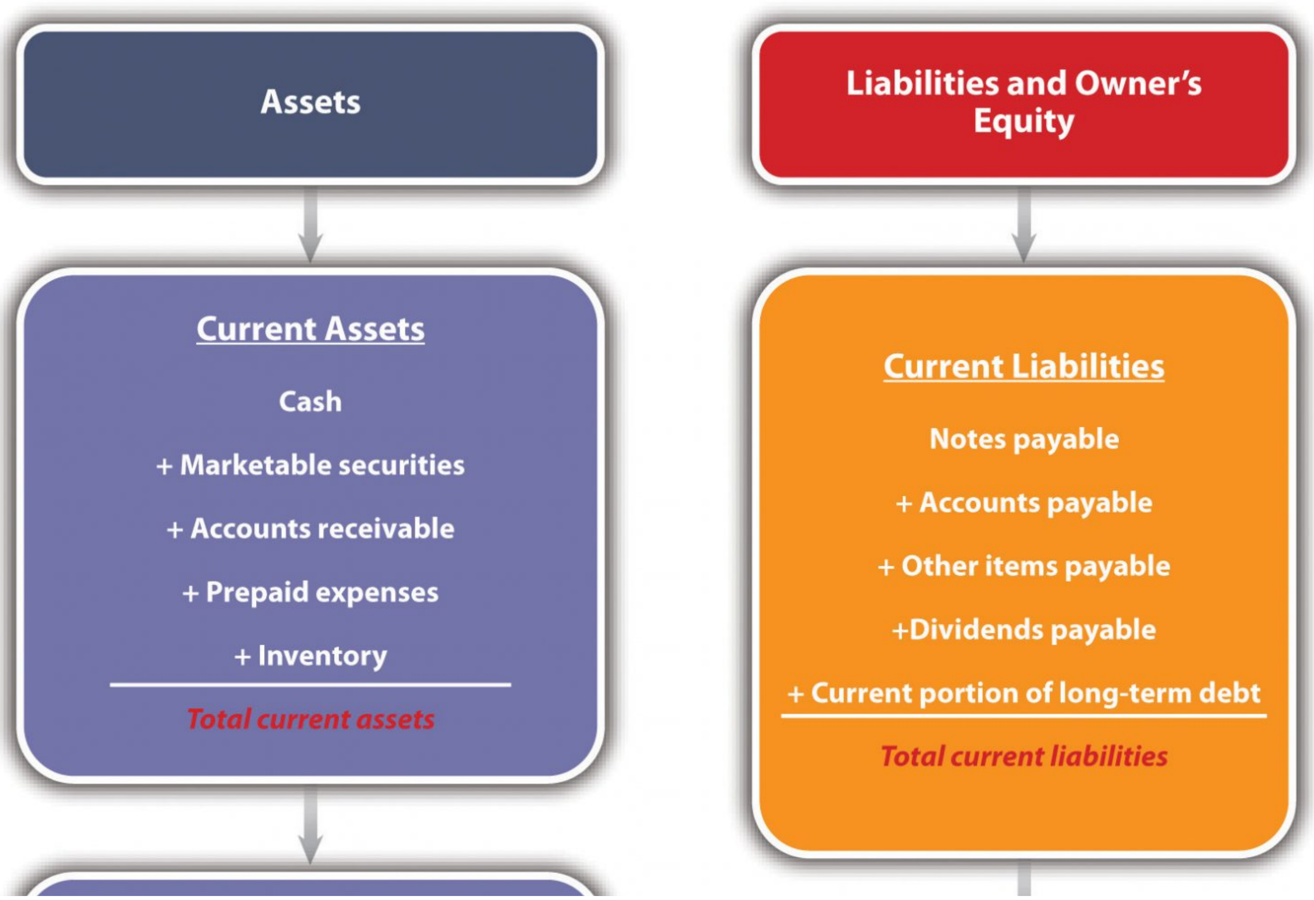
long-term liabilities = long-term debt + pension fund liabilities + long-term lease obligations.

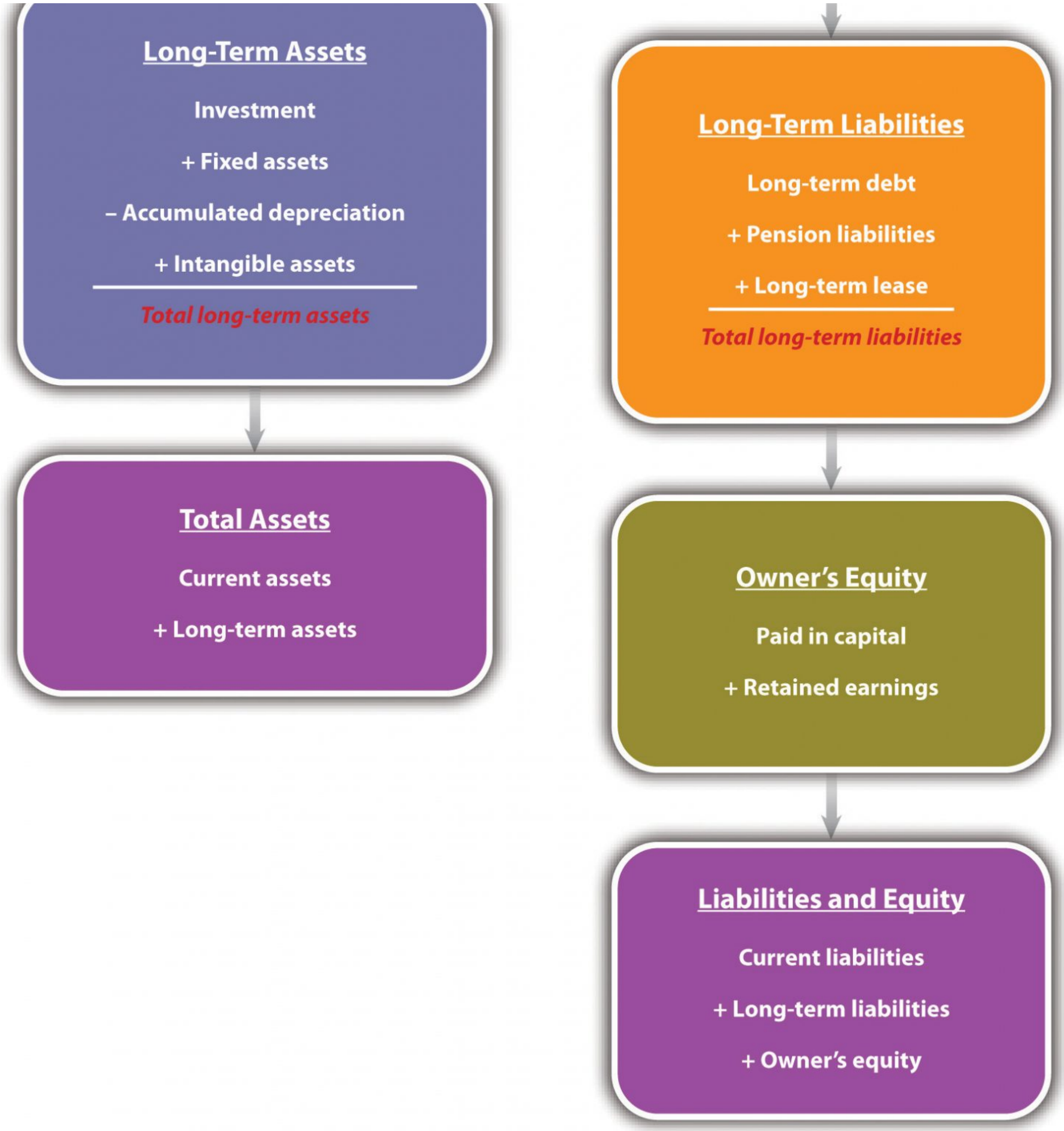
Total liabilities is the sum of current liabilities and long-term liabilities.

The other major component of the right-side of the balance sheet is owner's (or stockholders') equity. Owner's equity represents the value of the shareholders' ownership in a business. It is sometimes referred to as net worth. It may be composed of items such as paid in capital and retained earnings. Paid in capital is the amount of money provided by investors through the issuance of common or preferred stock.[16] ***Retained earnings*** is the cumulative net income that has been reinvested in a business and which has not been paid out to shareholders as dividends.[17]

The entire balance sheet and its calculations are summarized in Figure 10.2 "The Balance Sheet".

Figure 10.2 The Balance Sheet





In Table 10.2 "Acme Enterprises' Balance Sheet, 2005–2010 ($ Thousands)", we provide six years' worth of balance sheet statements for a hypothetical small business—Acme Enterprises. It is obviously important to have such information, but what exactly might this tell us in terms of the overall success and operation of the business? We will return to these statements in Section 10.3 "Financial Ratio Analysis" to show how those questions can be addressed with ratio analysis.

Table 10.2 Acme Enterprises' Balance Sheet, 2005–2010 ($ Thousands)

	December 31					
Assets	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**

	December 31					
Cash and marketable securities	$30.0	$32.3	$34.7	$37.3	$40.1	$43.1
Accounts receivable	$100.0	$107.5	$115.6	$124.2	$133.5	$143.6
Inventories	$70.0	$75.3	$80.9	$87.0	$93.5	$100.5
Other current assets	$90.0	$96.8	$104.0	$111.8	$120.2	$129.2
Total current assets	$290.0	$311.8	$335.1	$360.3	$387.3	$416.3
Property, plant, and equipment—gross	$950.0	$1,154.5	$1,387.2	$1,654.6	$1,958.1	$2,306.2
Accumulated depreciation	$600.0	$695.0	$810.5	$949.2	$1,114.6	$1,310.4
Property, plant, and equipment—net	$350.0	$459.5	$576.7	$705.4	$843.5	$995.7
Other noncurrent assets	$160.0	$176.0	$193.6	$213.0	$234.3	$257.7
Total assets	$800.0	$947.3	$1,105.5	$1,278.6	$1,465.1	$1,669.7
Liabilities						
Accounts payable	$91.0	$97.8	$105.2	$113.0	$121.5	$130.6
Short-term debt	$150.0	$177.5	$216.3	$264.2	$328.1	$406.0
Other current liabilities	$110.0	$118.3	$127.1	$136.7	$146.9	$157.9
Total current liabilities	$351.0	$393.6	$448.6	$513.9	$596.5	$694.6
Long-term debt	$211.0	$211.0	$211.0	$211.0	$211.0	$211.0
Deferred income taxes	$50.0	$53.8	$57.8	$62.1	$66.8	$71.8
Other noncurrent liabilities	$76.0	$81.7	$87.8	$94.4	$101.5	$109.1
Total liabilities	$688.0	$740.0	$805.2	$881.4	$975.8	$1,086.5
Paid in capital	$—	$—	$—	$—	$—	$—
Retained earnings	$112.0	$207.3	$300.3	$397.2	$489.3	$583.3
Total owner’s equity	$112.0	$207.3	$300.3	$397.2	$489.3	$583.3

	December 31					
Total liabilities + owner's equity	$800.0	$947.3	$1,105.5	$1,278.6	$1,465.1	$1,669.7

Video Clip 10.6 Beginner's Guide to Financial Statements: Balance Sheets

An introduction to the balance sheet.

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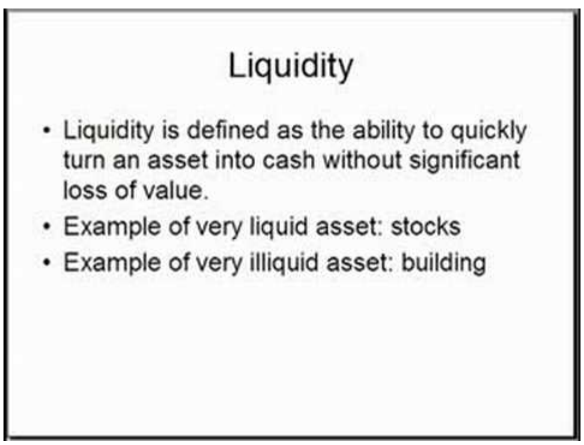
Video Clip 10.7 What Is the Balance Sheet?

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



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Video Clip 10.8 Balance Sheet: How to Explain How a Balance Sheet Works

Another description of the balance sheet.

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The Income Statement

Whereas the balance sheet looks at a firm at a particular point (date) in time, the ***income statement*** examines the overall profitability of a firm over a particular length or period of time. Normally, there are several time periods that may be used: fiscal year, fiscal quarter, or monthly. The income statement is also known as a *profit and loss statement*. It identifies all sources of revenues generated by a business and all the expenses incurred. The income statement provides the best insight into whether a business is profitable.

The income statement begins by identifying the sales or income for the designated period of time. Sales would be all the revenues derived from all the products and services sold during that time. The term *income* is sometimes used and represents all revenues and additional incomes produced by a business during the designated period. The next item in the income statement is the **cost of goods sold (COGS)**, which is composed of all costs associated with the direct production of goods and services that were sold during the time period. It would include the costs of the raw materials used to produce the goods and those costs associated with production, such as direct labor. With these two values, the first measure of profit—***gross profit*** —can be calculated:

gross profit = income − COGS.

The next element in the income statement is ***operating expenses*** —expenses that are incurred during the normal operation of a business. Operating expenses can be broken down into four broad categories: selling expenses, general and administrative expenses, depreciation, and other overhead expenses. Selling expenses would include all salaries and commissions paid to the business's sales staff. It would also include the cost of promotions, advertising expenses, and other sales expenditures. Promotion costs might consist of costs associated with samples or giveaways. Advertising expenses would include all expenditures for print, radio, television, or Internet ads. Other sales expenditures would include money spent on meals, travel, meetings, or presentations by the sales staff. General and administrative expenses are those associated with the operation of a business beyond COGS and direct-selling expenses. Expenditures in this category would include salaries of office personnel, rent, and utilities. Depreciation was covered in the previous subsection. The balance sheet has a component designated accumulated depreciation. This is the summation of several years' worth of depreciation on assets. In the income statement, depreciation is the value for a particular time period. If you look back in Table 10.1 "Depreciation Calculations", the annual depreciation on the vehicle was $5,000. If a business was developing an income statement for one particular year, then the depreciation would be listed as $5,000. It is a noncash expenditure expense. The last component of operating expenses would be other overhead costs—a fairly generic category that may include items such as office supplies, insurance, or a variety of services a business might use. Having identified all the components of operating expenses, one is now in a position to compute a second measure of profitability—***operating profit***, which is sometimes referred to as earnings before interest and taxes (EBIT):

operating profit (EBIT) = gross profit − operating expenses.

The next section of the income statement is designated ***other revenues and expenses***. This segment would include other nonoperational revenues (such as interest on cash or investments) and interest payments on loans and other debt instruments. When the other revenues and expenses are subtracted from the operating profit, one is left with earnings before taxes (EBT), Operating profit minus other revenue and expenses.:

EBT = operating profit − other revenues and expenses.

Taxes are then computed on the EBT and then subtracted. This includes all federal, state, and local tax payments that a business is obligated to pay. This brings us to our last measure of profitability—***net profit***, EBT minus taxes.:

net profit = EBT − taxes.

If a business does not pay out dividends, the net profit becomes an addition to retained earnings. The format of the income statement is summarized in Figure 10.3 "The Income Statement". The income statement is the item that most individuals look at to determine the success of business operations. In Table 10.3 "Acme Enterprises' Income Statement, 2005–10 ($ Thousands)", the income statements for Acme Enterprises are given for the period 2005 to 2010.

Figure 10.3 The Income Statement

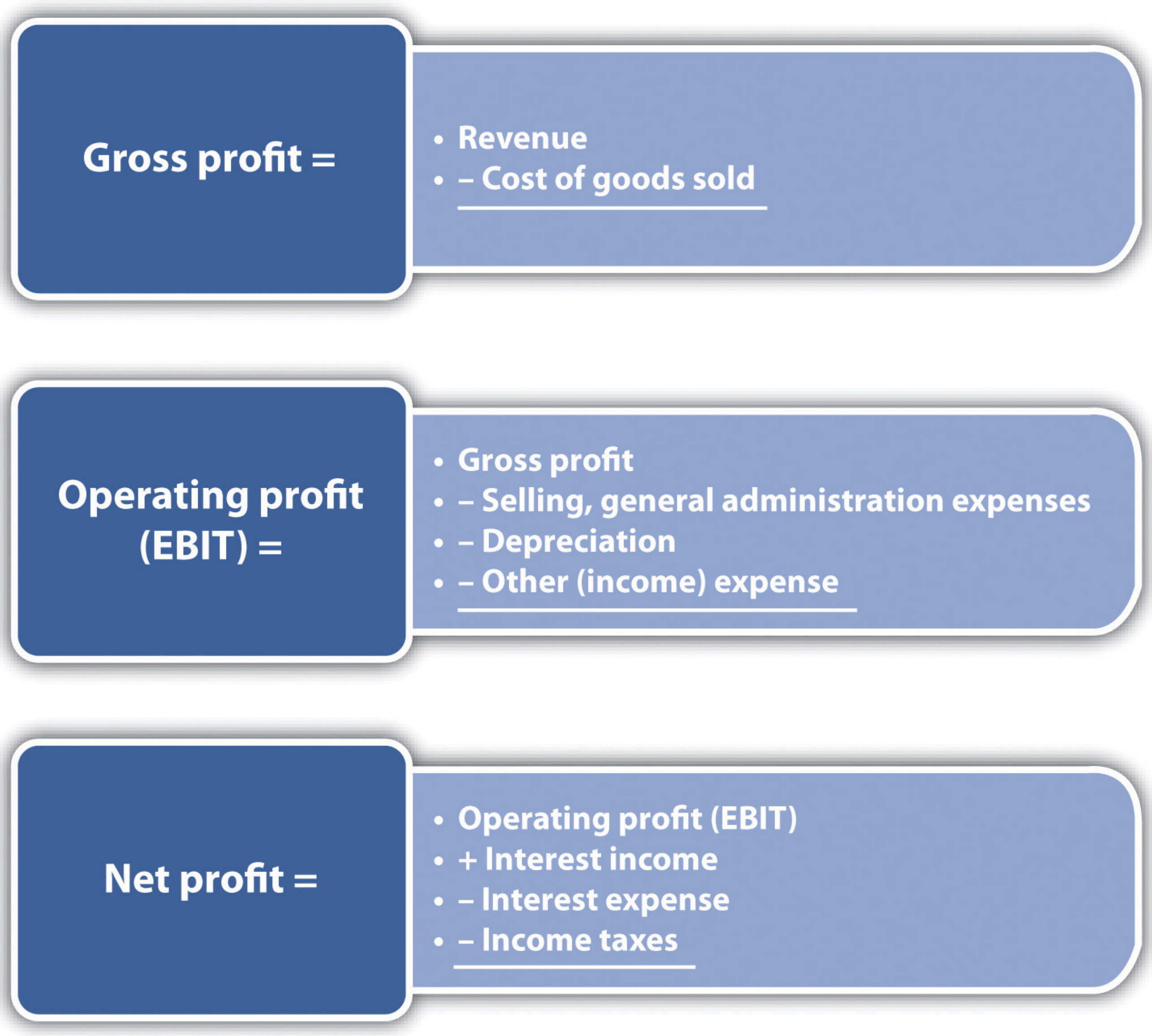


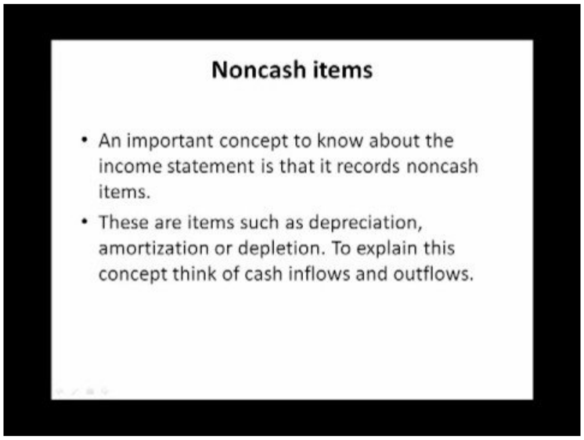
Table 10.3 Acme Enterprises' Income Statement, 2005–10 ($ Thousands)

	2005	2006	2007	2008	2009	2010
Sales	$1,000.0	$1,075.0	$1,155.6	$1,242.3	$1,335.5	$1,435.6
COGS	$500.0	$537.5	$566.3	$608.7	$641.0	$689.1

	2005	2006	2007	2008	2009	2010
Gross operating profit	$500.0	$537.5	$589.4	$633.6	$694.4	$746.5
Selling and general administrative expenses	$250.0	$268.8	$288.9	$310.6	$333.9	$358.9
Depreciation	$95.0	$115.5	$138.7	$165.5	$195.8	$230.6
Other net (income)/expenses	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
EBIT	$155.0	$153.3	$161.7	$157.5	$164.8	$157.0
Interest income	$2.1	$2.3	$2.4	$2.6	$2.8	$3.0
Interest expense	$10.5	$12.4	$15.1	$18.5	$23.0	$28.4
Pretax income	$146.6	$143.1	$149.0	$141.7	$144.6	$131.6
Income taxes	$51.31	$50.10	$52.16	$49.58	$50.61	$46.06
Net income	$95.29	$93.04	$96.87	$92.08	$93.99	$85.54
Dividends	$—	$—	$—	$—	$—	$—
Addition to retained earnings	$95.29	$93.04	$96.87	$92.08	$93.99	$85.54

Video Clip 10.9 What Is the Income Statement?

A basic introduction to income statements.



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Video Clip 10.10 Income Statement

A further description of an income statement.

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The Cash-Flow Statement

Customer satisfaction, employee satisfaction and cash flow the three most important indicators for business.[18]

Jack Welch

The third component of financial statements is the ***cash-flow statement***. There are two types of cash-flow statements—one examines cash flows for a given period (historic), and the other is a projection of future cash flows. The ***historic cash-flow statement*** is similar to the income statement in that it looks at cash inflows and cash outflows for a business during a specified period of time. Like the income statement, these periods of time can be the fiscal year, the fiscal quarter, or a month. The ***cash-flow projections statement*** attempts to identify cash flows into a firm and cash flows from a firm for some future period. This projection is extremely important because it may identify future subperiods in which a firm is producing a negative cash flow—where cash outflows exceed cash inflows.

From the standpoint of a small business owner, cash-flow statements provide insight into where cash flows are coming and going. The cash-flow projections statement may be the most important component of all the financial statements. Its importance stems from the fact that the flow of cash into a firm may not be synchronized with its cash outflows. Should there be a significant mismatch with cash outflows being significantly higher than cash inflows, a business may be in great difficulty with respect to meeting its current obligations, such as payroll, paying suppliers, and meeting short-term creditors. As we will see, cash-flow projection statements require several forecasts. These are discussed later in this section.

At some point, many businesses will experience negative cash flow. In fact, a negative cash flow is quite common in start-up operations and high-growth businesses where there is a pressing need for capital expenditures, research and development expenditures, and other significant cash outflows. One can also see the recurring presence of negative cash flows in businesses with seasonal sales. Negative cash flows can be covered by short-term borrowing. However, this type of borrowing brings up two important issues. First, any type of borrowing raises the overall debt level of a business, which might have an impact on the interest rate on the debt. Second, when a negative cash flow exists either because of an unforeseen exigency or because a business owner has failed to properly conduct a cash-flow projection analysis, a lender might look at a business in a jaundiced manner, which could have long-term consequences for a business.

A careful examination of the cash-flow statement could illustrate a point that has been mentioned several times in this book: there can be a significant difference between positive cash flow and profit. In looking at the income statement, one could find a positive net income (profit) and then examine the cash-flow statement and discover that a business has a significant negative cash flow. The cash-flow statement specifically maps out where cash is flowing into a firm and where it flows out. A properly developed cash-flow statement will show if a business will be generating enough cash to continue operations, whether it has sufficient cash for new investments, and whether it can pay its obligations. As previously stated, many of the uninitiated will look singularly at profits, while those who have greater expertise in business will always believe that cash is king.

As a way of visualization, the cash-flow statement bears some similarity to the bank statement you may receive at the end of the month. A bank statement shows the beginning cash balance, deposits (cash inflows), and checks you have written (cash outflows) for that month. Hopefully, you have a positive cash flow—cash inflows are greater than cash outflows—and you have not bounced any checks. Unlike the bank statement, the cash-flow statement is broken into three major categories: operations, financing, and investing. Cash flow from operations examines the cash inflows from all revenues, plus interest and dividend payments from investments held by a business. It then identifies the cash outflows for paying suppliers, employees, taxes, and other expenses. Cash flow from investing examines the impact of selling or acquiring current and fixed assets. Cash flow from financing examines the impact on the cash position from the changes in the number of shares and changes in the short and long-term debt position of a firm.

Cash inflows from operating activities consist of the following:

- Cash derived from the sale of goods or services
- Cash derived from accounts receivable
- Any cash derived from interest or dividends
- Any other cash derived that is not identified with financing or investments

The cash outflows from operating activities consist of the following:

- Cash outlays for goods purchased in the creation of goods and services
- Cash outlays for payment to suppliers
- Cash outlays to employees
- Cash paid for taxes or interest paid to creditors

Financing focuses on the cash flows associated with debt or equity. Some of the cash inflows associated with financing activities consist of the following:

- Cash from the sale of a company's stock
- Cash received from borrowing (debt)

Cash outflows associated with financing consist of the following:

- Cash outlays to repay principal on long- and short-term debt
- Cash outlays to repurchase preferred stocks
- Cash outlays to pay for dividends on either common or preferred stock

The third category is investing. The sources of cash flow from investing activities consist of the following:

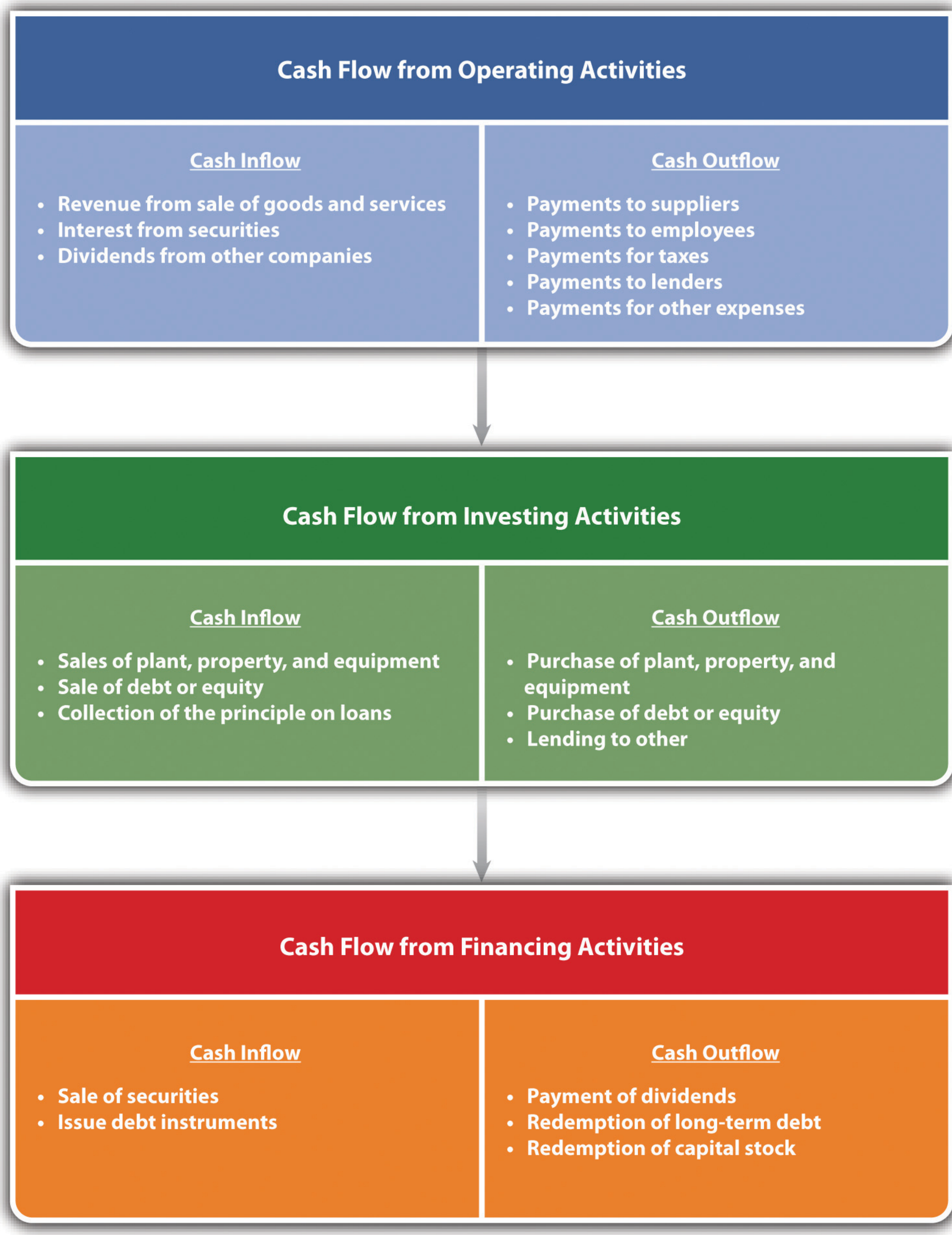
- Cash received from the sale of assets
- Cash received from the sale of equity investments
- Cash received from collections on a debt instrument

Cash outflows associated with investing activities consist of the following:

- Cash outlays to acquire a debt instrument of another business
- Cash payments to buy equity interest in other businesses
- Cash outlays to purchase a productive asset

A schematic of the cash-flow statement's three areas of analysis is presented in Figure 10.4 "Cash Flow Breakdown".

Figure 10.4 Cash Flow Breakdown


Cash Flow from Operating Activities
Cash Inflow
• Revenue from sale of goods and services
• Interest from securities
• Dividends from other companies
Cash Outflow
• Payments to suppliers
• Payments to employees
• Payments for taxes
• Payments to lenders
• Payments for other expenses
Cash Flow from Investing Activities
Cash Inflow
• Sales of plant, property, and equipment
• Sale of debt or equity
• Collection of the principle on loans
Cash Outflow
• Purchase of plant, property, and equipment
• Purchase of debt or equity
• Lending to other
Cash Flow from Financing Activities
Cash Inflow
• Sale of securities
• Issue debt instruments
Cash Outflow
• Payment of dividends
• Redemption of long-term debt
• Redemption of capital stock

Cash-flow projection statements are about the state of future cash flows, which means they require forecasts. This translates into multiple forecasts—sales forecasts, forecasts of expenses, forecasts for necessary investments, and forecasts for a business's financing requirements.

The most common approach for cash-flow forecasting in small businesses centers on projections of cash receipts and disbursements. These projections are often based on recent past data. We will demonstrate—shortly—this approach through an extensive example. This approach is generally limited to short and midterm forecasts (i.e., three to twelve months). There are other approaches to cash-flow forecasting; however, given the relative complexity of these approaches, they are often used only by larger and more sophisticated businesses. These other approaches include the adjusted net income method, the pro forma balance sheet method, and the accrual reversal method.[19]

The concept of cash-flow projection forecasting can be illustrated by using an example. Alex McLellan runs Soft Serve Services—a business that repairs and services soft-serve ice cream machines. His clients include ice cream parlors, resorts, and outlets at malls. Alex is a former engineer and somewhat methodical in developing his calculations for future budgets. He will be operating on the assumption that his business will be limited to his current locale. Alex has followed the same pattern for forecasting cash flows for years. First, he gathers together from his records his monthly and annual sales for the last five years, which are provided in Table 10.4 "Sales Data for Soft Serve Services".

Table 10.4 Sales Data for Soft Serve Services

	2006	2007	2008	2009	2010
January	$20,135	$20,562	$21,131	$22,657	$23,602
February	$19,545	$19,739	$19,852	$22,154	$22,307
March	$24,451	$24,360	$24,594	$26,361	$27,590
April	$22,789	$23,374	$24,000	$26,220	$32,968
May	$25,986	$28,531	$27,099	$30,057	$34,834
June	$28,357	$30,468	$32,893	$34,168	$37,078
July	$32,650	$35,307	$36,830	$40,321	$46,899
August	$34,488	$37,480	$40,202	$44,890	$52,042
September	$26,356	$27,909	$29,317	$32,917	$33,309
October	$24,211	$22,795	$23,719	$24,339	$25,691
November	$21,722	$22,272	$22,147	$23,080	$23,466
December	$22,017	$22,454	$28,321	$30,468	$33,583
Annual sales	$302,706	$315,252	$330,105	$357,631	$393,368

Using these data, Alex was able to calculate the growth rate in sales for the last four of the five years. As an example:

growth rate 2007 = (sales 2007 − sales 2006) / (sales 2006) = ($315,252 − $302,706) / ($302,706) = ($12,546) / ($302,706) = 4.14 percent.

Although the average of the four annual growth rates was 6.8 percent (the annual growth rates were 4.14 percent in 2007, 4.71 percent in 2008, 8.34 percent in 2009, and 9.99 percent in 2010, thus having an average of 6.8 percent), Alex believes that the last two years were unusually good, and the growth rate for 2011 would be slightly lower at a rate of 6.5 percent. This rate of growth would mean that his estimate for sales in 2011 would be $418,937, which comes from the following:

annual sales 2011 = annual sales 2010 × (1 + growth rate 2011) = $393,368 × (1.065).

He knows from experience that his sales are quite seasonal, as illustrated in Figure 10.5 "Seasonality in Sales". Alex believes that there is a high degree of consistency in this seasonality of sales across the years. So he computes (using a spreadsheet program) what percentage of annual sales occurs in each month. This calculation for January 2006 would be given as follows:

percentage of annual sales for January 2006 = (January 2006 sales) / (annual sales 2006) = ($20,135) / ($302,706) = 6.65 percent.

His analysis for each month in each of the five years is provided in Table 10.5 “Monthly Sales as a Percentage of Annual Sales”, as are the averages for each month.

Figure 10.5 Seasonality in Sales

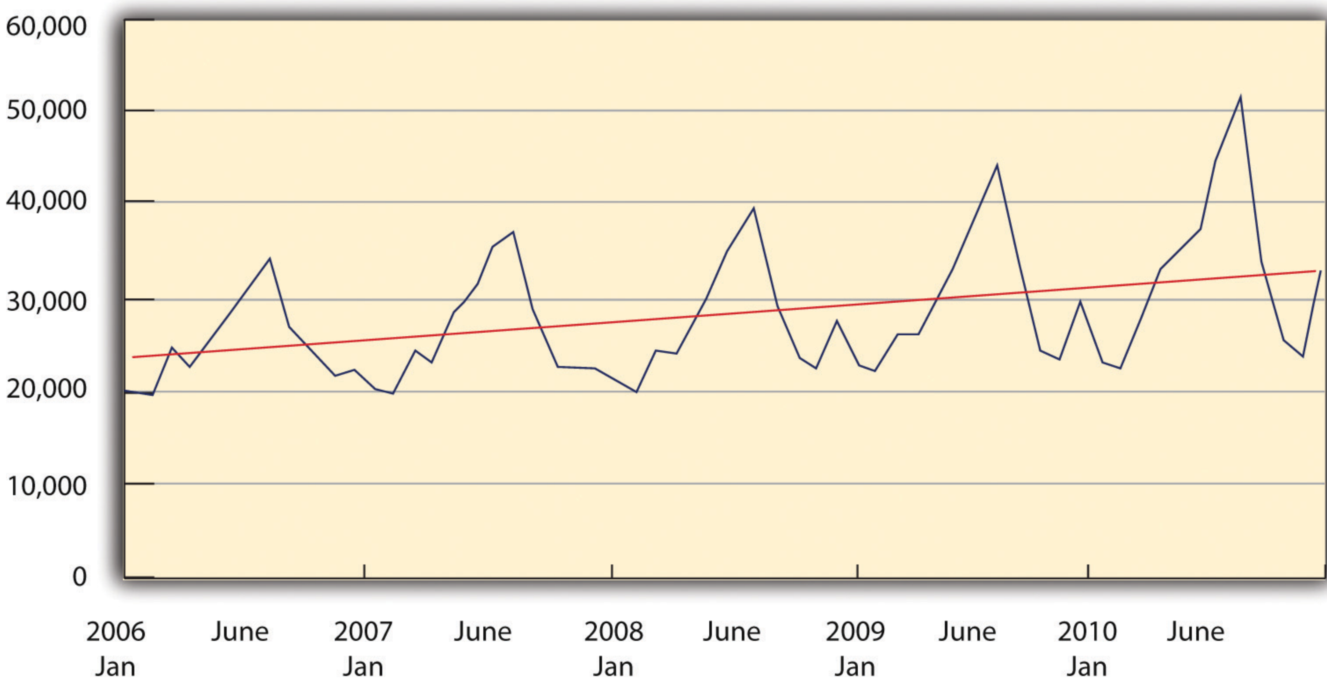


Table 10.5 Monthly Sales as a Percentage of Annual Sales

	2006 (%)	2007 (%)	2008 (%)	2009 (%)	2010 (%)	Average (%)
January	6.65	6.52	6.40	6.34	6.00	6.38
February	6.46	6.26	6.01	6.19	5.67	6.12
March	8.08	7.73	7.45	7.37	7.01	7.53
April	7.53	7.41	7.27	7.33	8.38	7.59
May	8.58	9.05	8.21	8.40	8.86	8.62
June	9.37	9.66	9.96	9.55	9.43	9.60
July	10.79	11.20	11.16	11.27	11.92	11.27
August	11.39	11.89	12.18	12.55	13.23	12.25
September	8.71	8.85	8.88	9.20	8.47	8.82
October	8.00	7.23	7.19	6.81	6.53	7.15
November	7.18	7.06	6.71	6.45	5.97	6.67
December	7.27	7.12	8.58	8.52	8.54	8.01

Alex was the able to estimate sales for January 2011 in the following manner:Because Alex was using spreadsheet software, the monthly averages were computed out to more than two decimal places. This explains why the calculations are not exact. As in the case of January, the actual monthly percentage was closer to 6.3821 percent, which provides the monthly forecast of $26,737.

January 2011 sales = annual sales 2011 × January percentage = ($418,937) × (6.38 percent) = $26,737.

Using the same approach, he was able to compute forecasted sales for February and March. To maintain sales, Alex offers his customers a rather generous credit policy. He asks them to pay 50 percent of the bill in the month in which the work is done; another 35 percent of the bill in the following month, and the remaining 15 percent of the bill two months after the work has been completed. For Alex to project cash inflows for January, he would need to consider sales from the two prior months—December and November. His projected cash inflows for January would be determined as follows:These calculations have been rounded to the nearest dollar. This is also true for the values in Table 10.6 “Cash-Flow Projections for the First Quarter of 2011”.

November 2010 sales = $23,466
December 2010 sales = $33,583
January 2011 sales = $26,737
cash inflow from November 2010 sales = ($23,466) × 15 percent = $3,520
cash inflow from December 2010 sales = ($33,583) × 35 percent = $11,754
cash inflow from January 2011 sales = ($26,737) × 50 percent = $13,368
total cash inflows from operations = sum of cash inflows for three months = $28,642.

Alex then estimates his cash outflows from operations. From past experience, he knows that the purchases of parts and materials run approximately 50 percent of the dollar value of his sales. However, because of delays in acquiring parts and materials, he must order them in advance. He has to anticipate what sales would be the following month and has to place a purchase order predicated on that value. Further, 60 percent of that dollar value is in that month and the remaining 40 percent is in the following month. This can be illustrated for January 2011. To determine the purchases of parts and materials in January, he begins with his forecast for sales in February 2011.

February 2011 sales = $25,637
parts and materials purchases in January 2011 = 50 percent of February 2011 sales = 50 percent × $25,637 = $12,819.

He is obligated to pay 60 percent of this amount in January 2011 and the remaining 40 percent in February 2011. This also means that his cash outlay in January 2011 must include a payment for 40 percent of December’s purchases.

parts and materials purchases in December 2011 = 50 percent of January 2011 sales = 50 percent × $26,737 = $13,369
parts and materials cash outlay in January 2011 = 60 percent of purchases January 2011 + 40 percent of purchases December 2010
parts and materials cash outlay in January 2011 = (60 percent × $12,819) + (40 percent × $13,369) = $13,038.

In addition to purchasing parts and materials, Alex has to consider his operational expenses, which include wages, payroll taxes, office supplies, repairs, advertising, and expenses related to automobiles, phone bills, rent, utilities, expenses associated with accounting services, and taxes. These are itemized in Table 10.6 “Cash-Flow Projections for the First Quarter of 2011”. Adding in these expenses brings his total cash outflow $19,864.

For January 2001, he has no cash inflows or cash outflows with respect to either investment activities or financing activities. This means that his total cash flow for January 2011 represents the difference between cash inflows and outflows for operational activities. His cash flow for January 2011 was a positive value of $8,778. Because he ended December 2010 with a cash position of $3,177, the addition of this $8,778 brings his cash position at the end of January 2011 to $11,955. His bank, with which he has an open line of credit, requires that he maintain a minimum of $2,500 in his cash account each month. Should Alex drop below this amount, his bank will lend him—automatically—up to $5,000.

It is useful to examine the rest of his projections (see Table 10.6 “Cash-Flow Projections for the First Quarter of 2011”). February 2011 follows much as January 2011. Alex was able to produce a positive net cash flow in February of $5,669, which brought his ending cash position at the end of February 2011 to $17,624.

Unlike the other months of 2011, Alex planned on producing cash flows with respect to investment activities in March 2011. He planned on selling an asset to a friend and anticipated a positive cash flow of $500 from this sale. He also planned on purchasing a used van in March 2011 and estimated that the price would be $21,000. His intention was to pay for the van from his cash account and not take out a car loan. His cash outflows for March 2011 were a negative $16,075. With the bank’s requirement of maintaining a $2,500 minimum balance, this meant that Alex activated the automatic borrowing option from his bank to the amount of $950. It required some effort on Alex’s part to build the cash-flow spreadsheet, but it enabled him to examine various options, such as the impact of deferring the purchase of the van until May 2011. Although any cash-flow spreadsheet is dependent on the accuracy of forecasts, it is a mechanism by which a small business owner can examine various scenarios and determine the possible impact of those scenarios on his or her overall cash flow.

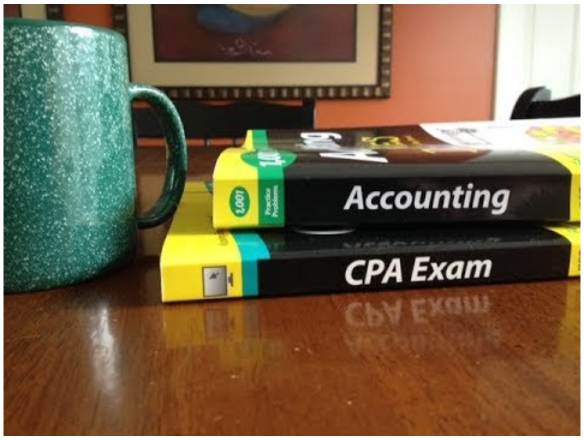
Table 10.6 Cash-Flow Projections for the First Quarter of 2011

	November	December	January	February	March
Cash Flow from Operating Activities					
Cash on hand at end of month		$3,177	$11,955	$17,624	$1,550
Cash Inflow from Operations					
Sales	$23,466	$33,583	$26,737	$25,637	$31,537
Cash flow from month of sales			$13,369	$12,818	$15,769
Cash flow from prior month's sales			$11,754	$9,358	$8,973
Cash flow from two month's prior sales			$3,520	$5,037	$4,011
Total cash inflow from operations			$28,642	$27,214	$28,752
Parts Purchases					
Cash outflow for this month's purchases			$7,691	$9,461	$9,533
Cash outflow for prior month's purchases			$5,347	$5,127	$6,307
Gross wages (excludes withdrawals)			$4,000	$4,000	$4,000
Payroll expenses (taxes, etc.)			$150	$150	$150
Outside services			$—	$—	$—
Supplies (office and operating)			$50	$50	$50
Repairs and maintenance			$—	$—	$450
Advertising			$100	$200	$250
Auto, delivery, and travel			$120	$150	$180
Accounting and legal			$200	$200	$200
Rent			$1,650	$1,650	$1,650
Telephone			$65	$65	$65

	November	December	January	February	March
Utilities			$325	$325	$325
Insurance			$166	$166	$166
Taxes (real estate, etc.)			$—	$—	$1,000
Interest			$—		
Other expenses			$—	$—	$—
Total cash outflows from operations			$19,864	$21,544	$24,327
Sale of asset			$—	$—	$500
Sale of debt or equity			$—	$—	$—
Collection of principal on a loan			$—	$—	$—
Total cash flow from investing activities			$—	$—	$500
Purchase of plant, property, and equipment			$—	$—	$21,000
Purchase of debt			$—	$—	$—
Total cash outflows from investing			$—	$—	$21,000
Sales of securities or equity			$—	$—	$—
Issue of debt instruments			$—	$—	$—
Total cash inflow from financing activities			$—	$—	$—
Payment of dividends			$—	$—	$—
Redemption of long-term debt			$—	$—	$—
Total cash outflows from financing			$—	$—	$—
Net cash flow			$8,778	$5,669	$(16,075)
Required cash balance	$2,500	$2,500	$2,500	$2,500	$2,500
Required borrowing			$—	$—	$(950)

Video Clip 10.11- Cash-Flow Analysis

A discussion of cash flow.



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Key Takeaways

- To truly understand how well a business is doing requires an ability to understand the financial statements of the business.
- The balance sheet shows what a business owns and what claims are on the business.
- The income statement shows how profitable a business is and identifies the expenses of the business.
- Cash flow is the lifeblood of a business's operation.
- Cash-flow projections are vital for any business.

Exercises

Edwina Haskell was an accomplished high school student who looked forward to attending Southern New England University (SNEU). SNEU was unique in that it operated on a trimester basis, its policy was to actively foster independent development among the students. Edwina's mother and father each own their own small businesses. Soon after freshman orientation at SNEU, Edwina recognized a need among the students that could be the basis for developing a small business. Freshman students could not bring their cars on the campus. In effect, they were confined to the dorm; if they wished to travel, they had to take school-provided buses that operated on a fixed schedule. Further, the university's cafeteria closed at eight in the evening. Students who wanted to have some food or snacks after 8:00 p.m. had to call local restaurants that delivered. The few restaurants in the neighborhood around SNEU that had delivery services often were late in their deliveries, and hot food, such as pizza, was frequently delivered cold.

Edwina felt that there was a niche market on the campus. She believed that students would be interested in ordering sandwiches, snacks, and sodas from a fellow student provided that the food could be delivered in a timely fashion. After talking with several students in her dorm complex, she believed that offering a package of a sandwich, a soda, and a small snack, such as potato chips, for $5 and a guaranteed delivery of 15 minutes or less would be a winner. Because her dorm complex consisted of four large adjoining buildings that house nearly 1,600 students, she felt that there would be sufficient demand to make the concept profitable. She talked about this concept with her roommates and with her parents. Her roommates were willing to help prepare the sandwiches and deliver them. She planned on paying each of them $250 per trimester for taking orders, making sandwiches, and delivering them. All three roommates, whom she knew from high school, were willing to be paid at the end of the trimester.

Edwina recognized that for this business plan to work, she would have to have a sufficient inventory of cold cuts, lettuce, tomatoes, soda, chips, and condiments to be able to meet student demands. The small refrigerators in the dorm rooms would not be sufficient. After talking to her parents, they were willing to help her set up her business. They would lend her $1,000 to buy a larger refrigerator to place in her dorm room. She did not have to repay this loan until she graduated in four years, but her parents wanted her to appreciate the challenges of operating a small business. They set up several conditions. First, although she did not have to pay back the $1,000 for the refrigerator for four years, she had to pay interest on this "loan." She had to repay 3 percent of this loan each trimester. Further, they reminded her that although she could pay her friends at the end of the semester, she would need funds to buy the cold cuts, bread, rolls, soda, snacks, condiments, and supplies such as foil to wrap the sandwiches, plus plates and paper bags. Although Edwina was putting $500 of her own money into her business, her parents felt that she might need an infusion of cash during the first year (i.e., the first three trimesters). They were willing to operate as her bank—lending her money, if needed, during the trimesters. However, she had to pay the loan(s) back by the end of the year. They also agreed that the loan(s) would be at a rate of 2 percent per trimester.

Within the first three weeks of her first trimester at SNEU, Edwina purchased the $1,000 refrigerator with the money provided by her parents and installed it in her dorm. She also went out and purchased $180 worth of supplies consisting of paper bags; paper plates; and plastic knives, spoons, and forks. She paid for these supplies out of her original $500 personal investment. She and her roommates would go out once or twice a week, using the SNEU bus system to buy what they thought would be the required amount of cold cuts, bread, rolls, and condiments. The first few weeks' worth of supplies were purchased out of the remainder of the $500. Students paid in cash for the sandwiches. After the first two weeks, Edwina would pay for the food supplies out of the cash from sales.

In the first trimester, Edwina and her roommates sold 640 sandwich packages, generating revenue of $3,200. During this first trimester, she purchased $1,710 worth of food supplies. She used $1,660 to make the 640 sandwich packages. Fortunately, the $50 of supplies were condiments and therefore would last during the two-week break between the trimesters. Only $80 worth of the paper products were used for the 640 sandwich packages. Edwina spent $75 putting up posters and flyers around the campus promoting her new business. She anticipated that the tax rate would be approximately 35 percent of her earnings before taxes. She estimated this number at the end of the first trimester and put that money away so as to be able to pay her tax bill.

During the two weeks off between the first and second trimester, Edwina and her roommates talked about how they could improve business operations. Several students had asked about the possibility of having warm sandwiches. Edwina decided that she would purchase two Panini makers. So at the beginning of the second trimester, she tapped into her parents' line of credit for two Panini grills, which in total cost $150. To make sure that the sandwiches would be delivered warm, she and her roommates spent $100 on insulated wrappings. The $100 came from cash. The second trimester proved to be even more successful. The business sold 808 sandwiches, generating revenue of $4,040. During this second trimester, the business purchased $2,100 worth of food supplies, using $2,020 of that to actually create the 808 sandwich packages. They estimated that during the second trimester, they used $101 worth of supplies in creating the sandwich packages.

There was only a one-week break between the second and third trimesters, and the young women were quite busy in developing ideas on how to further expand the business. One of the first decisions was to raise the semester salary of each roommate to $300 apiece. More and more students had been asking for a greater selection of warm sandwiches. Edwina and her roommates decided to do some cooking in the dorms so as to be able to provide meatball and sausage sandwiches. Edwina once again tapped into her parents' line of credit to purchase $275 worth of cooking supplies. One of the problems they noticed was that sometimes students would place calls to order a sandwich package, but the phones were busy. Edwina hired a fellow student to develop a website where students could place an order and select the time that they would like a sandwich package to be delivered. The cost of creating and operating this website for this third trimester was $300.

This last semester of Edwina's freshman year proved to be the most successful in terms of sales. They were able to fulfill orders for 1,105 sandwich packages, generating revenue of $5,525. Edwina determined that the direct cost of food for these sandwich packages came out to be $2,928.25. The direct cost of paper supplies was $165.75. At the end of her freshman year, Edwina repaid her parents the $425 that came from her credit line that was used to purchase the Panini makers and the cooking utensils.

1. Prepare a beginning balance sheet for the first day of Edwina's business.
2. Prepare income statements for the end of each trimester.
3. Prepare balance sheets for the end of each semester.

Financial Ratio Analysis

Learning Objectives

1. Understand why the numbers found on a balance sheet and an income statement may not be enough to properly evaluate the performance of a business.
2. Understand the concept of financial ratios and the different categories of financial ratios.
3. Acquire the ability to calculate financial ratios and interpret their meaning.

One can say that figures lie. But figures, when used in financial arguments, seem to have the bad habit of expressing a small part of the truth forcibly, and neglecting the other, as do some people we know.[20]

Fred Schwed

Section 10.1 "Understanding the Need for Accounting Systems" discusses the differences between managerial accounting and financial accounting. Managerial accounting focuses on providing information that is useful for the managers of a firm. Financial accounting provides information to interested external constituencies. Both use information derived from financial statements. These numbers, however, may not provide a singular insight into the overall economic effectiveness of any particular business. These numbers must be placed in some form of context. As an example, suppose you are told that a particular business earned $2 million worth of profit last year. Obviously, earning a $2 million profit is better than a $1 million profit and certainly better than a $2 million loss. However, you are still left with the question of exactly how good that $2 million profit is. After all, if you were told that Walmart made only $2 million profit last year, you would likely be concerned with respect to the management capability and performance of Walmart. Making only $2 million profit on revenues in excess of $400 billion worth of sales would not be at all impressive. However, if you were told that a mom-and-pop grocery store made $2 million profit last year based on $4 million of sales, you would be amazed at that mom-and-pop store and hold them in considerable esteem for their management capability.

One way of putting financial data into a comparative context is known as financial ratio analysis. From a financial accounting standpoint, ratio analysis enables external constituencies to evaluate the performance of a firm with respect to other firms in that particular industry. This is sometimes referred to as comparative ratio analysis. From a managerial accounting standpoint, ratio analysis can assist a management team to identify areas that might be of concern. The management team can track the performance on these ratios across time to determine whether the indicators are improving or declining. This is referred to as trend ratio analysis. There are literally scores of financial ratios that can be calculated to evaluate a firm's performance.

Financial ratios can be grouped into five categories: **liquidity ratios** ;**financial leverage ratios** ;**profitability ratios** ;**asset management or efficiency ratios** ; and **market value ratios**. Because many small businesses are not publicly held and have no publicly traded stock, market ratios play no role in analyzing a small firm's performance. This section will review some of the most commonly used ratios in each category.

Liquidity ratios provide insight into a firm's ability to meet its short-term debt obligations. It draws information from a business's current assets and current liabilities that are found on the balance sheet. The most commonly used liquidity ratio is the current ratio given by the formula:

current assets / current liabilities.

The normal rule of thumb is that the current ratio should be greater than one if a firm is to remain solvent. The greater this ratio is above one, the greater its ability to meet short-term obligations. As with all ratios, any value needs to be placed in context. This is often done by looking at standard ratio values for the same industry. These ratios are provided by Dun and Bradstreet; these data are also available on websites, such as Bizstats.com.

Another ratio used to evaluate a business's ability to meet in short-term debt obligations is the quick ratio—also known as the acid test. It is a more stringent version of the current ratio that recognizes that inventory is the least liquid of all current assets. A firm might find it impossible to immediately transfer the dollar value of inventory into cash to meet short-term obligations. Thus the quick ratio, in effect, values the inventory dollar value at zero. The quick ratio is given by the following formula:

current assets − inventory / current liabilities.

Using the data provided in the balance sheet for Acme Enterprises (Table 10.2 "Acme Enterprises' Balance Sheet, 2005–2010 ($ Thousands)"), we can compute the current ratio and the quick ratio. The results for Acme Enterprises and its industry's means are provided in Table 10.7 "Liquidity Ratio Results".

Table 10.7 Liquidity Ratio Results

	2005 (%)	2006 (%)	2007 (%)	2008 (%)	2009(%)	2010 (%)
Acme's current ratio	0.83	0.79	0.75	0.70	0.65	0.60
Industry's current ratio	1.15	1.08	1.04	1.02	1.03	1.01
Acme's quick ratio	0.63	0.60	0.57	0.53	0.49	0.45
Industry's quick ratio	1.04	1.02	0.98	0.95	0.94	0.91

One should immediately notice that this business appears to be in serious trouble. None of the current ratios are above of value of 1.0, which indicates that the business would be unable to meet short-term obligations to its creditors should they have to be paid. Acme's current ratios are below the industry's average values; however, it should be noted that the industry's values are quite close to one. Further, the current ratio values for Acme and the industry are declining, but Acme's are declining quite significantly. This indicates the financially precarious position of the firm is growing steadily worse. The quick ratio shows an even direr situation should the firm not be able to sell off its inventory at market value. Acme's quick ratio values are well below the industry's average. Without these two ratios, a quick perusal of the total current assets of Acme Enterprises would result in a false impression that the firm is growing in a healthy fashion and current assets are rising.

Financial leverage ratios provide information on a firm's ability to meet its total and long-term debt obligations. It draws on information from both the balance sheet and the income statement. The first of these ratios—the debt ratio—illustrates the extent to which a business's assets are financed with debt. The formula for the debt ratio is as follows:

total debt / total assets.

A variation on the debt ratio is the ratio of debt to the total owner's equity (the debt-to-equity ratio). As with the other ratios, one cannot target a specific, desirable value for the debt-to-equity ratio. Median values will vary significantly across different industries. The automobile industry, which is rather capital intensive, has debt-to-equity ratios above two. Other industries, such as personal computers, may have debt-to-equity ratios under 0.5.[21] The formula for the debt-to-equity ratio is as follows:

total debt / total owner's equity.

One can refine this ratio by examining only the long-term portion of total debt to the owner's equity. Comparing these two debt-to-equity ratios gives insight into the extent to which a firm is using long-term debt versus short-term debt. The formula for the long-term debt-to-owner's equity ratio is as follows:

long-term debt / total owner's equity.

The interest coverage ratio examines the ability of a firm to cover or meet the interest payments that are due in a designated period. The formula for the interest coverage ratio is as follows:

EBIT / total interest charges.

The financial leverage ratios for Acme and its industry are provided in Table 10.8 "Financial Leverage Ratios Results". Interestingly, Acme's debt-to-total-assets ratio has declined over the last six years. Further, its ratio has always been lower than the industry average in every year. This stands in contrast to the liquidity ratios. The business's debt-to-equity ratio has declined precipitously over the last six years and was significantly lower than the industry averages. The same is true for the long-term debt-to-equity ratios. These ratios have declined for several reasons. The total assets of the firm have doubled over the last six years, and equity has grown by a factor of five while the long-term debt has remained constant. It would appear that the firm has been financing its growth with short-term debt and its own profits. However, one should note that the ***times interest earned ratio*** has declined dramatically, falling to approximately half the level of the industry average in 2010. This indicates that the firm has less ability to meet its debt obligations. In conjunction with the results of the other ratios, one would say that Acme has relied, excessively, on its short-term debt and should take actions to return to a firmer financial footing.

Table 10.8 Financial Leverage Ratios Results

	2005 (%)	2006 (%)	2007 (%)	2008 (%)	2009 (%)	2010 (%)
Acme's debt-to-total assets ratio	0.86	0.78	0.73	0.69	0.67	0.65
Industry's debt-to-total assets ratio	1.01	0.97	0.95	0.92	0.89	0.86
Acme's debt-to-equity ratio	6.14	3.57	2.68	2.22	1.99	1.86
Industry's debt-to-equity ratio	3.31	3.25	3.67	3.11	2.96	2.65
Acme's long-term debt-to-equity ratio	1.88	1.02	0.70	0.53	0.43	0.36
Industry's long-term debt-to-equity ratio	1.52	1.54	1.42	1.32	1.27	1.12
Acme's times interest earned ratio	14.76	12.34	10.68	8.52	7.17	5.52
Industry's times interest earned ratio	11.55	11.61	10.95	10.65	10.43	10.01

The next grouping of ratios is the profitability ratios. Essentially, these ratios look at the amount of profit that is being generated by each dollar of sales (revenue). Remember, from the review of the income statement, we can identify three different measures of profit: gross profit, operating profit, and net profit. Each measure of profit can be examined with respect to the net sales of a business, and each can give us a different insight into the overall efficiency of a firm in generating profit.

The first profitability ratio examines how much gross profit is generated by each dollar of revenue and is given by the following formula:

gross profit margin = gross profit / revenue.

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

operating profit margin = operating profit / revenue.

Lastly, the net profit margin is the one that is mostly used to evaluate the overall profitability of a business. It is determined as follows:

net profit margin = net profit / revenue.

The profitability ratios for Acme and its industry are provided in Table 10.9 "Profitability Ratios Results". Acme has seen a slight increase in its gross profit margin over the last six years, which indicates a reduction in either direct labor or direct materials costs. Acme's gross profit margin is slightly lower, across the six years, than the industry's mean values. Acme's operating profit margins have declined, particularly since 2008. This would indicate, in light of an increasing gross profit margin, that its operating expenses have increased proportionately. Acme's operating profit margins had parity with its industry until 2008. The most troublesome results may be the net profit margins, which experienced a one-third decline over the last six years. Although the industry's net profit margins have declined, they have not done so at the same rate as those for Acme. These results indicate that Acme needs to carefully review its operational expenses with a clear intention to reduce them.

Table 10.9 Profitability Ratios Results

	2005 (%)	2006 (%)	2007 (%)	2008 (%)	2009 (%)	2010 (%)
Acme's gross profit margin	50.0	50.0	51.0	51.0	52.0	52.0
Industry's gross profit margin	51.2	51.3	51.6	51.5	53.2	53.1
Acme's operating profit margin	15.5	14.3	14.0	12.7	12.3	10.9
Industry's operating profit margin	14.7	14.1	14.2	13.2	13.0	13.2
Acme's net profit margin	9.5	8.7	8.4	7.4	7.0	6.0
Industry's net profit margin	9.2	8.9	8.5	8.4	8.1	7.9

The last category of financial ratios is the asset management or efficiency ratios. These ratios are designed to show how well a business is using its assets. These ratios are extremely important for management to determine its own efficiency. There are many different activity or efficiency ratios. Here we will examine just a few. The sales-to-inventory ratio computes the number of dollars of sales generated by each dollar of inventory. Firms that are able to generate greater sales volume for a given level of inventory are perceived as being more efficient. This ratio is determined as follows:

sales to inventory = sales / inventory.

There are other efficiency ratios that look at how well a business is managing its inventory. Some look at the number of days of inventory on hand; others look at the number of times inventory is turned over during the year. Both can be used to measure the overall efficiency of the inventory policy of a firm. For simplicity's sake, these ratios will not be reviewed in this text.

The sales-to-fixed-asset ratio is another efficiency measure that looks at the number of dollars of sales generated by a business's fixed assets. Again, one is looking for a larger value than the industry average because this would indicate that a business is more efficient in using its fixed assets. This ratio is determined as follows:

sales to fixed assets = sales / fixed assets.

Another commonly used efficiency ratio is the days-in-receivables ratio. This ratio shows the average number of days it takes to collect accounts receivables. The desired trend for this ratio is a reduction, indicating that a firm is being paid more quickly by its customers. This ratio is determined as follows:

days in receivables = accounts receivable / (sales / 365).

The 365 in the denominator represents the number of days in a year. A summary of the activity ratios for Acme and the industry is provided in Table 10.10 "Efficiency Ratios Results".

Table 10.10 Efficiency Ratios Results

	2005 (%)	2006 (%)	2007 (%)	2008 (%)	2009 (%)	2010 (%)
Acme's sales to inventory	14.3	14.3	14.3	14.3	14.3	14.3
Industry's sales to inventory	16.2	15.7	15.3	14.9	14.3	13.7
Acme's sales to fixed assets	8.57	7.02	6.01	5.28	4.75	4.33

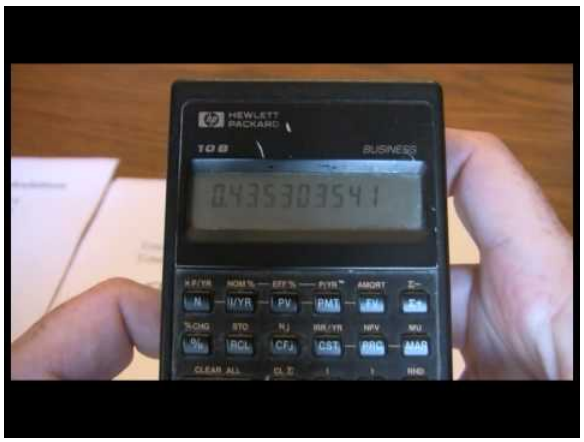
	2005 (%)	2006 (%)	2007 (%)	2008 (%)	2009 (%)	2010 (%)
Industry’s sales to fixed assets	7.64	7.12	6.78	6.55	6.71	6.34
Acme’s days in receivables	36.5	36.5	36.5	36.5	36.5	36.5
Industry’s days in receivables	33.2	34.6	38.2	37.4	33.9	35.1

Almost immediately one should notice several interesting sets of value. Acme’s sales-to-inventory ratios for the period 2005 to 2010 and its days in receivables for the same time frame are constant. This is not true for the industry values. This might indicate that Acme has a rigorous policy of tying its inventory level to sales. Likewise, it would appear that Acme has some formal policy to explicitly link accounts receivable to sales volume. Industry values for both ratios fluctuated across the time span; however, it should be noted that the industry’s days in receivables fluctuated across a rather narrow band. Acme’s sales to fixed assets have been declining from 2005 to 2010. In fact, it has dropped almost in half. This is a sign that Acme’s ability to manage its assets vis-à-vis sales has declined significantly and should be a source of considerable worry for the management team.

Financial ratios serve an extremely useful purpose for small business owners who are attempting to identify trends in their own operations and see how well their business’s stand up against its competitors. As such, owners should periodically review their financial ratios to get a better understanding of the current position of their firms.

Video Clip 10.12 Financial Ratios: Debt Management

Basic coverage for calculating debt ratios.



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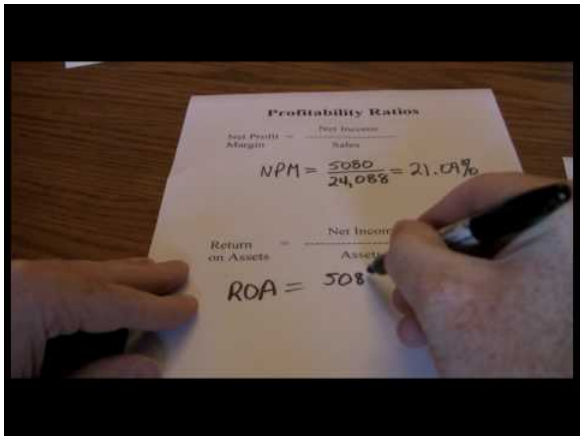
Video Clip 10.13 Financial Ratios: Profitability

Basic coverage for calculating profitability ratios.



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Video Clip 10.14 Financial Ratios: Asset Management

Basic coverage for calculating asset management ratios.

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Key Takeaways

- Financial ratios enable external constituencies to evaluate the performance of a firm with respect to other firms in a particular industry.
- Ratio analysis can help a management team identify areas that might be of concern.
- The management team can track the performance on these ratios across time to determine whether the indicators are improving or declining.
- Financial ratios can be grouped into five categories: liquidity ratios, financial leverage ratios, asset management or efficiency ratios, profitability ratios, and market value ratios.

The Three Threads

Learning Objectives

1. To understand that a functioning accounting system can provide customer value through accurate billings and records.
2. To understand that there are several techniques that can help a small business maintain a positive cash flow.
3. To appreciate that small businesses can use sophisticated, low-cost computer accounting systems to manage their accounting and operational operations.

Customer Value

One might find at first consideration a tenuous link between a business's accounting system and the concept of customer value. However, if looked at from the customer's perspective, a business that provides accurate and prompt billings is a business that can control its costs, which can result in lower prices. A business that improves its overall efficiency because it can accurately monitor and track its operations provides far greater value than a business with a haphazard approach to accounting controls.

The ability to tailor a business's operations to better meet customer needs is the key to providing value. As a business acquires a better appreciation of its capabilities, it can then make improvements that will better meet customer needs and outperform competitors.[22]

As a business grows more confident in its ability to handle accounting issues, it may wish to look at more sophisticated techniques that can better serve the business and the customer. As Andrew Hereth puts it, "An accounting process needs to be established that accounts for the cost of each customer, for each market and for each channel.[23]

Cash-Flow Implications

Like good health, positive cash flow is something you're most aware of when you haven't got it. That's one of the most profound truths in life.[24]

Robert Heller

Creating a positive cash flow or at least reducing a negative cash flow should be of central interest to all small businesses. Unlike the example of Alex's Soft Serve Services, not all small businesses can anticipate that they will be able to cover a negative cash flow simply by borrowing. That means that businesses must be much more proactive in attempting to eliminate or reduce negative cash flows. Therefore it is important to examine some ways in which a small business can increase its cash inflows.

- **Restrict credit and credit terms.** Many small businesses, but not all, offer credit terms and policies for current and potential customers. The easier the credit, the more likely a business will be able to generate a sale; however, easy credit terms generally mean that it will take a longer period of time for the business to receive the total cash payment from a sale. Thus many businesses accept only cash or debit and credit cards. Restricting the credit terms may simply mean that credit is provided only to particular customers or the terms of the credit are tightened—for example, 60 percent of the sale price is due the day of the sale, and the remaining 40 percent would be due in thirty days.
- **Conduct credit checks.** Businesses that plan to offer credit to customers, particularly customers who will be making large purchases, may find that it pays to spend money to conduct a credit check on these customers. Again, the use of credit checks is very much a function of the type and size of the business and the potential sales that may be involved.
- **Make credit terms explicit.** For businesses that provide credit to their customers, it is critical to make sure the customer has an explicit idea of what the exact credit terms are. In the long run, it will pay to clearly indicate on the invoice the exact payment schedule.
- **Provide incentives to expedite customer payment.** It is often worth to knock off several percentage points on a sale to speed up a customer's payment. The exact size of the discount will have to be determined by the business owner.
- **Request partial payment in advance.** When providing credit terms, small businesses should consider the requirement of a deposit or a retainer up front. Hopefully, this should not deter many customers from purchasing particularly high-priced items. The request for payment in advance assures that a business will receive some cash inflow even if the customer defaults.

One of the best ways to maintain a positive cash flow is to reduce the size of the negative cash flow, which can be done by conducting cash-flow analyses on a regular basis. Throughout this chapter, the time frame most commonly used has been the fiscal year or a fiscal month. In the case of rigorously monitoring cash flow, it is strongly suggested that one consider using even smaller time units, namely a weekly analysis or even a daily analysis.

Digital Technology and E-Environment Implications

Computer-based accounting systems have much to offer the owner of a small business. Most small businesses would find that a computerized accounting system has the following advantages over a manual system:

- **Accuracy.** In computerized systems, data entry can be structured so as to preclude the input of wrong information. Further, transactions are entered only once in computerized systems, whereas they may require several entries in a manual system.
- **Speed.** Data entry and data retrieval can occur on a real-time basis. Calculations are done instantly in a computerized system. For businesses with multiple locations, data can be instantly coordinated rather than waiting for the collection of data from

diverse locations as would occur with manual systems.

- **Report generation.** Computerized systems can provide real-time generation of a variety of reports that can enable owners or operators to improve their decision making.
- **Cost reduction.** Although small businesses may be required to expend money on the initial purchase (and maintenance) of computerized accounting system, these systems often provide significant savings in terms of reducing the amount of time required for bookkeepers and accountants to track businesses records.[25]
- **Backup.** The records in a computerized system can be backed up at a variety of locations. This minimizes the chance that all records would be destroyed in some form of accident, such as a fire or a flood, as might be the case with paper records in a manual system.[26]

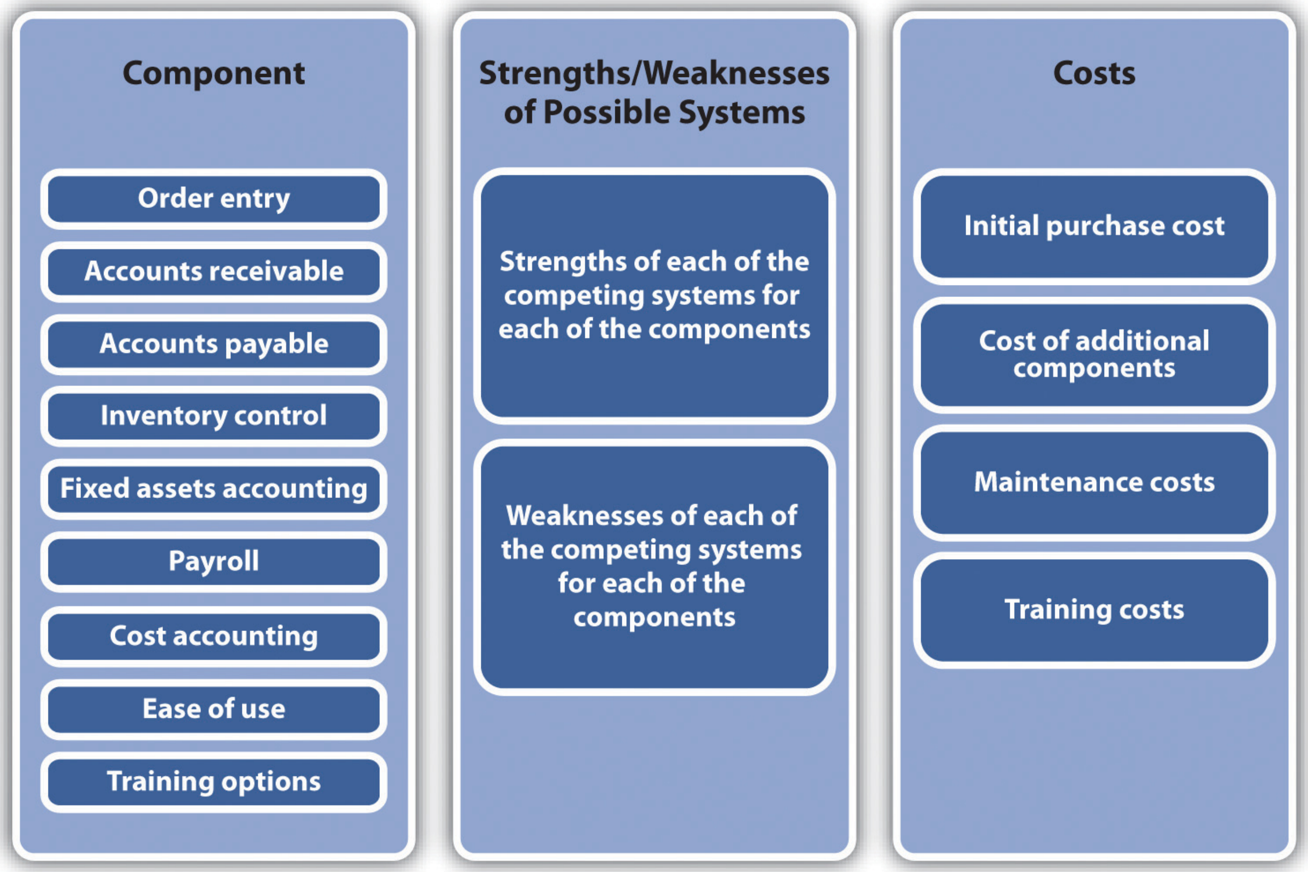
Computer-based accounting packages that have been designed for small to midsize businesses have been available for more than a quarter of a century. Many of the packages that existed twenty-five years ago are no longer available. Some have argued that a natural selection process exists for computerized accounting system so that today's survivors represent the best qualities required of such systems.[27] In recent years, a whole new category of accounting software has been developed—cloud-based software. This software resides on the web and does not require a software package to be downloaded on small business owner's computer. Such programs are accessible from any computer.

Selecting a new computer accounting system or changing from a manual system to a computer-based system is a major step for any small business. It should be conducted with careful consideration and treated as a major project. Prior to starting the project, it is highly advisable to sit down with one's accountant and consider the options. Some of the first steps in starting this project involve specifying the budget and the required attributes of the software package. In developing the budget, one should consider the initial acquisition price of the software, training costs, and maintenance costs. If one is planning to move from one computerized accounting system to another, the cost of transferring operations should also be considered in the overall budgeting process. With regard to the initial purchase price, these packages can range from being free to costing thousands of dollars depending on the number of modules required. Some systems use a fee structure that is based on the number of users. This would allow a business owner to get some sense of the look and the feel of the software package.

The second initial phase of the acquisition process centers on identifying what is needed in the accounting package. This relates to the elements (support services) or modules that are absolutely required. One should also identify what modules might be of benefit at some point in the future. To assist an owner in identifying what modules are required or may be required in the future, the information that flows into the accounting system must be specified. In Section 10.1 "Understanding the Need for Accounting Systems", we refer to the idea of accounting transactions, which fall into several categories. A business needs to identify all the required categories, particularly if it is transitioning from a manual system to a computerized system. A business also needs to identify the accounting reports that are required throughout the business. It is important to consider if the software is compatible with e-business, e-commerce, and Internet capabilities.

Another issue is to consider how many people will have to access the system throughout the entire business. This number will have a dramatic impact on the training requirements. Recognize that the business will have to provide manuals that must be accessible to all who will be using the accounting system. This also brings up the issue of the necessity of employee training programs. Consider the relative ease of use of any computerized accounting system—not only for yourself but also for the employees. This is where an understanding of the learning curve of using the system will be extremely important. Again, a business's accountant can play a critical role not only in determining the selection of the system but also in developing training programs for the employees and showing them how to use the system. Having generated this list of the required components of the accounting system, one should identify competing software products (along with their costs) and prioritize them, as shown in Figure 10.6 "Evaluation of Computer Accounting Systems". In addition to consulting with an accountant, a business owner should review the various accounting software packages by talking to other business owners, reading evaluations in the business and computer press, and exploring software packages on a trial basis.[28] Many accounting software packages allow users to try out the system with no initial charge. After a fixed period of time, usually thirty days, the program becomes inoperative. This allows you to become familiar with the look and the feel of the software.

Figure 10.6 Evaluation of Computer Accounting Systems



The third preliminary step is the creation of a timeline that would determine when you must successfully implement the accounting package into the actual operations of the business. This timeline should consider the time required to conduct test runs of the software. Tests should be conducted with only one or two modules. They should be operated for a sufficient period of time (at least a month) to examine if the system works as well as the manual system or the current computerized system. A timeline should also be created for training the personnel who will be using the software.

Moving to a computerized accounting system or a new system means that you should be ready for any disaster. To prepare for such disasters, there should be a formal policy of backing up all data on a regular basis. The backed up data should be at another locale other than the main storage site. Portable hard drives for off-site data storage site serve this purpose well. Some software packages perform their own backup procedures.

Several factors may need to be considered when examining accounting software for small businesses, including the following: will the software run on computers that a business currently uses, how often should the company provide updates of the software, and are there specific versions of the accounting software for the industry in which a business operates. Small businesses should also consider cloud computing options with regard to accounting software. ***Cloud computing*** refers to the fact that programs and data are stored off-site at another location. This means that accounting transactions can be entered from any computer, in some cases from smartphones, and are accessible anywhere in the world. Although for start-up businesses and the very smallest of businesses the adoption of a computerized accounting system appears to be a daunting task, in the long run, it is a key element for the long-term survival of the business.

Video Link 10.1- Evaluating Accounting Software

Video that discusses ways to determine what software is best.

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

Key Takeaways

- Good accounting systems can help a firm provide value to its customers through better billing and increased efficiency.
- Small businesses can be proactive in preserving cash flow through a variety of simple actions.
- Small businesses today can acquire very powerful computer accounting software packages. These packages are affordable and relatively easy to use.

Exercises

1. Besides the suggestions provided, what other approaches might a small business use to preserve cash flow?
2. Select five or six computerized accounting packages (including one of the cloud variety) that might be used by a start-up restaurant, and prepare a rigorous analysis of which should be selected and why.

Disaster Watch

Sales and cash-flow forecasting can often prove to be a significant challenge to small business owners. Assumptions have to be made, forecasting models must be selected, and calculations have to be made. In many cases, the forecasts will not be exact. This can be profoundly frustrating. Yet one of the great benefits of forecasting is that it may force a small business owner to think about what the future may hold. However, neither small businesses nor large businesses can predict or plan for all events. Certain events just happen. Given this element of unpredictable chance, businesses should think about how they might protect and conserve their cash flow should the "unthinkable" occur.

Yankee Gas had a project that involved installing a pipeline from Waterbury, Connecticut, to Wallingford, Connecticut.[29] The original intent according to Yankee Gas was that all work on the pipeline would occur during the night to minimize customer disruptions. Or at least, this was what the storeowners along the line of the work were told. During one phase of the project, the company altered the schedule and began working during daytime hours. Installation involved digging a trench into which the pipeline was laid. This produced a major disruption that required that traffic be diverted away from several businesses' main entrances and their parking lots. Multiple businesses found their customers had to be "forceful" with the local police to enter areas near the businesses. One of the businesses was a deli that focused on preparing fresh food on a daily basis. Food that was not sold during the day had to be discarded that night. This occurred during the summer months, which were the best times for this deli. A local gas station saw sales drop so precipitously that the owner was unable to meet the rent.

One of the responses on the part of many of the business owners was to seek compensation. Unfortunately, they found that no one was willing to accept responsibility for the detour policy. As an owner of a travel agency put it, "The Town said it was the State, the State said it was the (local) police and the police said it was Yankee Gas."[30]. While the owners await the resolution of responsibility, they have to consider the possibility of more street work during the following summer.

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3.2: Chapter 11- Financial Management

The Notch Store. Used with permission from Frank Salvatore.

No small business, or for that matter no large business, becomes a landmark and community-gathering place overnight. It takes time along with some very sharp management skills. In the case of the Notch Store, a local legend in Cheshire, Connecticut, it took ninety years and three generations of family members.

The business began in 1921 when Pauline Salvatore recognized a business opportunity. Her husband Mike worked in the nearby quarry, and she recognized that the employees needed a location where they could buy groceries for their lunch or to bring home for dinner. She began to sell them from her living room. Soon the business located to a facility next to her home. The name Notch Store came from its use in the quarry.

A few years later, Mike left the quarry and began to work with Pauline. Over the years, the Notch Store evolved as customer needs changed. They began to expand their offerings. The physical store was enlarged. A gasoline pump was installed, and for several years, one wall of the store carried auto parts.

In 1967, Mike and Pauline's son Frank and his wife Josephine took over the operation of the business. In the 1970s, the Notch Store extended its offerings to include deli items and lunches. It even offered a homemade cider every fall. The business grew and included its third generation of Salvatores—Frank Jr.

In the early 1990s, Frank Jr. was in charge of operations. Like any business man, he was open to suggestions from others, including his employees. One woman who worked for Frank Jr. suggested that he add breakfast sandwiches to the menu. To make these sandwiches, Frank Jr. needed a restaurant-quality stove. In one of those strange twists of life, Frank Jr. had a friend who knew Joe Namath and his wife. The Namaths were building a new home, and Joe's wife did not like the stove in the home. Frank Jr. acquired it, and since then, the breakfast sandwich offerings have become a major staple in the Notch Store.

No business develops without encountering problems, and the Notch Store was no exception. Several years ago, a number of customers complained that they had become ill from the Notch's cider. This was followed by several lawsuits. For most businesses, this might have been a fatal crisis and financial ruin. Fortunately, years before, Frank Jr. had listened to his brother Robert's advice (Robert was in the insurance industry). The Notch Store had $2.3 million in insurance coverage, which was more than enough to ensure its survival. For several reasons, including recognition of the risk of serving food to the public, the Notch Store has adopted a limited liability corporation format. Even with the best of financial planning and risk reduction strategies, many businesses have to deal with factors beyond their control. The recent economic downturn has meant that there is a significant reduction in new homes being built in Cheshire. This means that there are far fewer builders buying breakfasts and lunches, but Frank Jr. is coping with a small line of credit at a local bank. The future is still bright for the Notch Store and so is the possibility of it continuing into a fourth generation.Frank Salvatore (owner), in discussion with the authors.

The Importance of Financial Management in Small Business

Learning Objectives

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

Chapter 10 "Accounting and Cash Flow" discusses the critical importance of a small business owner understanding the fundamentals of accounting—"the language of business." This chapter examines finance and argues that the small business owner should acquire a basic understanding of some key principles in this discipline. One question that might come to someone's mind immediately is as follows: "What is the difference between accounting and finance?" As an academic discipline, finance began in the early decades of the twentieth century. We have already seen that accounting predates the formal study of finance by millennia.[1] Yet some have argued that accounting should be seen as a subset of finance.[2]. Others have argued that both accounting and finance should be seen as subdisciplines of economics. Not surprisingly, others have argued in favor of the primacy of accounting. If we get beyond this debate, we can see that accounting is involved with the precise reporting of the financial position of a firm through the financial statements, which is presented in Chapter 10 "Accounting and Cash Flow". The accounting function is expected to collect, organize, and present financial information in a systematic fashion. Finance can be seen as "the science of money management" and consists of three major activities: financial planning, financial control, and financial decision making. Financial planning deals with the acquisition of adequate funds to maintain the operations of a business and making sure that funds are available when needed. Control seeks to assure that assets are being efficiently used. Decision making is associated with determining how to acquire funds, where to acquire funds, and how those funds should be used and within the context of the risk assessment of the aforementioned decisions. As an academic discipline, finance has grown tremendously over the last four decades.

Much of the work produced during this period possessed both an esoteric analytical quality and profound practical consequences. One only has to look at newspapers and the business press, during the last few years, to see how financial theory (efficient market hypothesis) and financial models (options pricing, derivatives, and arbitrage models) have played a dominant role in the global economy. Fortunately, most small businesses have no need to directly involve themselves with these analytical abstractions. But this does not mean that small business owners do not need to concern themselves with fundamental issues of financing their firms.

Impact of Organization Type on Finance Decisions

Selecting the form of business organization that is adopted by a business depends on many factors. One could begin by anticipating the eventual size and nature of the business.[3] The complexity of a business may dictate the type of business organization that is adopted. However, many of the factors that go into this determination are either directly or indirectly financial in nature. The indirect factors are as follows: the extent to which a business owner wishes to attain control of the business, the relationship that the owner would have with partners or investors, and the perceived risk associated with the business. This last factor is tied to the question of the extent to which the owner will invest his or her own money and assets. The direct financial factors that go into selecting the type of the business organization include the following: expected profits or losses, tax issues, the vulnerability and threat from lawsuits, and the ability to extract profits from the business for the owner's use. The federal government recognizes six forms of business organizations for tax purposes: ***sole proprietorship***, partnership, ***C-corporation***,***S-corporation***, trust, and nonprofit. The last two are unlikely to be adopted by small businesses. It is useful to examine the financial implications of organizing along the remaining four basic formats.

Sole Proprietorship

Many small businesses operated by a single individual adopt sole proprietorship format of business organization. It is the most basic type of business organization. It is also the least expensive to create and the easiest to operate and dissolve. Sole proprietorships can be incorporated if the owner so desires. Not being a legal entity, single scratch sole proprietorships disappear after the death of the owner. This type of business is essentially a format for a single-person business (although many have between one and ten employees), where the owner makes *all* the decisions related to the business's operations. The owner can extract all profits from the business for his or her personal use, or the owner can decide to reinvest any portion of the profits back into the business. It is interesting to know that 70 percent of all businesses in the United States are sole proprietorships yet they only produce 20 percent of all the nation's profits.[4] Because a single proprietorship is not a legal entity, any income generated by the business goes directly on the owner's personal tax return. However, the single owner is also personally responsible for any debts that the business acquires. This means that the owner may put his or her own personal assets at risk. In addition, this business organization means unlimited liability for its owner. The format means that there is very little opportunity to raise funds from sources other than the owner's own capital or consumer loans.

Partnerships

Partnerships generally are unincorporated businesses. From a financial standpoint, partnerships offer a few advantages over sole proprietorship. By having more than one owner (investor), it is often easier to raise additional capital. In some businesses, such as law firms and accounting firms, the prospect of becoming a partner may be an attractive inducement to gain employees. There are several versions of partnerships.

The ***general partnership*** is composed of two or more owners who contribute the initial capital of the business and share in the profits and any losses. It is similar to a sole proprietorship in that all partners are personally responsible for all the debts and the liabilities of the business. A general partnership is comparable to a sole proprietorship in that neither is a taxable entity; therefore, the partners' profits are taxed as personal income. They can deduct any business losses from their personal income taxes. The exact proportion of ownership of the firm is generally found in a written document known as the partnership agreement.

A ***limited partnership*** is a business that may have several general partners and several more limited partners. The major difference with a general partnership is that the limited partners do not have unlimited liability. Their losses are limited to their original investment in the business. Common practice means that these limited partners do not play a major decision-making role in the life of the business.

C-Corporations

Selecting a C-corporation form of business entails more effort and expense in creating this format. Corporations must be chartered by the state in which they are headquartered. Corporations are viewed as legal entities, meaning that they can enter into legal agreements with individuals and other corporations. They are also subject to numerous local and state regulations. This often results in extensive paperwork that can be costly. Corporations are owned by their shareholders. The shareholders are liable only for their original investment in the business. They cannot be sued for more than that amount. One of the major advantages of adopting a corporate format is that in this type of business, it is sometimes much easier to raise capital through either debt or the issuance of stock. Profits derived from this type of business are taxed at the corporate rate. It is important to note that dividends paid to shareholders, unlike interest expenses, are not deductible. So in a real sense, this form of income is doubly taxed.

S-Corporations

The S-corporation is a special format designed to eliminate the problem of double taxation that one might find with a C-corporation format. It first differs from a C-corporation in that it is limited to a hundred shareholders, although it can be created with just one shareholder. If a shareholder is an employee of the business and contributes any service to the business, then the corporation is required to pay that individual a salary. The term that is used is "reasonable" salary. This definition may vary under several conditions. A failure to comply with this ambiguous definition of "reasonable" salary means that the IRS can reclassify the profits as wages and tax the amount at the personal income rate.

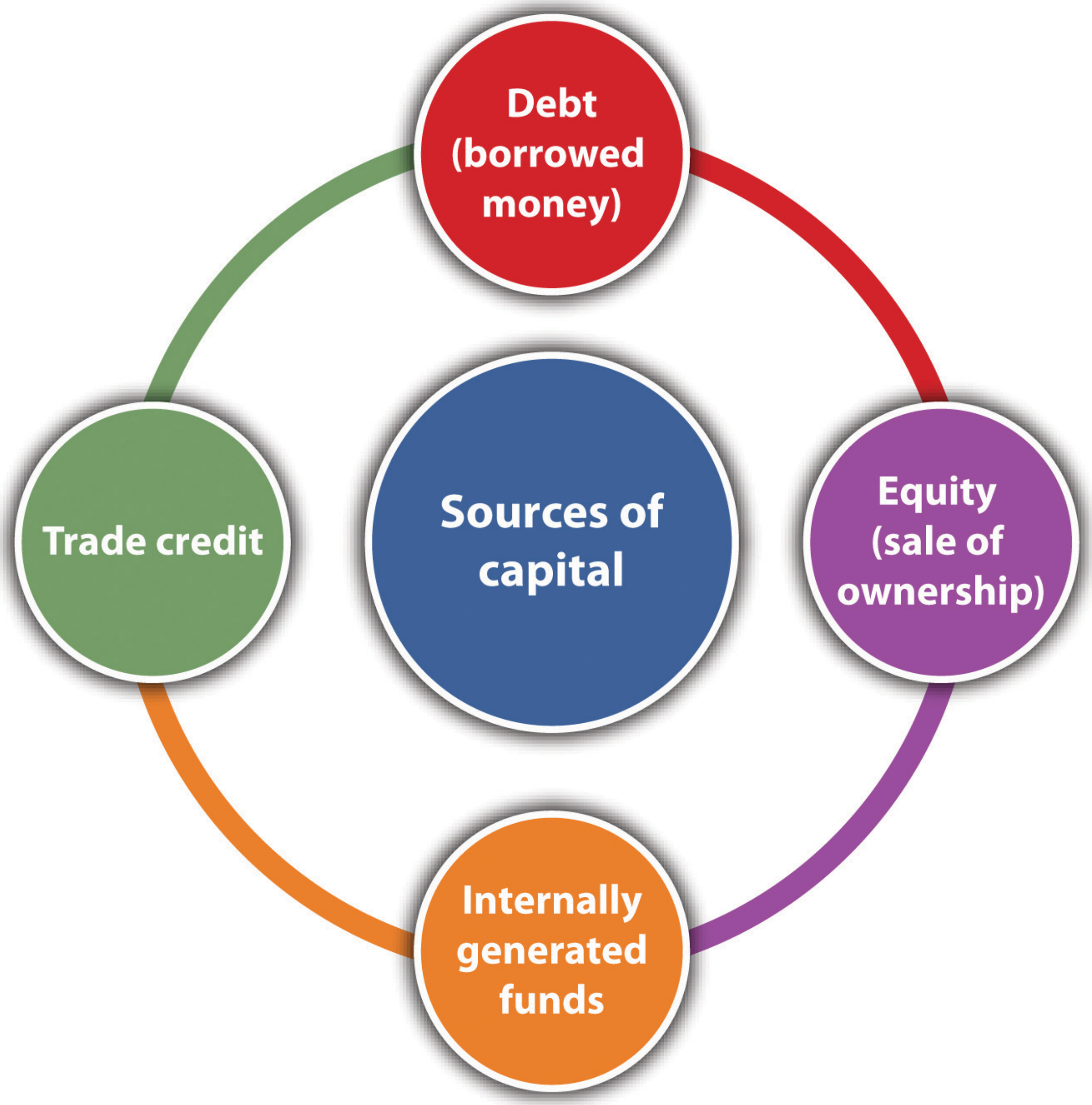
Limited Liability Company

A ***limited liability company*** is an organizational form that can be limited to a single individual or several other owners or shareholders. Like a general partnership, there is a requirement for documents that define the distribution of responsibilities, profits, or losses. Generally, the members of a limited liability company are liable for the debts of the company. This format may provide tax and financial benefits for the participants. This format cannot be used in the banking or insurance industries.

Acquisition of Funds

Capital is the lifeblood of all businesses. It is needed to start, operate, and expand a business. Capital comes from several sources: equity, debt, internally generated funds, and trade credits (see Figure 11.1 "Sources of Capital").

Figure 11.1 Sources of Capital



Equity financing raises money by selling a certain share of the ownership of the business. It involves no explicit obligation or expectation, on the part of the investors, to be repaid their investment. The value of equity financing lies in the partial ownership of the business.

Perhaps the major source of equity financing for most small start-up businesses comes from personal savings. The term *bootstrapping* refers to using personal, family, or friends' money to start a business.[5] The use of one's own money (or that of family and friends) is a strong indicator that a business owner has a strong commitment to and belief in the success of the business. If a business is financed totally from one's personal savings, that means the owner or the operator has total control of the business.

If a business is structured as a corporation, it may issue stock. Generally, two major types of stock may be issued: common stock and preferred stock. It should be noted that in most cases, owners of common stock have what are known as voting rights. They have a proportional vote (directly related to the number of shares they own) for members of the board of directors. Preferred stock does not carry with it voting rights, but it has a form of guaranteed dividend.

Corporations that issue stock must comply with several steps to meet both federal and state statutes, including the following: outlines to issue stock to shareholders, determining the price and number of shares to be issued, creating stock certificates; developing a record to record all stock transactions; and meeting all federal and state securities requirements.[6] Smaller businesses may choose to issue stock only to those who were involved in the initial investment of the business. In such cases, one generally does not have to register these securities with state or federal agencies. However, one may be required to fill out all the forms.[7]

Venture capitalists are looking for substantial returns on their initial investment—five, ten, sometimes even twenty-five times their original investment. They will be looking for firms that can rapidly generate significant profits or significant growth in sales. Angel investors may be more attracted to their interest in the small business concept than in reaping significant returns. This is not to say that they are not interested in recouping their original investment with some type of significant return. It is much more likely that angel investors, as compared to venture capitalists, will play a much more active role in the decision-making process of the small business.

One area for possible capital infusion into a small business may come from a surprising source. Many students (and some adults) may find funding to start up a business through business plan competitions. These competitions are often hosted by colleges and universities or small business associations. The capital investment may not be large, but it might be enough to start very small businesses.

Debt financing represents a legal obligation to repay the original debt plus interest. Most debt financing involves a fixed payment schedule to repay both principal and interest. A failure to meet the schedule has serious consequences, which might include the bankruptcy of the business. Those who provide debt financing expect that the principal will be repaid with interest, but they are not formal investors in the business.

There are numerous sources for debt financing. Some small businesses begin with financing by borrowing from friends and family. Some firms may choose to finance business operations by using either personal or corporate credit cards. This approach to financing can be extraordinarily expensive given the interest rates charged on credit cards and the possibility that the credit card companies may change (by a significant amount) the credit limit associated with the credit card.

The largest source of debt financing for small businesses in the United States comes from commercial banks.[footnote]"How Will a Credit Crunch Affect Small Business Finance?," *Federal Reserve Bank of San Francisco*, March 6, 2009, accessed December 2, 2011, www.frbsf.org/publications/economics/letter/2009/el2009-09.html.[/footnote] Bank lending can take many forms. The most common loan specifies the amount of money to be repaid within a specific time frame for a specific interest rate. These loans can be either secured or unsecured. Secured loans involve pledging some assets—such as a home, real estate, machinery, and plant—as collateral. Unsecured loans provide no such collateral. Because they are riskier for the bank, they generally have higher interest rates. For a more comprehensive discussion of bank loans, see Section 10.2.1 "Relationships with Bank and Bankers".

The Small Business Administration (SBA) has a large number of programs designed to help small businesses. These include the business loan programs, investment programs, and bonding programs. The SBA operates three different loan programs. It should be understood that the SBA does not make the loan itself to a small business but rather guarantees a portion of the loan to its partners that include private lenders, microlending institutions, and community development organizations. To secure one of these loans, the borrower must meet criteria set forth by the SBA. It should be recognized that these SBA loan rules and guidelines can be altered by the US Congress and are dependent on prevailing economic and political conditions. The following subsections briefly describe some of the loan programs used by the SBA.

(a) Loan Programs

This class of loans may be used for a variety of reasons, including the purchase of land, buildings, equipment, machinery, supplies, or materials. It may also be used for long-term working capital (paying accounts payable or the purchase of inventory). It may even be used to purchase an existing business. This class of loans cannot, however, be used to refinance existing debt, to pay delinquent taxes, or to change business ownership.

- **Special-purpose loans program.** These loans are designed to assist small businesses for specific purposes. They have been used to help small businesses purchase and incorporate pollution control systems, develop employee stock ownership plans, and aid companies negatively impacted by the North American Free Trade Agreement (NAFTA). It includes programs such as the CAPLines, which provide assistance to businesses for meeting their short-term working capital needs. There is also the Community Adjustment and Investment Program. This program is designed to assist businesses that might have been adversely impacted by NAFTA.
- **Express and pilot programs.** These loan programs are designed to accelerate the process of providing loans. SBA Express can respond to a loan application within thirty-six hours while also providing lower interest rates.
- **Community express programs.** These programs are designed to assist borrowers whose businesses are located in economically depressed regions of the country.

- **Patriot express loans.** These loans are designed to assist members of the US military who wish to create or expand a small business. These loans have lower interest rates and can be used for starting a business, real estate purchases, working capital, expansions, and helping the business if the owner should be deployed.
- **Export loan programs.** Given the remarkable fact that 70 percent of American exporters have less than twenty employees, it is not surprising that the SBA makes a special effort to support these businesses by providing specialized loan programs. These programs include the following:
  - **Export Express Program.** This program has a rapid turnaround time to support export-based activities. It can provide for funds up to $500,000 worth of financing. Financing can be either a term loan or a line of credit.
  - **Export Working Capital Program.** A major challenge that small exporters face is the fact that many American banks will not provide working capital advances on orders, receivables, or even letters of credit. This SBA program assures up to the 90 percent of a loan so as to enhance a business's export working capital.
  - **SBA and Ex-Im Bank Coguarantee Program.** This is an extension of the Export Working Capital Program and deals with expanding a business's export working capital lines up to $2 million.
  - **International Trade Loan Program.** This program, with a maximum guarantee of $1.75 million, enables small businesses to start an exporting program, enlarge an exporting program, or deal with the consequences of competition from overseas imports.

Another source of debt financing is the issuance of bonds. Bonds are promissory notes. There are many forms of bonds, and here we discuss only the most basic type. The fundamental format of the bond is that it is a debt instrument that promises to repay a fixed amount of money within a given time frame while providing interest payments on a regular basis. The issuance of bonds is generally an option available to businesses with a corporation format. It also requires extensive legal and financial preparations.

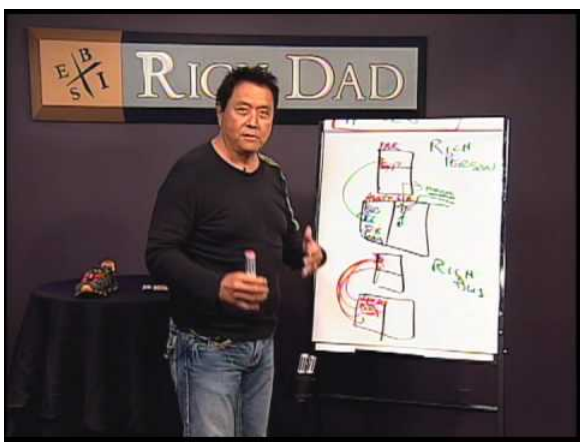
Another source of capital is the generation of internal funding. This simply means that a business plows its retained earnings back into the business. This is a viable source of capital when a business is highly profitable.

The last source of capital is trade credit. Trade credit involves purchasing supplies or equipment through financing made available by vendors. This approach may allow someone to acquire inventory of materials and supplies without having the full price at the time of purchase. Some analysts say that trade credit is the second largest source of financing for small businesses after borrowing from banks.[8] Trade credit is often a vital way of securing supplies.

Trade credit is often expressed in terms of three important numbers—a discount rate, the number of days for one to pay to qualify for the discount, and the number of days on which the bill must be paid. As an example, a trade credit offered by a supplier might be listed as 5/5/30. This translates into a 5 percent discount if the bill is paid within five days of the issuance. The third number means that the bill must be paid *in full* within thirty days.

Video Clip 11.1 How to Raise Capital: The #1 Skill of an Entrepreneur

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



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Video Clip 11.2 Pat Gage: Getting Business Financing for a Small Business

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

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Video Clip 11.3 How to Finance a Business: How to Get Start-Up Business Financing

Examines the use of bank financing for the small business.

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=114

Video Clip 11.4 Financing a New Business: How to Find Government Small Business Grants

Locate places to find small business grants through search engines with ideas from a certified public accountant in this free video on new business financing.

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=114

Video Clip 11.5 The Role of Credit Cards in Small Business Financing

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

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=114

Video Clip 11.6 Financial Analysis for Small-Business Owners

This excerpt from the popular video learning series at BusinessBuffet.com introduces the core concepts behind financial analysis for small business.

https://www.youtube.com/watch?v=Yyq4X71H5Fw

Web Resources

- Financing Small Business Portal: Discusses financing opportunities. www.businessfinance.com/
- Credit Loans for Small Businesses: The Chase portal—one provider of loans for small businesses.

www.chase.com/index.jsp?pg_name=ccpmapp/smallbusiness/credit_loans/page/bb_lending

- Five Ways to Finance a Business in Difficult Financial Times: Alternative ways of financing when banks are not lending.

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

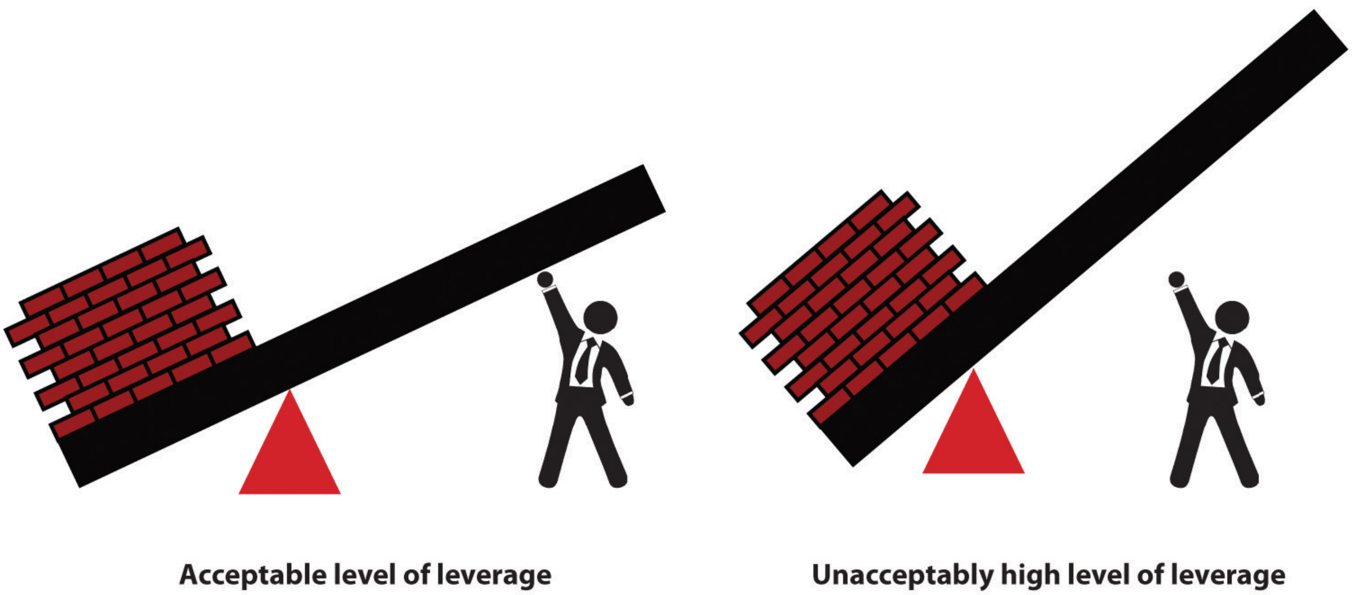
Capital Structure: Debt versus Equity

A critical component of financial planning for any business is determining the extent to which a firm will be financed by debt and by equity. This decision determines the ***financial leverage*** of a business. Many factors enter into this decision, particularly for the small business. From the classic economic and finance perspective, one should evaluate the cost of both debt and equity. Debt's cost centers largely on the interest rate associated with a specific debt. Equity's cost includes ceding control to other equity partners, the cost of issuing stock, and dividend payments. One should also consider the fact that the interest payment on debt is deductible and therefore will lower a business's tax bill.[9] Neither the cost of issuing stock nor dividend payments is tax deductible.

Larger businesses have many more options available to them than smaller enterprises. Although this is not always true, larger businesses can often arrange for larger loans at more favorable rates than smaller businesses.[10] Larger businesses often find it easier to raise capital through the issuance of stock (equity).

By increasing a business's proportion of debt, its financial leverage can be increased. There are many reasons for attempting to increase a business's financial leverage. First, one is growing the business with someone else's money. Second, there is the deductible nature of interest on debt. Third, as more clearly shown in Section 11.3.2 "Capital Structure Issues in Practice", increasing one's financial leverage can have a positive impact on the business's return on equity. For all these benefits, however, there is the inescapable fact that increasing a business's debt level also increases a business's overall risk. The term *financial leverage* can be seen as being comparable to the base word—lever. Levers are tools that can amplify an individual's power. A certain level of debt can amplify the "lifting" power of a business (see the upper portion of Figure 11.2 "Acceptable and Unacceptable Levels of Leverage"). However, beyond a certain point, the debt may be out of reach, and therefore the entire lifting power of financial leverage may be lost (see the lower portion of Figure 11.2 "Acceptable and Unacceptable Levels of Leverage"). Beyond the loss of lifting power, the assumption of too much debt may lead to an inability to pay the interest on the debt.

Figure 11.2 Acceptable and Unacceptable Levels of Leverage



This major issue for small businesses—determining how to raise funds through either debt or equity—often transcends economic or financial decisions. For many small business owners, the ideal way of financing business growth is through generating internal funds. This means that a business does not have to acquire debt but has generated sufficient profits from its operations. Unfortunately, many small businesses, particularly at the beginning, cannot generate sufficient internal funds to finance areas such as product development, the acquisition of new machinery, or market expansions. These businesses have to rely on securing additional capital debt, equity, or some combination of both.

Many individuals start small businesses with the express purpose of finding independence and control over their own economic and business lives. This desire for independence may make many small business owners averse to the idea of equity financing because that might mean ceding business control to equity partners.[11] Another issue that makes some small business owners averse to acquiring additional equity partners is the simple fact that the acquisition of these partners means less profit to the business owner. This factor in the control issue must be considered when the small business owner is looking to raise additional capital through venture capitalist and angel investors.[12]

A recent research paper [13] examined the relationship between profitability and sources of financing for firms that had fewer than twenty-five employees. It found several rather interesting results:

- Firms that use only equity have a low probability of being profitable compared to firms that use only business or personal debt.
- Firms owned by females and minority members relied less on personal debt than male and minority owners.
- Female owners will be more likely to rely on equity from friends and family than their male counterparts.
- Firms that rely exclusively on personal savings to finance business operations will more likely be profitable than firms using equity forms of debt.

Web Resources

- Capital Structure: Definition and explanation of capital structure.

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

- Capital Structure from an Investor's Perspective: This reviews how an investor would interpret a business's capital structure.

beginnersinvest.about.com/od/financialratio/a/capital-structure.htm

Key Takeaways

- Business owner must be aware of the implications of financing their firms.
- Owners should be aware of the financial and tax implications of the various forms of business organizations.
- Business owners should be aware of the impact of financing their firms through equity, debt, internally generated funds, and trade credit.
- Small-business owners should be aware of the various loans, grants, and bond opportunities offered by the SBA. They should also be aware of the restrictions associated with these programs.

Exercises

1. Interview the owners of five local businesses and ask them what business organizational format they use and why they adopted that form.
2. Ask them how they initially financed the start-up of their businesses.
3. Ask these same owners how they prefer to finance the firm. (Note that most owners will probably not want to go into any detail about the financial operations of their businesses.)
4. Ask them if they have had any experience with any SBA loan program and if they have any reactions to these programs.

Financial Control

Learning Objectives

1. Learn about the importance of cultivating a relationship with a banker.
2. Understand the elements of the CAMPARI approach to evaluating a loan.

Relationships with Bank and Bankers

One often hears the following standard complaint of small businesses: bankers lend money only to those businesses that do not need the money. The inverse of this complaint from the bank's standpoint might be that small businesses request money only when they are least likely to be able to repay it. The conflict between small businesses and bankers may stem from a misunderstanding of the respective roles of both groups. At face value, it might appear—particularly to small businesses—that bankers are investing in their companies.

Under normal conditions, bankers are extremely risk averse. This means they are not investors anticipating a substantial return predicated on the risks associated with a particular business. Bankers lend money with the clear expectation that they will be repaid both principal and interest. It is in the interest of both parties to transcend these two conflicting perceptions of the role of bankers in the life of a small business. The key way is for the small business owner to try to foster improved communications with a banker. This communication promoted by the small business owner should become the basis of a solid working relationship with the bank. Most often, this means developing a personal relationship with the loan officer of the bank, which is sometimes a problematic proposition. Bank loan officers are often moved to different branches, or they may change jobs and work for different banks. It should be the responsibility of the small business owner to maintain frequent contact with whoever is representing the bank. This should involve more than just providing quarterly statements. It should include face-to-face discussions and even asking the officer to tour a business's facilities. The point is to personalize the working relationship between the two parties. "Ideally, it's a human relationship as well as a business relationship," says Bill Byne, an entrepreneur and author of *Habits of Wealth*.[14]

Although bankers and loan officers will rely heavily on data related to the creditworthiness of a small business, they will also consider the trustworthiness and integrity of the business owner. This intangible sense that a business owner is a worthy credit risk may play a determinant role in whether a loan is approved with the extension of a credit line. This notion of integrity has to be built over time. It is predicated on projecting an image that you can be counted on to honor what you say, know the right thing to do to make the business a success, and be able to execute the correct decisions.

It is sometimes said that bankers, when reviewing a perspective loan applicant, think of the drink "CAMPARI" which stands for the following:

- **Character.** As previously stated, bankers will consider the issue of personal integrity. Part of that definition of integrity will include a sense of professionalism, which can be reflected in one's attitude and dress. Bankers will also review one's history as a business leader, namely one's track record of success. This notion of character may also be extended to the upper echelon of the management team of a small business.
- **Ability.** The bank's prime concern is with repayment of the principal and the interest of a loan. The loan application should clearly demonstrate a business's ability to repay the loan. All support materials should be brought to bear to prove to the banker that the loan will not be defaulted on and will be paid in a timely fashion.
- **Means.** This refers to a business's ability to function in a way so that it can repay the loan. Bankers must be convinced of this crucial point. The best way to do this is by providing a comprehensive business plan with detailed numbers that indicate the business's ability to repay the loan. The business plan should also include the business strategy and the business model that will be employed to convince the banker of the validity of the overall plan.
- **Purpose.** Bankers want to know for what purpose the borrowed money will be used. You should never request a loan with the argument that having more money is better for the business than having less money. You should clearly identify how the money will be used, such as purchasing a piece of capital equipment. Having done that, you should also indicate how the acquisition of the capital equipment will positively affect the bottom line of the business.
- **Amount.** It would be extraordinarily inadvisable to begin a request for a business loan by saying "I need some money." It is very important that you specify the exact amount of the loan and also justify how you determined this amount of money. As an example, you might want to identify a particular piece of capital equipment that you plan to acquire. How did you determine its price? You should be able to address what additional expenditures might be required—such as training on the use of the equipment. The greater the degree of precision that is brought to this proposal, the greater the confidence the bank might have in granting the loan.
- **Repayment.** This refers to demonstrating an ability to repay both the interest and the principal. Again, detailed documentation, such as sales projections, profit margins, and projected cash flows, is essential if you wish to secure the loan. It is important when generating these data that you try to be as honest as possible. Extremely positive projections may be misleading. Worse still, if they are misleading and inaccurate, it may result in the business defaulting on the loan and perhaps losing the business.
- **Insurance.** Even the most scrupulously developed sales and profit projections might not pan out. It would be extraordinarily useful to show contingency plans to the bank that would indicate how you would repay the loan in the event that the scenarios that you have identified do not come to fruition.

One should recognize that a good relationship with the bank can yield benefits above and beyond credit lines and business loans. Bankers can serve as interlocutors, connecting you to potential customers, suppliers, and other investors. A good working relationship with a bank can be the best reference a business could have. This is particularly true in the current business climate where bankers have significantly restricted lending to small businesses.

Key Takeaways

- Any business owner must be aware that bankers consider several factors when considering a loan decision.
- Business owners should be aware of their own and their business's creditworthiness.
- Business owners should be aware that bankers appreciate precision, particularly when it comes to the exact size of the loan, its purpose, and how it will be repaid.

Exercises

1. Arrange an interview with a loan officer at a local bank. Ask him or her what factors are considered when evaluating a small business loan for
   1. a start-up business
   2. a line-of-credit
   3. an equipment purchase
   4. a real estate purchase
2. Ask him or her how the bank evaluates the risk associated with these loans.
3. Ask the loan officer what might constitute a “red flag” that would mean that the loan would not be approved.

Financial Decision Making

Learning Objectives

1. Learn the importance of a breakeven analysis.
2. Understand how to conduct a breakeven analysis.
3. Understand the potential power and danger of financial leverage.
4. Learn how changing financial leverage can affect measures of profitability, such as ROA and ROE.
5. Learn how to use scenarios to evaluate the impact of various levels of financial leverage.

Break-even Analysis

A ***break-even analysis*** is remarkably useful to someone considering starting up a business. It examines a business’s potential costs—both fixed and variable—and then determines the sales volume necessary to produce a profit for given selling price.[15] This information enables one to determine if the entire concept is feasible. After all, if one has to sell five million shoes in a small town to turn a profit, one would immediately recognize that there may be a severe problem with the proposed business model.

A break-even analysis begins with several simplifying assumptions. In its most basic form, it assumes that you are selling only one product at a particular price, and the production cost per unit is constant over a wide range of values. The purpose of a break-even analysis is to determine the sales volume that is required so that you neither lose money nor make a profit. This translates into a situation in which the profit level is zero. Put in equation form, this simply means

total revenue − total costs = $0.

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

total revenue = total costs.

We can define total revenue as the selling price of the product times the number of units sold, which can be represented as follows:

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

Total costs are seen as being composed of two parts: fixed costs and total variable costs. Fixed costs exist whether or not a firm produces any product or has any sales and consist of rent, insurance, property taxes, administrative salaries, and depreciation. Total variable costs are those costs that change across the volume of production. As part of the simplifying assumptions of the breakeven analysis, it is assumed that there is a constant unit cost of production. This would be based on the labor input and the amount of materials required to make one unit of product. As production increases, the total variable cost will likewise increase, which can be represented as follows:

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

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

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

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

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

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

SP × Q = TC.

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

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

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

SP × Q = FC + (VC × Q).

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

(SP × Q) − (VC × Q) = FC.

Because the term *sales volume* is present in both terms on the left-hand side of the equation, it can be factored to produce

Q × (SP − VC) = FC.

The sales value to produce the break-even point can now be solved for in the following equation:

Q = FC / (SP − VC).

The utility of the concept of break-even point can be illustrated with the following example.

Carl Jacobs, a retired engineer, was a lifelong enthusiast of making plastic aircraft models. Over thirty years, he entered many regional and national competitions and received many awards for the quality of his model building. Part of this success was due to his ability to cast precision resin parts to enhance the look of his aircraft models. During the last ten years, he acquired a reputation as being an expert in this field of creating these resin parts. A friend of his, who started several businesses, suggested that Carl look at turning this hobby into a small business opportunity in his retirement. This opportunity stemmed from the fact that Carl had created a mold into which he could cast the resin part for a particular aircraft model; this same mold could be used to produce several hundred or several thousand copies of the part, all at relatively low cost.

Carl had experience only with sculpturing and casting parts in extremely low volumes—one to five parts at a time. If he were to create a business format for this hobby, he would have to have a significant investment in equipment. There would be a need to create multiple metal molds of the same part so that they could be cast in volume. In addition, there would be a need for equipment for mixing and melting the chemicals that are required to produce the resin. After researching, he could buy top-of-the-line equipment for a total of $33,000. He also found secondhand but somewhat less efficient equipment. Carl estimated that the total cost of acquiring all the necessary secondhand equipment would be close to $15,000. After reviewing the equipment specifications, he concluded that with new equipment, the unit cost of producing a set of resin parts for a model would run $9.25, whereas the unit cost for using the secondhand equipment would be $11.00. After doing some market research, Carl determined that the maximum price he could set for his resin sets would be $23.00. This would be true whether the resin sets were produced with new or secondhand equipment.

Carl wanted to determine how many resin sets would have to be sold to break even with each set of equipment. For simplicity's sake, he assumed that the initial purchase price of both options would be his fixed cost. His analysis is presented in Table 11.1 "break-even point Analysis".

Table 11.1 break-even point Analysis

Option	Fixed Costs	Variable Cost	Selling Price	break-even point
New equipment	$33,000	$9.25/unit	$23.00	Q = $33,000 / ($23.00 − $9.25) Q = $33,000 / $13.75 Q = 2,400 units
Secondhand equipment	$15.000	$11.00/unit	$23.00	Q = $15,000 / ($23.00 − $11.00) Q = $15,000 / $12.00 Q = 1,250 units

From this analysis, he could see that although the secondhand equipment is not as efficient (hence the higher variable cost per unit), it will break even at a significantly lower level of sales than the new equipment. Carl was still curious about the profitability of the two sets of equipment at different levels of sales. So he ran the numbers to calculate the profitability for both sets of equipment at sales levels of 1,000 units, 3,000 units, 5,000 units, 7,500 units, and 10,000 units. The results are presented in Table 11.2 "Sales Level versus Profit Breakdown".

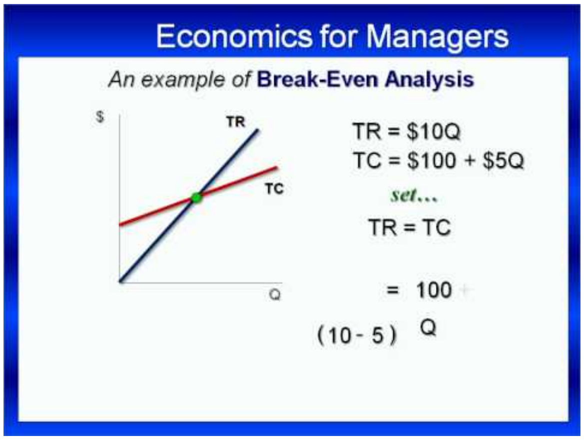
Table 11.2 Sales Level versus Profit Breakdown

	Secondhand Equipment				New Equipment			
Sales Level	**Revenue**	**Fixed Cost**	**Total Variable Costs**	**Profit**	**Revenue**	**Fixed Cost**	**Total Variable Costs**	**Profit**
1,000	$23,000	$15,000	$11,000	$(3,000)	$23,000	$33,000	$9,250	$(19,250)
3,000	$69,000	$15,000	$33,000	$21,000	$69,000	$33,000	$27,750	$8,250
5,000	$115,000	$15,000	$55,000	$45,000	$115,000	$33,000	$46,250	$35,750
7,500	$172,500	$15,000	$82,500	$75,000	$172,500	$33,000	$69,375	$70,125
10,000	$230,000	$15,000	$110,000	$105,000	$230,000	$33,000	$92,500	$104,500

From these results, it is clear that the secondhand equipment is preferable to the new equipment. At 10,000 units, the highest annual sales that Carl anticipated, the overall profits would be greater with secondhand equipment.

Video Clip 11.7 Breakeven Analysis: Economics for Managers

A slide show showing breakeven calculations.



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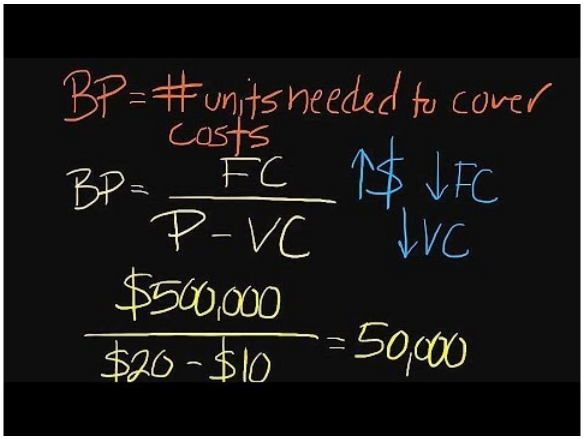
Video Clip 11.8 Break-even Analysis

A break-even tutorial with voice-over.



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Video Clip 11.9 Perform a Break-even Analysis with Excel's Goal Seek Tool

Shows how Excel can be used to conduct sophisticated break-even analyses.

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=114

- Break-even Analysis

This site provides a straightforward description of break-even analysis with an example.

www.businesstown.com/accounting/projections-breakeven.asp

Capital Structure Issues in Practice

In Section 11.2 "Financial Control", the need to balance debt and equity, with respect to financing a firm's operations, is briefly discussed. A critical financial decision for any business owner is determining the extent of financial leverage a firm should acquire. Building a firm using debt amplifies a return of equity to the owners; however, the acquisition of too much debt, which cannot be repaid, may lead to bankruptcy, which represents a complete failure of the firm.

In the early 1950s, the field of finance tried to describe the effect of financial leverage on the valuation of a firm and its cost of capital.[16] A major breakthrough occurred with the works of Franco Modigliani and Merton Miller.[17][18] Reduced to simplest form, their works hypothesized that the valuation of a firm increases as the financial leverage increases. This is true but only *up to a point*. When a firm exceeds a particular value of financial leverage—namely, it has assumed too much debt—the overall value of the firm begins to decline. The point at which the valuation of a firm is maximized determines the optimal capital structure of the business. The model defined valuation as a firm's earnings before interest and taxes (EBIT) divided by its cost of capital. **Cost of capital** is a weighted average of a firm's debt and equity, where equity directly relates to a firm's stock. The reality is that this model is far more closely attuned, from a mathematical standpoint, to the corporate entity. It cannot be directly applied to most small businesses. However, the basic notion that there is some desired level of debt to equity, a level that yields maximum economic benefit, is germane, as we will now illustrate.

Let us envision a small family-based manufacturing firm that until now has been able to grow through the generation of internal funds and the equity that has been invested by the original owners. Presently, the firm has no long-term debt. It has a revolving line of credit, but in the last few years, it has not had to tap into this line of credit to any great extent. The income statement for the year 2010 and the projected income statement for 2011 are given in Table 11.3 "Income Statement for 2010 and Projections for 2011". In preparing the projected income statement for 2011, the firm assumed that sales would grow by 7.5 percent due to a rapidly rising market. In fact, the sales force indicated that sales could grow at a much higher rate if the firm can significantly increase its productive capacity. The projected income statement estimates the cost of goods sold to be 65 percent of the firm's revenue. This estimate is predicated on the past five years' worth of data. Table 11.4 "Abbreviated Balance Sheet" shows an abbreviated balance sheet for 2010 and a projection for 2011. The return on assets (ROA) and the return on equity (ROE) for 2010 and the projected values for 2011 are provided in Table 11.5 "ROA and ROE Values for 2010 and Projections for 2011".

Table 11.3 Income Statement for 2010 and Projections for 2011

	2010	2011
Revenue	$475,000	$510,625
Cost of goods sold	$308,750	$331,906
Gross profit	$166,250	$178,719
General sales and administrative	$95,000	$102,125
EBIT	$71,250	$76,594
Interest	$—	$—
Taxes	$21,375	$22,978
Net profit	$49,875	$53,616

Table 11.4 Abbreviated Balance Sheet

	2010	2011
Total assets	$750,000	$765,000
Long-term debt	$—	$—
Owners' equity	$750,000	$765,000
Total debt and equity	$750,000	$765,000

Table 11.5 ROA and ROE Values for 2010 and Projections for 2011

	2010 (%)	2011 (%)
Return on assets	6.65	7.01
Return on equity	6.65	7.01

After preparing these projections, the owners were approached by a company that manufactures computer-controlled machinery. The owners were presented with a series of machines that will not significantly raise the productive capacity of their business while also reducing the unit cost of production. The owners examined in detail the productive increase in improved efficiency that this computer-controlled machinery would provide. They estimated that demand in the market would increase if they had this new equipment, and sales could increase by 25 percent in 2011, rather than 7.5 percent as they had originally estimated. Further, the efficiencies brought about by the computer-controlled equipment would significantly reduce their operating costs. A rough estimate indicated that with this new equipment the cost of goods sold would decrease from 65 percent of revenue to 55 percent of revenue. These were remarkably attractive figures. The only reservation that the owners had was the cost of this new equipment. The sales price was $200,000, but the business did not have this amount of cash available. To raise this amount of money, they would either have to bring in a new equity partner who would supply the entire amount, borrow the $200,000 as a long-term loan, or have some combination of equity partnership and debt. They first approached a distant relative who has successfully invested in several businesses. This individual was willing to invest $50,000, $100,000, $150,000, or the entire $200,000 for taking an equity position in the firm. The owners also went to the bank where they had line of credit and asked about their lending options. The bank was impressed with the improved productivity and efficiency of the proposed new machinery. The bank was also willing to lend the business $50,000, $100,000, $150,000, or the entire $200,000 to purchase the computer-controlled equipment. The bank, however, stipulated that the lending rate would depend on the amount that was borrowed. If the firm borrowed $50,000, the interest rate would be 7.5 percent; if the amount borrowed was $100,000, the interest rate would increase to 10 percent; if $150,000 was the amount of the loan, the interest rate would be 12.5 percent; and if the firm borrowed the entire $200,000, the bank would charge an interest rate of 15 percent.

To correctly analyze this investment opportunity, the owners could employ several financial tools and methods, such as ***net present value (NPV)***. This approach examines a lifetime stream of additional earnings and cost savings for an investment. The cash flow that might exist is then discounted by the cost of borrowing that money. If the NPV is positive, then the firm should undertake the investment; if it is negative, the firm should not undertake the investment. This approach is too complex—for the needs of this text —to be examined in any detail. For the purpose of illustration, it will be assumed that the owners began by looking at the impact of alternative investment schemes on the projected results for 2011. Obviously, any in-depth analysis of this investment would have to entail multiyear projections.

They examined five scenarios:

1. Their relative provides the entire $200,000 for an equity position in the business.
2. They borrow $50,000 from the bank at an interest rate of 7.5 percent, and their relative provides the remaining $150,000 for a smaller equity position in the business.
3. They borrow $100,000 from the bank at an interest rate of 10 percent, and their relative provides the remaining $100,000 for a smaller equity position in the business.
4. They borrow $150,000 from the bank at an interest rate of 12.5 percent, and their relative provides the remaining $50,000 for an even smaller equity position in the business.
5. They borrow the entire $200,000 from the bank at an interest rate of 15 percent.

Table 11.6 “Income Statement for the Five Scenarios” presents the income statement for these five scenarios. (An abbreviated balance sheet for the five scenarios is given in Table 11.7 “Abbreviated Balance Sheet for the Five Scenarios”.) All five scenarios begin with the assumption that the new equipment would improve productive capacity and allow sales to increase, in 2011, by 25 percent, rather than the 7.5 percent that had been previously forecasted. Likewise, all five scenarios have the same cost of goods sold, which in this case is 55 percent of the revenues rather than the anticipated 65 percent if the new equipment is not purchased. All five scenarios have the same EBIT. The scenarios differ, however, in the interest payments. The first scenario assumes that all $200,000 would be provided by a relative who is taking an equity position in the firm. This is not a loan, so there are no interest payments. In the remaining four scenarios, the interest payments are a function of the amount borrowed and the corresponding interest rate. The payment of interest obviously impacts the earnings before taxes (EBT) and the amount of taxes that have to be paid. Although the tax bill for those scenarios where money has been borrowed is less than the scenario where the $200,000 is provided by equity, the net profit also declines as the amount borrowed increases.

Table 11.6 Income Statement for the Five Scenarios

	Borrow $0	Borrow $50,000	Borrow $100,000	Borrow $150,000	Borrow $200,000
Revenue	$593,750	$593,750	$593,750	$593,750	$593,750
Cost of goods sold	$326,563	$326,563	$326,563	$326,563	$326,563
Gross profit	$267,188	$267,188	$267,188	$267,188	$267,188
General sales and administrative	$118,750	$118,750	$118,750	$118,750	$118,750
EBIT	$148,438	$148,438	$148,438	$148,438	$148,438
Interest	$—	$3,750	$10,000	$18,750	$30,000
Taxes	$44,531	$43,406	$41,531	$38,906	$35,531
Net profit	$103,906	$101,281	$96,906	$90,781	$82,906

Table 11.7 Abbreviated Balance Sheet for the Five Scenarios

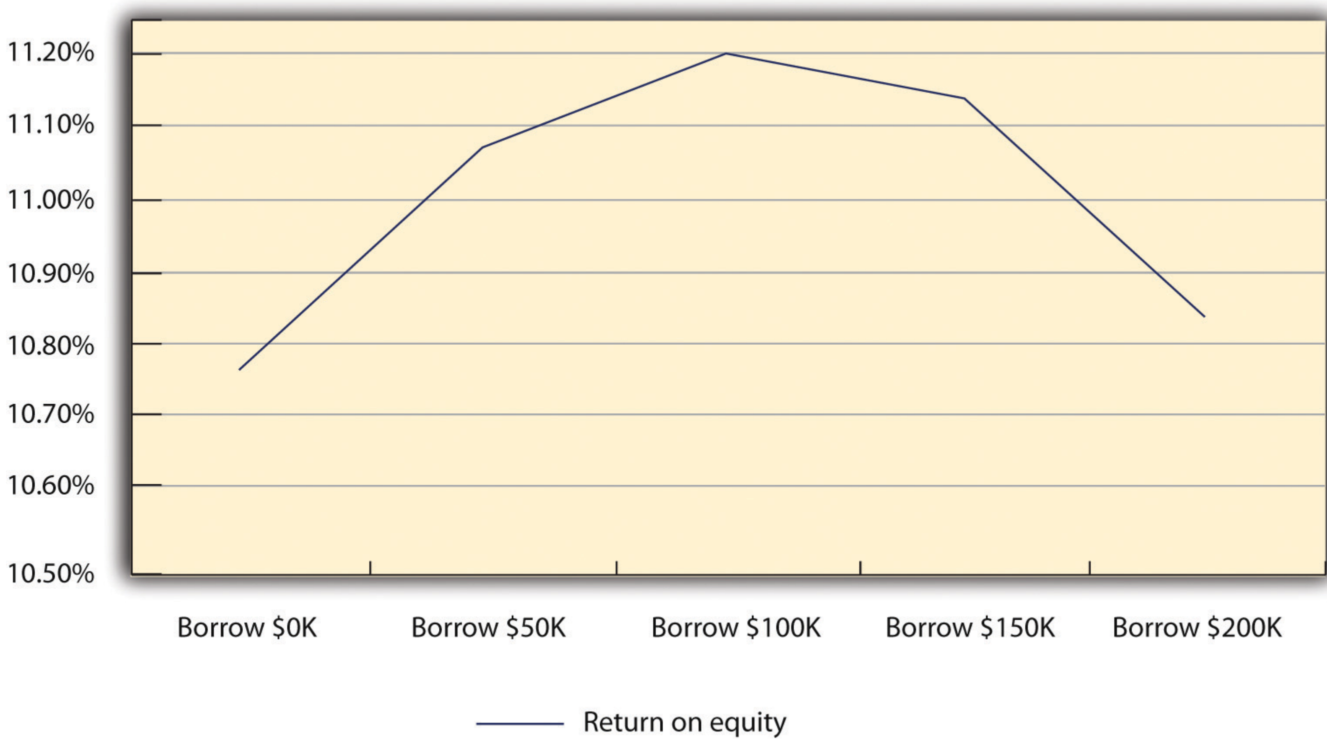
	Borrow $0	Borrow $50,000	Borrow $100,000	Borrow $150,000	Borrow $200,000
Total assets	$965,000	$965,000	$965,000	$965,000	$965,000
Long-term debt	$—	$50,000	$100,000	$150,000	$200,000
Owners' equity	$965,000	$915,000	$865,000	$815,000	$765,000
Total debt and equity	$965,000	$965,000	$965,000	$965,000	$965,000

The owners then calculated the ROA and the ROE for the five scenarios (see Table 11.8 "ROA and ROE for the Five Scenarios"). When they examined these results, they noticed that the greatest ROA occurred when the new machinery was financed exclusively by equity capital. The ROA declined as they began to fund new machinery with debt: the greater the debt, the lower the ROA. However, they saw a different situation when they looked at the ROE for each scenario. The ROE was greater in each scenario where the machinery was financed either exclusively or to some extent by debt. In fact, the lowest ROE (the firm borrowed the entire $200,000) was 50 percent higher than if the firm did not acquire the new equipment. A further examination of the ROE results provides a very interesting insight. The ROE increases as the firm borrows up to $100,000 of debt. When the firm borrows more money ($150,000 or $200,000), the ROE declines (see Figure 11.3 "ROE for the Five Scenarios"). This is a highly simplified example of optimal capital structure. There is a level of debt beyond which the benefits measured by ROE begins to decline. Small businesses must be able to identify their "ideal" debt-to-equity ratio.

Table 11.8 ROA and ROE for the Five Scenarios

	Borrow $0	Borrow $50,000	Borrow $100,000	Borrow $150,000	Borrow $200,000
ROA	10.77%	10.50%	10.04%	9.41%	8.59%
ROE	10.77%	11.07%	11.20%	11.14%	10.84%

Figure 11.3 ROE for the Five Scenarios



The owners decided to carry their analysis one step further; they wondered if the sales projections were too enthusiastic. They were concerned about the firm's ability to repay any loan should there be a drop in sales. Therefore, they decided to examine a worst-case scenario. Such analyses are absolutely critical if one is to fully evaluate the risk of undertaking debt. They ran the numbers to see what the results would be if there was a 25 percent decrease in sales in 2011 rather than a 25 percent increase in sales compared to 2010. The results of this set of analyses are in Table 11.9 “Income Statement for the Five Scenarios Assuming a 25 Percent Decrease in Sales”. Even with a heavy debt burden for the five scenarios, the firm is able to generate a profit, although it is a substantially lower profit compared to if sales increased by 25 percent. They examined the impact of this proposed declining sales on ROA and ROE. These results are found in Table 11.10 “ROA and ROE for the Five Scenarios under the Condition of Declining Sales”.

Table 11.9 Income Statement for the Five Scenarios Assuming a 25 Percent Decrease in Sales

	Borrow $0	Borrow $50,000	Borrow $100,000	Borrow $150,000	Borrow $200,000
Revenue	$356,250	$356,250	$356,250	$356,250	$356,250
Cost of goods sold	$195,938	$195,938	$195,938	$195,938	$195,938
Gross profit	$160,313	$160,313	$160,313	$160,313	$160,313
General sales and administrative	$71,250	$71,250	$71,250	$71,250	$71,250
EBIT	$89,063	$89,063	$89,063	$89,063	$89,063
Interest	$—	$3,750	$10,000	$18,750	$30,000
Taxes	$26,719	$25,594	$23,719	$21,094	$17,719
Net profit	$62,344	$59,719	$55,344	$49,219	$41,344

Table 11.10 ROA and ROE for the Five Scenarios under the Condition of Declining Sales

	Borrow $0	Borrow $50,000	Borrow $100,000	Borrow $150,000	Borrow $200,000
ROA	6.46%	6.19%	5.74%	5.10%	4.28%
ROE	6.46%	6.53%	6.40%	6.04%	5.40%

Video Clip 11.10 Debt Financing versus Equity Financing: Which Is Best for Us?

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

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=114

Video Clip 11.11 Capital Structure

Compares capital structure to a commercial aircraft.

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=114

Video Clip 11.12 Lecture in Capital Structure

Explains why capital structure matters.

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Video Clip 11.13 The Capital Structure of a Company

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

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Key Takeaways

- A relatively simply model—breakeven analysis—can indicate what sales level is required to start making a profit.
- Financial leverage—the ratio of debt to equity—can improve the economic performance of a business as measured by ROE.
- Excessive financial leverage—too much debt—can begin to reduce the economic performance of a business.
- There is an ideal level of debt for a firm, which is its optimal capital structure.

Exercises

1. A new start-up business will have fixed costs of $750,000 per year. It plans on selling one product that will have a variable cost of $20 per unit. What is the product’s selling price to break even?
2. Using data from the business in Exercise 1, in its second year of operation, it adds a second selling facility, which increases the fixed cost by $250,000. The variable cost has now decreased by $2.50 per unit. What is the new selling price to break even?
3. Using the example in Section 10.3.2 “Capital Structure Issues in Practice”, how would the ROA and the ROE change if economic conditions made borrowing money more expensive? Specifically, what would be the impact if the interest rate on $50,000 was 10 percent; $100,000, 15 percent; $150,000, 17.5 percent; and $200,000, 20 percent?
4. Again using the example in Section 10.3.2 “Capital Structure Issues in Practice”, how much would sales have to decrease to threaten the business’s ability to repay its interest on a $100,000 loan?

The Three Threads

Learning Objectives

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

Customer Value

There has been extensive discussion of the notion of market segmentation. By segmenting the market, one improves the probability that a business will be able to better serve particular customers’ needs and thus provide better customer value. From a financial perspective, there may be an equivalent notion of segmentation. Earlier discussions on market segmentation were centered on how a business could provide value to particular sets of customers. A subsequent stage of this analysis would be to examine how and if these customers can provide value to a business. No one is served if the business provides significant value to its customers but the business goes broke in the process. The financial equivalent of customer segmentation examines the profitability of different groups of customers. Some customer groups may be extremely profitable to a firm, while others produce nothing but losses. Identifying these different groups requires a commitment to accounting and a financial analysis of each customer base. The first step is to determine the margin provided by each customer group. In many cases, this is a bit of a challenge. It may require more extensive record keeping. The business may have to use ***activity-based costing systems***. (Activity-based costing systems were developed in the late 1970s and the early 1980s.) This approach to accounting “[I]s a process where costs are assigned due to the cause and effect relationship between costs and the activity that drives the cost.”[19]

Done properly, activity-based accounting can help a business identify the true costs for serving particular customer groups and therefore identify their real profit margins. A business may discover that some customer groups are actually a source of losses for the firm.

It should be pointed out that activity-based accounting is complex, difficult to implement, and, in some instances, does not conform to the requirements of generally accepted accounting principles. This might mean that a business would have to have two coexisting accounting systems, which may be too much of a burden for the small business.

Cash-Flow Implications

It should not be too surprising to find that good financial management can benefit tremendously when a firm’s cash flow is improved. Two areas where good financial management can help would be e-procurement and factoring. ***E-procurement*** involves managing the timing of invoices to customers and from suppliers to improve the cash flow of the firm.[20] The electronic handling of orders and their associated invoices assures that customers will receive their orders in a more timely fashion. E-procurement means that fewer personnel are required to take and handle orders. This can be a tremendous source of cash saving in and of itself. E-procurement should be on any supply chain management program of a business.

Another area where good financial management can improve cash flow is factoring. The most common form of factoring is associated with a business's accounts receivable. Trade credits involve purchasing and taking delivery of supplies now while planning to pay for it later. (See Section 11.1 "The Importance of Financial Management in Small Business" for a discussion of trade credits.) Three key numbers often identify trade credits: a discount rate for early payment, the time to pay to take advantage of the discount rate, and the date by which the entire bill must be paid. We underscore the kinds of the factoring with the following example.

A firm makes a large sale of supplies—$200,000. The trade credit program is 2/10/60. This means that the firm will give a 2 percent discount if the customer pays the entire $200,000 within 10 days and expects the payment of the entire $200,000 within the next 60 days. The firm knows that its customer never exercises the discount opportunity and always pays on the last possible date. Further, let us assume that this firm is having a problem with its cash flow. It would like to expedite payment as quickly as possible but does not expect that the customer will obtain a 2 percent discount by paying within 10 days. This firm could exercise the factoring option. This business goes to another firm that would provide as much as 80 percent of the cash receivable invoice immediately for small fee. In other words, the firm would receive $160,000 immediately rather than waiting 60 days. When its customer pays the bill, the firm would receive, in total, slightly less than the $200,000 but would have expedited the payment and thus aided its cash flow. Factoring can be an important element in improving the overall cash flow of any firm.

Digital Technology and E-Environment Implications

We identify four sources of capital in Section 11.1 "The Importance of Financial Management in Small Business", one of which is internally generated funds. Businesses can increase the supply of capital money by becoming more operationally efficient. Improved operational efficiency can save any organization considerable amounts of money. Many start-ups, particularly those with some technological savvy, use technology to produce significant cost savings. This recognition of the vital role of technology as a cost-saving tool came to the forefront at a recent GeeknRolla conference in London. This conference brings together new business start-ups and potential investors. There is a heavy emphasis on how new businesses (and established businesses) can successfully integrate a variety of technologies and improve their operational efficiencies. As one participant in the conference, Michael Jackson, an investor, said, "Companies that are cottoning on quickly to these tools are doing very well, and they are taking business away from those who are too slow to adapt."[21]

The 2011 conference paid special attention to the concept of ***cloud computing***. This term refers to having software programs and databases located on an outsourced site. As an example, rather than buying Microsoft's Office Suite for every computer in a business, one could access a word-processing program, a spreadsheet program, or a database as needed. The firm would be charged for each use or a monthly fee rather than having to purchase an entire package. As Sharif Sakr said, "In addition to being 'pay-as-you-go,' cloud computing has the advantage of reducing the number of computers, servers and network connections that a small business needs."[22]

In addition to reducing a small business's initial commitment to an information technology (IT) infrastructure—computers, software, network systems, and IT staff—cloud computing provides some of the following additional benefits:

- **Scalability.** Many cloud applications allow for the growth of a business. As an example, some cloud accounting packages charge on the basis of the number of users; therefore, a company could purchase as much capability as it needed.
- **Updates.** Businesses do not have to worry about purchasing the latest version of the software, uninstalling the old version, and installing the latest version. This is done automatically by the vendor.
- **Access.** Cloud programs can be accessed wherever one has a connection to the Internet. A business is not tied to its own computer or the network where the software resides. This results in tremendous flexibility; as an example, one can access the program and the data while on the road with a client.
- **Integration.** Having programs and databases on the cloud facilitates multiple members of an organization successfully working together. No one has to worry whether he or she is working with the latest version of the spreadsheet or the client list.
- **Security.** Cloud providers recognize that securing their client's data is a core issue for business survival. They will bring into play the required technology to ensure that every one's data are secure and safe. They have much greater capability of assuring this than almost any small business.
- **Customization.** Businesses can acquire the software that they need.
- **Extensions into the world of social media.** More and more businesses are using various forms of social media—Facebook, Twitter, LinkedIn, and so forth—yet many small businesses lack the technological savvy to fully exploit these new avenues of marketing. Cloud providers can assist these businesses in this vital area. [23]

So how can smaller businesses aspire to efficiencies that much larger organizations have achieved through the use of IT while achieving it at a fraction of the cost? Entire accounting systems can be placed on the cloud. FreshBooks, which is free for solo location businesses, provides an accounting system that can be extended to allow business operators to submit invoices via the iPhone. Shoeboxed, another cloud-based company, allows small businesses to take digitalized receipts and turn them into invoices.

Owners and employees can more productively manage their time by using a variety of scheduling programs. TimeTrade is an effective personal scheduling assistant. It can show prospective clients available times and assist in arranging a scheduled appointment. Major companies, such as Microsoft and Google, provide cloud-based applications that can be employed by both large corporations and the smallest of businesses. Microsoft has an e-mail system—Exchange—that can be used by smaller businesses for fees as low as $50 per month. Google Voice can translate voice mail and e-mail messages and forward them anywhere in the world. Programs such as Mail-Chimp can send information packages to any or all of a business's clients and then automatically post the same information on the company's Facebook and Twitter sites.

Key Takeaways

- Just as a business must identify what is of value to its customers, it should also determine how valuable its customers are to the business.
- It may not "pay" to attract and keep all customers.
- Techniques such as factoring accounts receivable may improve the cash flow of a firm.
- The use of cloud computing can significantly reduce costs and improve the financial position of a firm.
- Local, national, and international economic conditions can affect any firm. Businesses should plan on how to deal with major economic upheavals.

Exercises

1. Search the Internet to find out about the availability and price of activity-based accounting software.
2. Imagine your boss has asked you to prepare a small report on using factoring as an option in her auto parts business. Search the Internet to find out about the economics of factoring.
3. Prepare a report on accounting and finance software packages available through cloud computing. Discuss their pros, cons, and pricing structures.

Disaster Watch

If one looks at that statement at face value, the only conclusion one can come to is that failure solely rests on the shoulders of the small business owner. This is far from the full story. Small businesses can face disastrous financial situations over which they have absolutely no control. This simple fact has been brought to the forefront in the last few years with the economic downturn.

For most small businesses, the major source of external financing comes from banks. Anything that affects the banks' ability or desire to lend to small businesses can have a profound effect. One of the first responses on the part of commercial banks to the crisis of 2008 was a severe restriction of credit. At the height of the crisis in October 2008, nearly 72 percent of large banks and 78 percent of small banks stated that they were tightening their credit standards for small businesses[24]. This slightly more restrictive approach on the part of smaller banks represented a change from some prior recessions. Berger and Udell (1994) found that during the credit crunch of 1990–92 smaller banks were more willing to lend than larger banks.[25]

The current credit crunch has even more significance for small businesses. The originator of current economic difficulties was in the US real estate industry. The result has been a significantly depressed real estate market. Many small businesses use either personal residences or business property (real estate) as the basis for collateral to secure loans. A depressed real estate market reduces the viability of this option. Other negative consequences for small businesses in this current economic environment revolve around its impact on alternatives of raising capital via commercial bank loans. In earlier credit crunches, many small businesses turned to commercial finance companies. These types of companies would lend money to small businesses that pledged assets as collateral[26]. Since the early 1990s, many of these firms either disappeared or have been absorbed by larger commercial banking institutions. Today, many of the largest firms in the United States are holding onto cash (some estimate it in the neighborhood of $2 trillion to $3 trillion). Their unwillingness to spend or invest is impacting smaller businesses that operate further down the supply chain. Another impact of the current economic crisis has been that many banks have changed their lending practices for credit cards. They have raised rates, raised fees, and lowered credit limits. Many small businesses are sometimes reduced to using credit cards as a basis for attaining short-term financing for purchases or meeting bills. This sudden change in the "rules of the game" for credit cards has presented many small businesses with an unexpected challenge.

None of these changes in the financial landscape were brought about by the decision making or the knowledge of entrepreneurs and small business operators. Only an extraordinarily small number of financial experts saw the crisis coming. Nonetheless, entrepreneurs and small business owners have found that they must learn to rapidly adapt to what is simply a disastrous situation. The financial lesson to be learned from the current crisis is that any business, particularly small businesses, must prepare to have alternative sources of financing available for the continued operations.

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3.3: Chapter 12- Personal Finances

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Do you wonder where your money goes? Do you have trouble controlling your spending? Have you run up the balances on your credit cards or gotten behind in your payments and hurt your credit rating? Do you worry about how you'll pay off your student loans? Would you like to buy a new car or even a home someday and you're not sure where the money will come from? If you do have extra money, do you know how to invest it? Do you know how to find the right job for you, land an offer, and evaluate the company's benefits? If these questions seem familiar to you, you could benefit from help in managing your personal finances. This chapter will provide that help.

Where Does Your Money Go?

Learning Objectives

1. Offer advice to someone who is burdened with debt.
2. Offer advice to someone whose monthly bills are too high.

Let's say that you're single and twenty-eight. You have a good education and a good job—you're pulling down $60K working with a local accounting firm. You have $6,000 in a retirement savings account, and you carry three credit cards. You plan to buy a house (maybe a condo) in two or three years, and you want to take your dream trip to the world's hottest surfing spots within five years (or, at the most, ten). Your only big worry is the fact that you're $70,000 in debt, mostly from student loans, your car loan, and credit card debt. In fact, even though you've been gainfully employed for a total of six years now, you haven't been able to make a dent in that $70,000. You can afford the necessities of life and then some, but you've occasionally wondered if you're ever going to have enough income to put something toward that debt.[1]

Now let's suppose that while browsing through a magazine in the doctor's office, you run across a short personal-finances self-help quiz. There are two sets of three statements each, and you're asked to check off each statement with which you *agree*:

- **Part 1**
- If I didn't have a credit card in my pocket, I'd probably buy a lot less stuff.
- My credit card balance usually goes up at the holidays.
- If I really want something that I can't afford, I put it on my credit card or sign up for a payment plan.

- **Part 2**
- I can barely afford my apartment.
- Whenever something goes wrong (car repairs, doctors' bills), I have to use my credit card.
- I almost never spend money on stuff I don't need, but I always seem to owe a balance on my credit card bill.

At the bottom of the page, you're asked whether you agreed with *any* of the statements in Part 1 and *any* of the statements in Part 2. It turns out that you answered yes in both cases and are thereby informed that you're probably jeopardizing your entire financial future.

Unfortunately, personal-finances experts tend to support the author of the quiz: if you agreed with any statement in Part 1, you have a problem with splurging; if you agreed with any statement in Part 2, your monthly bills are too high for your income.

Building a Good Credit Rating

So, you have a financial problem: according to the quick test you took, you're a splurger and your bills are too high for your income. How does this put you at risk? If you get in over your head and can't make your loan or rent payments on time, you risk hurting your credit—your ability to borrow in the future.

Let's talk about your credit. How do potential lenders decide whether you're a good or bad credit risk? If you're a poor credit risk, how does this affect your ability to borrow, or the rate of interest you have to pay, or both? Here's the story. Whenever you use credit, those you borrow from (retailers, credit card companies, banks) provide information on your debt and payment habits to three national credit bureaus: Equifax, Experian, and TransUnion. The credit bureaus use the information to compile a numerical credit score, generally called a FICO score; it ranges from 300 to 900, with the majority of people falling in the 600–700 range. (Here's a bit of trivia to bring up at a dull party: FICO stands for Fair Isaac Company—the company that developed the score.) In compiling the score, the credit bureaus consider five criteria: payment history—do you pay your bills on time? (the most important), total amount owed, length of your credit history, amount of new credit you have, and types of credit you use. The credit bureaus share their score and other information about your credit history with their subscribers.

So what does this do for you? It depends. If you paid your bills on time, carried only a reasonable amount of debt, didn't max out your credit cards, had a history of borrowing, hadn't applied for a bunch of new loans, and borrowed from a mix of lenders, you'd be in good shape. Your FICO score would be high and lenders would like you. Because of your high credit score, they'd give you the loans you asked for at reasonable interest rates. But if your FICO score is low (perhaps you weren't so good at paying your bills on time), lenders won't like you and won't lend you money (or would lend it to you at high interest rates). A low FICO score can raise the amount you have to pay for auto insurance and cell phone plans and can even affect your chances of renting an apartment or landing a particular job. So it's very, very, very (the last "very" is for emphasis) important that you do everything possible to earn a high credit score. If you don't know your score, here is what you should do: go to https://www.quizzle.com/ and request a free copy of your credit report.

As a young person, though, how do you build a credit history that will give you a high FICO score? Your means for doing this changed in 2009 with the passage of the Credit CARD Act, federal legislation designed to stop credit card issuers from treating its customers unfairly.[2] Based on feedback from several financial experts, Emily Starbuck Gerson and Jeremy Simon of CreditCards.com compiled the following list of ways students can build good credit.[3]

1. *Become an authorized user on your parents' account.* According to the rules set by the Credit CARD Act, if you are under age twenty-one and do not have independent income, you can get a credit card in your own name **only** if you have a cosigner (who is over twenty-one and does have an income). This is a time when a parent can come in handy. Your parent could add you to his or her credit card account as an authorized user. Of course, this means your parent will know what you're spending your money on (which could make for some interesting conversations). But, on the plus side, by piggybacking on your parent's card you are building good credit (assuming, of course, that your parent pays the bill on time).
2. *Obtain your own credit card.* If you can show the credit card company that you have sufficient income to pay your credit card bill, you might be able to get your own card. It isn't as easy to get a card as it was before the passage of the Credit CARD Act, and you won't get a lot of goodies for signing up (as was true before), but you stand a chance.
3. *Get the right card for you.* If you meet the qualifications to get a credit card on your own, look for the best card for you. Although it sounds enticing to get a credit card that gives you frequent flyer miles for every dollar you spend, the added cost for this type of card, including higher interest charges and annual fees, might not be worth it. Look for a card with a low interest rate and no annual fee. As another option, you might consider applying for a retail credit card, such as a Target or Macy's card.
4. *Use the credit card for occasional, small purchases.* If you do get a credit card or a retail card, limit your charges to things you can afford. But don't go in the other direction and put the card in a drawer and never use it. Your goal is to build a good credit history by showing the credit reporting agencies that you can handle credit and pay your bill on time. To accomplish this, you need to use the card.
5. *Avoid big-ticket buys, except in case of emergency.* Don't run up the balance on your credit card by charging high-cost, discretionary items, such as a trip to Europe during summer break, which will take a long time to pay off. Leave some of your credit line accessible in case you run into an emergency, such as a major car repair.
6. *Pay off your balance each month.* If you cannot pay off the balance on your credit card each month, this is likely a signal that you're living beyond your means. Quit using the card until you bring the balance down to zero. When you're first building credit, it's important to pay off the balance on your card at the end of each month. Not only will this improve your credit history, but it will save you a lot in interest charges.
7. *Pay all your other bills on time.* Don't be fooled into thinking that the only information collected by the credit agencies is credit card related. They also collect information on other payments including phone plans, Internet service, rental payments, traffic fines, and even library overdue fees.
8. *Don't cosign for your friends.* If you are twenty-one and have an income, a nonworking, under-age-twenty-one friend might beg you to cosign his credit card application. Don't do it! As a cosigner, the credit card company can make you pay your friend's balance (plus interest and fees) if he fails to meet his obligation. And this can blemish your own credit history and lower your credit rating.
9. *Do not apply for several credit cards at one time.* Just because you can get several credit cards, this doesn't mean that you should. When you're establishing credit, applying for several cards over a short period of time can lower your credit rating. Stick with one card.
10. *Use student loans for education expenses only, and pay on time.* For many, student loans are necessary. But avoid using student loans for noneducational purposes. All this does is run up your debt. When your loans become due, consolidate them if appropriate and don't miss a payment.

What if you've already damaged your credit score—what can you do to raise it? Do what you should have done in the first place: pay your bills on time, pay more than the minimum balance due on your credit cards and charge cards, keep your card balances low, and pay your debts off as quickly as possible. Also, scan your credit report for any errors. If you find any, work with the credit bureau to get them corrected.

Understand the Cost of Borrowing

Because your financial problem was brought on, in part, because you have too much debt, you should stop borrowing. But, what if your car keeps breaking down and you're afraid of getting stuck on the road some night? So, you're thinking of replacing it with a used car that costs $10,000. Before you make a final decision to incur the debt, you should understand its costs. The rate of interest matters a lot. Let's compare three loans at varying interest rates: 6, 10, and 14 percent. We'll look at the monthly payment, as well as the total interest paid over the life of the loan.

$10,000 Loan for 4 Years at Various Interest Rates			
Interest Rate	6%	10%	14%
Monthly Payment	$235	$254	$273
Total Interest Paid	$1,272	$2,172	$3,114

If your borrowing interest rate is 14 percent, rather than 6 percent, you'll end up paying an additional $1,842 in interest over the life of the loan. Your borrowing cost at 14 percent is more than twice as much as it is at 6 percent. The conclusion: search for the best interest rates and add the cost of interest to the cost of whatever you're buying before deciding whether you want it and can afford it. If you have to borrow the money for the car at the 14 percent interest rate, then the true cost of the car isn't $10,000, but rather $13,114.

Now, let's explore the complex world of credit cards. First extremely important piece of information: not all credit cards are equal. Second extremely important piece of information: watch out for credit card fees! Credit cards are a way of life for most of us. But they can be very costly. Before picking a credit card, do your homework. A little research can save you a good deal of money. There are a number of costs you need to consider:

- *Finance charge*. The interest rate charged to you often depends on your credit history; those with good credit get the best rates. Some cards offer low "introductory" rates—but watch out; these rates generally go up after six months.
- *Annual fee*. Many credit cards charge an annual fee: a yearly charge for using the card. You can avoid annual fees by shopping around (though there can be trade-offs: you might end up paying a higher interest rate to avoid an annual fee).
- *Over-limit fee*. This fee is charged whenever you exceed your credit line.
- *Late payment fee*. Pretty self-explanatory, but also annoying. Late payment fees are common for students; a study found students account for 6 percent of all overdraft fees.[4] One way to decrease the chance of paying late is to call the credit card company and ask them to set your payment due date for a time that works well for you. For example, if you get paid at the end of the month, ask for a payment date around the 10th of the month. Then you can pay your bill when you get paid and avoid a late fee.
- *Cash advance fee*. While it's tempting to get cash from your credit card, it's pretty expensive. You'll end up paying a fee (around 3 percent of the advance), and the interest rate charged on the amount borrowed can be fairly high.

An alternative to a credit card is a debit card, which pulls money out of your checking account whenever you use the card to buy something or get cash from an ATM. These cards don't create a loan when used. So, are they better than credit cards? It depends—each has its advantages and disadvantages. A big advantage of a credit card is that it helps you build credit. A disadvantage is that you can get in over your head in debt and possibly miss payments (thereby incurring a late payment fee). Debit cards help control spending. Theoretically, you can't spend more than you have in your checking account. But be careful—if you don't keep track of your checking account balance, it's easy to overdraft your account when using your debit card. Prior to July 2010, most banks just accepted purchases or ATM withdrawals even if a customer didn't have enough money in his or her account to cover the transaction. The banks didn't do this to be nice, and they didn't ask customers if they wanted this done—they just overdrafted the customer's account and charged the customer a hefty overdraft fee of around $35 through what they call an "overdraft protection program".[5] Overdraft fees can be quite expensive, particularly if you used the card to purchase a hamburger and soda at a fast-food restaurant.

The Federal Reserve changed the debit card rules in 2010, and now banks must get your permission before they enroll you in an overdraft protection program.[6] If you opt in (agree), things work as before: You can spend or take out more money through an ATM machine than you have in your account, and the bank lets you do this. But it charges you a fee of about $30 plus additional fees of $5 per day if you don't cover the overdraft in five days. If you don't opt in, the bank will not let you overdraft your account. The downside is that you could get embarrassed at the cash register when your purchase is rejected or at a restaurant when trying to pay for a meal. Obviously, you want to avoid being charged an overdraft fee or being embarrassed when paying for a purchase. Here are some things you can do to decrease the likelihood that either would happen:[7]

- Ask your bank to e-mail or text you when your account balance is low.
- Have your bank link your debit card account to a savings account. If more money is needed to cover a purchase, the bank will transfer the needed funds from your savings to your checking account.
- Use the online banking feature offered by most banks to check your checking account activity.

A Few More Words about Debt

What should you do now to turn things around—to start getting out of debt? According to many experts, you need to take two steps:

1. Cut up your credit cards and start living on a cash-only basis.
2. Do whatever you can to bring down your monthly bills.

Figure 12.1 Visa Credit Card

Living on a cash-only basis is the first step in getting debt under control.[8]

Step 1 in this abbreviated two-step personal-finances "plan" is probably the easier of the two, but taking even this step can be hard enough. In fact, a lot of people would find it painful to give up their credit cards, and there's a perfectly logical reason for their reluctance: the degree of pain that one would suffer from destroying one's credit cards probably stands in direct proportion to one's reliance on them.

As of May 2011, total credit card debt in the United States is about $780 billion, out of $2.5 trillion in total consumer debt. Closer to home, one recent report puts *average credit card debt per U.S. household* at $16,000 (up 100 percent since 2000). The 600 million credit cards held by U.S. consumers carry an average interest rate on these cards of 15 percent.[9] Why are these numbers important? Primarily because, *on average*, too many consumers have debt that they simply can't handle. "Credit card debt," says one expert on the problem, "is clobbering millions of Americans like a wrecking ball,"[10] and if you're like most of us, you'd probably like to know whether your personal-finances habits are setting you up to become one of the clobbered.

If, for example, you're worried that your credit card debt may be overextended, the American Bankers Association suggests that you ask yourself a few questions:[11]

- Do I pay only the minimum month after month?
- Do I run out of cash all the time?
- Am I late on critical payments like my rent or my mortgage?
- Am I taking longer and longer to pay off my balance(s)?
- Do I borrow from one credit card to pay another?

If such habits as these have helped you dig yourself into a hole that's steadily getting deeper and steeper, experts recommend that you take three steps as quickly as possible:[12]

1. *Get to know the enemy*. You may not want to know, but you should collect all your financial statements and figure out exactly how much credit card debt you've piled up.
2. *Don't compound the problem with late fees*. List each card, along with interest rates, monthly minimums, and due dates. Bear in mind that paying late fees is the same thing as tossing what money you have left out the window.
3. *Now cut up your credit cards (or at least stop using them)*. Pay cash for everyday expenses, and remember: swiping a piece of plastic is one thing (a little too easy), while giving up your hard-earned cash is another (a little harder).

And, if you find you're unable to pay your debts, don't hide from the problem, as it will not go away. Call your lenders and explain the situation. They should be willing to work with you in setting up a payment plan. If you need additional help, contact a nonprofit credit assistance group such as the National Foundation for Credit Counseling (http://www.nfcc.org).

Why You Owe It to Yourself to Manage Your Debts

Now, it's time to tackle step 2 of our recommended personal-finances miniplan: do whatever you can to bring down your monthly bills. As we said, many people may find this step easier than step 1—cutting up your credit cards and starting to live on a cash-only basis.

If you want to take a gradual approach to step 2, one financial planner suggests that you perform the following “exercises” for one week: [13]

- Keep a written record of everything you spend and total it at week’s end.
- Keep all your ATM receipts and count up the fees.
- Take $100 out of the bank and don’t spend a penny more.
- Avoid gourmet coffee shops.

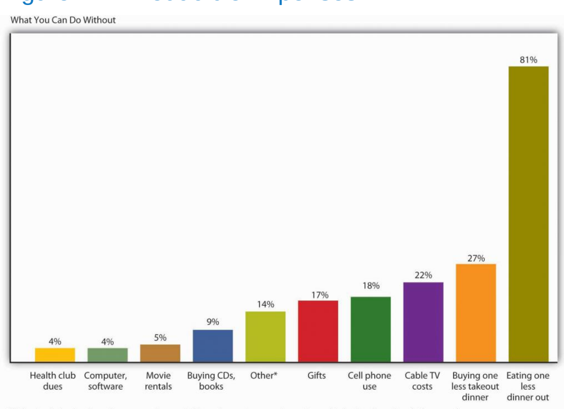
Among other things, you’ll probably be surprised at how much of your money can become somebody else’s money on a week-by-week basis. If, for example, you spend $3 every day for one cup of coffee at a coffee shop, you’re laying out nearly $1,100 a year. If you use your ATM card at a bank other than your own, you’ll probably be charged a fee that can be as high as $3. The average person pays more than $60 a year in ATM fees, and if you withdraw cash from an ATM twice a week, you could be racking up $300 in annual fees. As for your ATM receipts, they’ll tell you whether, on top of the fee that you’re charged by that other bank’s ATM, your *own* bank is *also* tacking on a surcharge.[14][15][16][17]

If this little exercise proves enlightening—or if, on the other hand, it apparently fails to highlight any potential pitfalls in your spending habits—you might devote the next week to another exercise:

- Put all your credit cards in a drawer and get by on cash.
- Take your lunch to work.
- Buy nothing but groceries and gasoline.
- Use coupons whenever you go to the grocery store (but don’t buy anything just because you happen to have a coupon).

The obvious question that you need to ask yourself at the end of week 2 is, “how much did I save?” An equally interesting question, however, is, “what can I do without?” One survey asked five thousand financial planners to name the two expenses that most consumers should find easiest to cut back on. Figure 12.2 “Reducible Expenses” shows the results.

Figure 12.2 Reducible Expenses



You may or may not be among the American consumers who buy thirty-five million cans of Bud Light each and every day, or 150,000 pounds of Starbucks coffee, or 2.4 million Burger King hamburgers, or 628 Toyota Camrys. Yours may not be one of the 70 percent of U.S. households with an unopened consumer-electronics product lying around.[18] And you may or may not be ready to make some major adjustments in your personal-spending habits, but if, at age twenty-eight, you have a good education and a good job, a $60,000 income, and a $70,000 debt—by no means an implausible scenario—there’s a very good reason why you should think hard about controlling your modest share of that $2.5 trillion in U.S. consumer debt: your level of indebtedness will be a key factor in your ability—or inability—to reach your longer-term financial goals, such as home ownership, a dream trip, and, perhaps most important, a reasonably comfortable retirement.

The great English writer Samuel Johnson once warned, “Do not accustom yourself to consider debt only as an inconvenience; you will find it a calamity.” In Johnson’s day, you could be locked up for failing to pay your debts; there were even so-called debtors’ prisons for the purpose, and we may suppose that the prospect of doing time for owing money was one of the things that Johnson had in mind when he spoke of debt as a potential “calamity.” We don’t expect that you’ll ever go to prison on account of indebtedness, and we won’t suggest that, say, having to retire to a condo in the city instead of a tropical island is a “calamity.” We’ll simply say that you’re more likely to meet your lifetime financial goals—whatever they are—if you plan for them. What you need to know about planning for and reaching those goals is the subject of this chapter.

Key Takeaways

- Before buying something on credit, ask yourself whether you really need the goods or services, can afford them, and are willing to pay interest on the purchase.
- Whenever you use credit, those you borrow from provide information on your debt and payment habits to three national credit bureaus.
- The credit bureaus use the information to compile a numerical credit score, called a FICO score, which they share with subscribers.
- The credit bureaus consider five criteria in compiling the score: payment history, total amount owed, length of your credit history, amount of new credit you have, and types of credit you use.
- As a young person, you should do the following to build a good credit history that will give you a high FICO score.
  - Become an authorized user on your parents' account.
  - Obtain your own credit card
  - Get the right card for you.
  - Use the credit card for occasional, small purchases
  - Avoid big-ticket buys, except in case of emergency.
  - Pay off your balance each month.
  - Pay all your other bills on time.
  - Don't cosign for your friends.
  - Do not apply for several credit cards at *one time*.
  - Use student loans for education expenses only, and pay on time.
- To raise your credit score, you should pay your bills on time, pay more than the minimum balance due, keep your card balances low, and pay your debts off as quickly as possible. Also, scan your credit report for any errors and get any errors fixed.
- If you can't pay your debt, explain your situation to your lenders and see a credit assistance counselor.
- Before you incur a debt, you should understand its costs. The interest rate charged by the lender makes a big difference in the overall cost of the loan.
- The costs associated with credit cards include finance charges, annual fees, over-limit fees, late payment fees, and cash advance fees.
- The Federal Reserve changed the debit card rules in 2010 and now banks must get your permission before they enroll you in an overdraft protection program.
- If you have a problem with splurging, cut up your credit cards and start living on a cash-only basis.
- If your monthly bills are too high for your income, do whatever you can to bring down those bills.

Exercise

(AACSB) Analysis

There are a number of costs associated with the use of a credit card, including finance charges, annual fee, over-limit fee, late payment fee, and cash advance fee. Identify these costs for a credit card you now hold. If you don't presently have a credit card, go online and find an offer for one. Check out these costs for the card being offered.

Financial Planning

Learning Objectives

1. Define *personal finances* and *financial planning*.
2. Explain the *financial planning life cycle*.
3. Discuss the advantages of a college education in meeting short- and long-term financial goals.
4. Describe the steps you'd take to get a job offer and evaluate alternative job offers, taking benefits into account.
5. Understand the ways to finance a college education.

Before we go any further, we need to nail down a couple of key concepts. First, just what, exactly, do we mean by personal finances? *Finance* itself concerns the flow of money from one place to another, and your personal finances concern your money and what you plan to do with it as it flows in and out of your possession. Essentially, then, personal finance is the application of financial principles to the monetary decisions that you make either for your individual benefit or for that of your family.

Second, monetary decisions work out much more beneficially when they're planned rather than improvised. Thus our emphasis on financial planning—the ongoing process of managing your personal finances in order to meet goals that you've set for yourself or your family.

Financial planning requires you to address several questions, some of them relatively simple:

- What's my annual income?
- How much debt do I have, and what are my monthly payments on that debt?

Others will require some investigation and calculation:

- What's the value of my assets?
- How can I best budget my annual income?

Still others will require some forethought and forecasting:

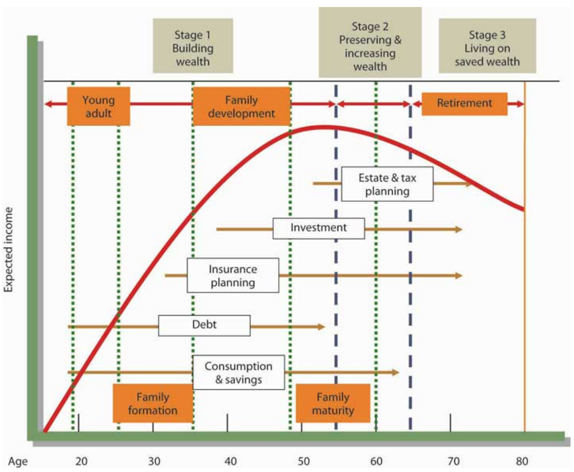
- How much wealth can I expect to accumulate during my working lifetime?
- How much money will I need when I retire?

The Financial Planning Life Cycle

Another question that you might ask yourself—and certainly would do if you were a professional in financial planning—is something like, "How will my financial plans change over the course of my life?" Figure 12.3 "Financial Life Cycle" illustrates the financial life cycle of a typical individual—one whose financial outlook and likely outcomes are probably a lot like yours.[19] As you can see, our diagram divides this individual's life into three stages, each of which is characterized by different life events (such as beginning a family, buying a home, planning an estate, retiring). At each stage, too, there are recommended changes in the focus of the individual's financial planning:

- In stage 1, the focus is on building wealth.
- In stage 2, the focus shifts to the process of preserving and increasing the wealth that one has accumulated and continues to accumulate.
- In stage 3, the focus turns to the process of living on (and, if possible, continuing to grow) one's saved wealth.

Figure 12.3 Financial Life Cycle



At each stage, of course, complications can set in—say, changes in such conditions as marital or employment status or in the overall economic outlook. Finally, as you can also see, your financial needs will probably peak somewhere in stage 2, at approximately age fifty-five, or ten years before typical retirement age.

Choosing a Career

Until you're eighteen or so, you probably won't generate much income; for the most part, you'll be living off your parents' wealth. In our hypothetical life cycle, however, financial planning begins in the individual's early twenties. If that seems like rushing things, consider a basic fact of life: this is the age at which you'll be choosing your career—not only the sort of work you want to do during your prime income-generating years, but also the kind of lifestyle you want to live in the process.[20]

What about college? Most readers of this book, of course, have decided to go to college. If you haven't yet decided, you need to know that college is an extremely good investment of both money and time.

Table 12.1 "Education and Average Income", for example, summarizes the findings of a study conducted by the U.S. Census Bureau.[21] A quick review shows that people who graduate from high school can expect to increase their average annual earnings by about 49 percent over those of people who don't, and those who go on to finish college can expect to generate 82 percent more annual income than that. Over the course of the financial life cycle, families headed by those college graduates will earn about $1.6 million more than families headed by high school graduates who didn't attend college. (With better access to health care—and, studies show, with better dietary and health practices—college graduates will also live longer. And so will their children.)[22]

Table 12.1 Education and Average Income

Education	Average income	Percentage increase over next-highest level
High school dropout	$20,873	—
High school diploma	$31,071	48.9%
College degree	$56,788	82.8%
Advanced higher-education degree	$82,320	45.0%

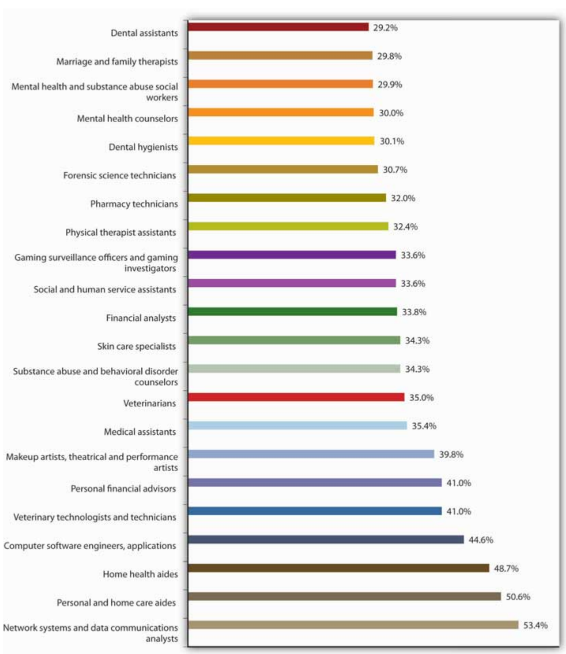
And what about the debt that so many people accumulate to finish college? For every $1 that you spend on your college education, you can expect to earn about $35 during the course of your financial life cycle.[23] At that rate of return, you should be able to pay off your student loans (unless, of course, you fail to practice reasonable financial planning).

Naturally, there are exceptions to these average outcomes. You'll find English-lit majors stocking shelves at 7-Eleven, and you'll find college dropouts running multibillion-dollar enterprises. Microsoft cofounder Bill Gates dropped out of college after two years, as did his founding partner, Paul Allen. Current Microsoft CEO Steve Ballmer finished his undergraduate degree but quit his MBA program to join Microsoft (where he apparently fit in among the other dropouts in top management). It's always good to remember, however, that though exceptions to rules (and average outcomes) occasionally modify the rules, they invariably fall far short of disproving them: in entrepreneurship as in most other walks of adult life, the better your education, the more promising your financial future. One expert in the field puts the case for the average person bluntly: educational credentials "are about being employable, becoming a legitimate candidate for a job with a future. They are about climbing out of the dead-end job market".[24]

Finally, does it make any difference *what* you study in college? To a perhaps surprising extent, not necessarily. Some career areas, such as engineering, architecture, teaching, and law, require targeted degrees, but the area of study designated on your degree often doesn't matter much when you're applying for a job. If, for instance, a job ad says, "Business, communications, or other degree required," most applicants and hires will have those "other" degrees. When poring over résumés for a lot of jobs, potential employers look for the degree and simply note that a candidate has one; they often don't need to focus on the particulars.[25]

This is not to say, however, that all degrees promise equal job prospects. Figure 14.4 "Top 25 Fastest-Growing Jobs, 2006–2016", for example, summarizes a U.S. Bureau of Labor Statistics projection of the thirty fast-growing occupations for the years 2006–2016. Veterinary technicians and makeup artists will be in demand as never before, but as you can see, occupational prospects are fairly diverse. [26]

Figure 12.4 Top 25 Fastest-Growing Jobs, 2006–2016



Nor, of course, do all degrees pay off equally. In Table 12.2 "College Majors and Average Annual Earnings", we've extracted the findings of a study conducted by the National Science Foundation on the earnings of individuals with degrees in various undergraduate fields.[27] [28] Clearly, some degrees—notably in the engineering fields—promise much higher average earnings than others. Chemical engineers, for instance, can earn nearly twice as much as elementary school teachers, but there's a catch: if you graduate with a degree in chemical engineering, your average annual salary will be about $67,000 *if you can find a job related to that degree*; if you can't, you may have to settle for as much as 40 percent less.[29] (Supermodel Cindy Crawford cut short her studies in chemical engineering because there was more money to be made on the runway.)

Table 12.2 College Majors and Average Annual Earnings

Major	Average Earnings with Bachelor's Degree	Major	Average Earnings with Bachelor's Degree
Chemical engineering	$67,425	History	$45,926
Aerospace engineering	$65,649	Biology	$45,532
Computer engineering	$62,527	Nursing	$45,538
Physics	$62,104	Psychology	$43,963
Electrical engineering	$61,534	English	$43,614
Mechanical engineering	$61,382	Health technology	$42,524
Industrial engineering	$61,030	Criminal justice	$41,129
Civil engineering	$58,993	Physical education	$40,207
Accounting	$56,637	Secondary education	$39,976
Finance	$55,104	Fine arts	$38,857
Computer science	$52,615	Philosophy	$38,239
Business management	$52,321	Dramatic arts	$37,091
Marketing	$51,107	Music	$36,811
Journalism	$46,835	Elementary education	$34,564
Information systems	$46,519	Special education	$34,196

In short, when you're planning what to do with the rest of your life, it's a good idea to check into the fine points and realities, as well as the statistical data. If you talk to career counselors and people in the workforce, you might be surprised by what you learn about the relationship between certain college majors and various occupations. Onetime Hewlett-Packard CEO Carly Fiorina majored in medieval history and philosophy.

Financing a College Education

Let's revisit one of the facts included in the earlier discussion: for every $1 that you spend on your college education, you can expect to earn about $35 during the course of your financial life cycle. And let's say you're convinced (as you should be) that getting a college degree is a wise financial choice. You still have to deal with the cost of getting your degree. We're sure this won't come as a surprise: attending college is expensive—tuition and fees have gone up sharply, the cost of books has skyrocketed, and living expenses have climbed. Many students can attend college only if they receive some type of financial aid. Though the best way to learn what aid is available to you is to talk with a representative in the financial aid office at your school, this section provides an overview of the types of aid offered to students. Students finance their education through scholarships, grants, education loans, and work-study programs.[30] We'll explore each of these categories of aid:

- *Scholarships*, which don't have to be repaid, are awarded based on a number of criteria, including academic achievement, athletic or artistic talent, special interest in a particular field of study, ethnic background, or religious affiliation. Scholarships are generally funded by private donors such as alums, religious institutions, companies, civic organizations, professional associations, and foundations.
- *Grants*, which also don't have to be repaid, are awarded based on financial need. They're funded by the federal government, the states, and academic institutions. An example of a common federal grant is the Pell Grant, which is awarded to undergraduate students based on financial need. The maximum Pell Grant award for the 2011–12 award year (July 1, 2011, to June 30, 2012) is $5,550.[31]
- *Education loans*, which must be repaid, are available to students from various sources, including the federal government, states, and academic institutions. While recent problems in the credit markets have made college loans more difficult to obtain, most students are able to get the loans they need.[32] The loans offered directly to undergraduate students by the federal government include the need-based, subsidized Federal Stafford, the non–need-based unsubsidized Federal Stafford, and the need-based Federal Perkins loans. With the exception of the unsubsidized Federal Stafford, no interest accrues while the student is enrolled in college at least part time. There

are also a number of loans available to parents of students, such as the Federal Parent PLUS program. Under this program, parents can borrow federally guaranteed low-interest loans to fund their child's education.

- Work-study is a federally sponsored program that provides students with paid, part-time jobs on campus. Because the student is paid based on work done, the funds received don't have to be repaid.

Find a Great Job

As was highlighted earlier, your financial life cycle begins at the point when you choose a career. Building your career takes considerable planning. It begins with the selection of a major in college and continues through graduation as you enter the workforce full time. You can expect to hold a number of jobs over your working life. If things go as they should, each job will provide valuable opportunities and help you advance your career. A big challenge is getting a job offer in your field of interest, evaluating the offer, and (if you have several options) selecting the job that's right for you.[33]

Getting a Job Offer

Most likely your college has a career center. The people working there can be a tremendous help to you as you begin your job search. But most of the work has to be done by you. Like other worthwhile projects, your job search project will be very time-consuming. As you get close to graduation, you'll need to block out time to work on this particularly important task.

The first step is to prepare a résumé, a document that provides a summary of educational achievements and relevant job experience. Its purpose is to get you an interview. A potential employer will likely spend less than a minute reviewing your résumé, so its content should be concise, clear, and applicable to the job for which you're applying. For some positions, the person in charge of hiring might read more than a hundred résumés. If you don't want your résumé kicked out right away, be sure it contains no typographical or grammatical errors. Once you've completed your résumé, you can use it to create different versions tailored to specific companies you'd like to work for. Your next step is to write a cover letter, a document accompanying your résumé that explains why you're sending your résumé and highlights your qualifications. You can find numerous tips on writing résumés and cover letters (as well as samples of both) online. Be sure your résumé is accurate: never lie or exaggerate in a résumé. You could get caught and not get the job (or—even worse—you could get the job, get caught, and then get fired). It's fairly common practice for companies to conduct background checks of possible employees, and these checks will point out any errors. In effect, says one expert, "you jeopardize your future when you lie about your past".[34]

After writing your résumé and cover letter, your next task is to create a list of companies you'd like to work for. Use a variety of sources, including your career services office and company Web sites, to decide which companies to put on your list. Visit the "career or employment" section of the company Web sites and search for specific openings.

You could also conduct a general search for positions that might be of interest to you, by doing the following:

- Visiting career Web sites, such as Monster.com, Wetfeet.com, or Careerbuilder.com (which maintain large databases of openings for all geographical areas)
- Searching classified ads in online and print newspapers
- Attending career fairs at your college and in your community
- Signing up with career services to talk with recruiters when they visit your campus
- Contacting your friends, family, and college alumni and letting them know you're looking for a job and asking for their help

Once you spot a position you want, send your résumé and cover letter (tailored to the specific company and job). Follow up in a few days to be sure your materials got to the right place, and offer to provide any additional information. Keep notes on all contacts.

Figure 12.5 Preparing for an Interview

Preparing well for an interview can make it easier to relax and help the interviewer get to know you.[35]

When you're invited for an interview, visit to the company's Web site and learn as much as you can about the company. Practice answering questions you might be asked during the interview, and think up a few pertinent questions to ask your interviewer. Dress conservatively—males should wear a suit and tie and females should wear professional-looking clothes. Try to relax during the interview (though everyone knows this isn't always easy). Your goal is to get an offer, so let the interviewer learn who you are and how you can be an asset to the company. Send a thank-you note (or thank-you e-mail) to the interviewer after the interview.

Evaluating Job Offers

Let's be optimistic and say that you did quite well in your interviews, and you have two job offers. It's a great problem to have, but now you have to decide which one to accept. Salary is important, but it's clearly not the only factor. You should consider the opportunities the position offers: will you learn new things on the job, how much training will you get, could you move up in the organization (and if so, how quickly)? Also consider quality of life issues: how many hours a week will you have to work, is your schedule predictable (or will you be asked to work on a Friday night or Saturday at the last minute), how flexible is your schedule, how much time do you get off, how stressful will the job be, do you like the person who will be your manager, do you like your coworkers, how secure is the job, how much travel is involved, where's the company located, and what's the cost of living in that area? Finally, consider the financial benefits you'll receive. These could include health insurance, disability insurance, flexible spending accounts, and retirement plans. Let's talk more about the financial benefits, beginning with health insurance.

- Employer-sponsored health insurance plans vary greatly. Some cover the employee only, while others cover the employee, spouse, and children. Some include dental and eye coverage while others don't. Most plans require employees to share some of the cost of the medical plan (by paying a portion of the insurance premiums and a portion of the cost of medical care). But the amount that employees are responsible for varies greatly. Given the rising cost of health insurance, it's important to understand the specific costs associated with a health care plan and to take these costs into account when comparing job offers. More important, it's vital that you have medical insurance. Young people are often tempted to go without medical insurance, but this is a major mistake. An uncovered, costly medical emergency (say you're rushed to the hospital with appendicitis) can be a financial disaster. You could end up paying for your hospital and doctor care for years.
- Disability insurance isn't as well known as medical insurance, but it can be as important (if not more so). Disability insurance pays an income to an insured person when he or she is unable to work for an extended period. You would hope that you'd never need disability insurance, but if you did it would be of tremendous value.
- A flexible spending account allows a specified amount of pretax dollars to be used to pay for qualified expenses, including health care and child care. By paying for these costs with pretax dollars, employees are able to reduce their tax bill.
- There are two main types of *retirement plans*. One, called a defined benefit retirement plan, provides a set amount of money each month to retirees based on the number of years they worked and the income they earned. This form of retirement plan was once very popular, but it's less common today. The other, called a defined contribution retirement plan, is a form of savings plan. The employee contributes money each pay period to his or her retirement account, and the employer matches a portion of the contribution. Even when retirement is exceedingly far into the future, it's financially wise to set aside funds for retirement.

Key Takeaways

- *Finance* concerns the flow of money from one place to another; your *personal finances* concern your money and what you plan to do with it as it flows in and out of your possession. **Personal finance** is thus the application of financial principles to the monetary decisions that you make, either for your individual benefit or for that of your family.
- **Financial planning** is the ongoing process of managing your personal finances to meet goals that you've set for yourself or your family.
- The *financial life cycle* divides an individual's life into three stages, each of which is characterized by different life events. Each stage also entails recommended changes in the focus of the individual's financial planning:
  1. In stage 1, the focus is on *building* wealth.
  2. In stage 2, the focus shifts to the process of *preserving and increasing* the wealth that one has accumulated and continues to accumulate.
  3. In stage 3, the focus turns to the process of *living on* (and, if possible, continuing to grow) one's saved wealth.
- According to the model of the financial life cycle, financial planning begins in the individual's early twenties, the age at which most people choose a *career*—both the sort of *work* they want to do during their income-generating years and the kind of *lifestyle* they want to live in the process.
- College is a good investment of both money and time. People who graduate from high school can expect to improve their average annual earnings by about 49 percent over those of people who don't, and those who go on to finish college can expect to generate 82

percent more annual income than that. The area of study designated on your degree often doesn't matter when you're applying for a job: when poring over résumés, employers often look for the degree and simply note that a candidate has one.

- The first step in your job search is to prepare a **résumé**, a document that provides a summary of educational achievements and relevant job experience. Your résumé should be concise, clear, applicable to the job for which you are applying, and free of errors and inaccuracies.
- A **cover letter** is a document that accompanies your résumé and explains why you're sending your résumé and highlights your qualifications.
- To conduct a general search for positions that might be of interest to you, you could:
  1. Visit career Web sites, such as Monster.com, Wetfeet.com, or Careerbuilder.com.
  2. Search classified ads in online and print newspapers.
  3. Attend career fairs at your college and in your community.
  4. Talk with recruiters when they visit your campus.
  5. Contact people you know, tell them you're looking for a job, and ask for their help.
- When you're invited for an interview, you should research the company, practice answering questions you might be asked in the interview, and think up pertinent questions to ask the interviewer.
- When comparing job offers, consider more than salary. Also of importance are quality of life issues and benefits. Common financial benefits include health insurance, disability insurance, flexible spending accounts, and retirement plans.
  1. *Employer-sponsored health insurance* plans vary greatly in coverage and cost to the employee.
  2. Disability insurance pays an income to an insured person when he or she is unable to work for an extended period of time.
  3. A *flexible spending account* allows a specified amount of pretax dollars to be used to pay for qualified expenses, including health care and child care. By paying for these costs with pretax dollars, employees are able to reduce their tax bill.
- There are two main types of *retirement plans*: a defined benefit plan, which provides a set amount of money each month to retirees based on the number of years they worked and the income they earned, and a defined contribution plan, which is a form of savings plan into which both the employee and employer contribute. A well-known defined contribution plan is a 401(k).

Exercise

(AACSB) Analysis

Think of the type of job you'd like to have. Describe the job and indicate how you'd go about getting a job offer for this type of job. How would you evaluate competing offers from two companies? What criteria would you use in selecting the right job for you?

Time Is Money

Learning Objectives

1. Explain *compound interest* and *the time value of money*.
2. Discuss the value of getting an early start on your plans for saving.

The fact that you have to choose a career at an early stage in your financial life cycle isn't the only reason that you need to start early on your financial planning. Let's assume, for instance, that it's your eighteenth birthday and that on this day you take possession of $10,000 that your grandparents put in trust for you. You could, of course, spend it; in particular, it would probably cover the cost of flight training for a private pilot's license—something you've always wanted but were convinced that you couldn't afford for another ten or fifteen years. Your grandfather, of course, suggests that you put it into some kind of savings account. If you just wait until you finish college, he says, and if you can find a savings plan that pays 5 percent interest, you'll have the $10,000 plus another $2,209 to buy a pretty good used car.

The total amount you'll have— $12,209—piques your interest. If that $10,000 could turn itself into $12,209 after sitting around for four years, what would it be worth if you actually held on to it until you did retire—say, at age sixty-five? A quick trip to the Internet to find a compound-interest calculator informs you that, forty-seven years later, your $10,000 will have grown to $104,345 (assuming a 5 percent interest rate). That's not really enough to retire on, but after all, you'd at least have some cash, even if you hadn't saved another dime for nearly half a century. On the other hand, what if that four years in college had paid off the way you planned, so that (once you get a good job) you're able to add, say, another $10,000 to your retirement savings account every year until age sixty-five? At that rate, you'll have amassed a nice little nest egg of slightly more than $1.6 million.

Compound Interest

In your efforts to appreciate the potential of your $10,000 to multiply itself, you have acquainted yourself with two of the most important concepts in finance. As we've already indicated, one is the principle of compound interest, which refers to the effect of earning interest on your interest.

Let's say, for example, that you take your grandfather's advice and invest your $10,000 (your *principal*) in a savings account at an annual interest rate of 5 percent. Over the course of the first year, your investment will earn $512 in interest and grow to $10,512. If you now reinvest the entire $10,512 at the same 5 percent annual rate, you'll earn another $537 in interest, giving you a total investment at the end of year 2 of $11,049. And so forth. And that's how you can end up with $104,345 at age sixty-five.

Time Value of Money

You've also encountered the principle of the time value of money—the principle whereby a dollar received in the present is worth more than a dollar received in the future. If there's one thing that we've stressed throughout this chapter so far, it's the fact that, for better or for worse, most people prefer to consume now rather than in the future. This is true for both borrowers and lenders. If you borrow money from me, it's because you can't otherwise buy something that you want at the present time. If I lend it to you, it's because I'm willing to postpone the opportunity to purchase something I want at the present time—perhaps a risk-free, ten-year U.S. Treasury bond with a present yield rate of 3 percent.

I'm willing to forego my opportunity, however, only if I can get some compensation for its loss, and that's why I'm going to charge you interest. And you're going to pay the interest because you need the money to buy what you want to buy. How much interest should we agree on? In theory, it could be just enough to cover the cost of my lost opportunity, but there are, of course, other factors. Inflation, for example, will have eroded the value of my money by the time I get it back from you. In addition, while I would be taking no risk in loaning money to the U.S. government (as I would be doing if I bought that Treasury bond), I am taking a risk in loaning it to you. Our agreed-on rate will reflect such factors.[36]

Finally, the time value of money principle also states that a dollar received today starts earning interest sooner than one received tomorrow. Let's say, for example, that you receive $2,000 in cash gifts when you graduate from college. At age twenty-three, with your college degree in hand, you get a decent job and don't have an immediate need for that $2,000. So you put it into an account that pays 10 percent compounded *and* you add another $2,000 ($167 per month) to your account every year for the next eleven years[1]. The left panel of Table 12.3 "Why to Start Saving Early (I)" shows how much your account will earn each year and how much money you'll have at certain ages between twenty-three and sixty-seven. As you can see, you'd have nearly $52,000 at age thirty-six and a little more than $196,000 at age fifty; at age sixty-seven, you'd be just a bit short of $1 million. The right panel of the same table shows what you'd have if you hadn't started saving $2,000 a year until you were age thirty-six. As you can also see, you'd have a respectable sum at age sixty-seven—but less than half of what you would have accumulated by starting at age twenty-three. More important, even to accumulate that much, *you'd have to add $2,000 per year for a total of thirty-two years, not just twelve*.

Table 12.3 Why to Start Saving Early (I)[37]

	Savings accumulated from age 23, with deposits of $2,000 annually until age 67			Savings accumulated from age 36, with deposits of $2,000 annually until age 67		
Age	Annual deposit	Annual interest earned	Total saved at the end of the year	Annual deposit	Annual interest earned	Total saved at the end of the year
23	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
24	$2,000	$200.00	$2,200	$0.00	$0.00	$0.00
25	$2,000	$420.00	$4,620	$0.00	$0.00	$0.00
30	$2,000	$1,897.43	$20,871.78	$0.00	$0.00	$0.00
35	$2,000	$4,276.86	$47,045.42	$0.00	$0.00	$0.00
36	$0.00	$4,704.54	$51,749.97	$2,000	$200.00	$2,200.00
40	$0.00	$6,887.92	$75,767.13	$2,000	$1,221.02	$13,431.22
45	$0.00	$11,093.06	$122,023.71	$2,000	$3,187.48	$35,062.33
50	$0.00	$17,865.49	$196,520.41	$2,000	$6,354.50	$69,899.46
55	$0.00	$28,772.55	$316,498.09	$2,000	$11,455.00	$126,005.00
60	$0.00	$46,338.49	$509,723.34	$2,000	$19,669.41	$216,363.53
65	$0.00	$74,628.59	$820,914.53	$2,000	$32,898.80	$361,886.65
67	$0.00	$90,300.60	$993,306.53	$2,000	$40,277.55	$442,503.09

Here's another way of looking at the same principle. Suppose that you're twenty years old, don't have $2,000, and don't want to attend college full-time. You are, however, a hard worker and a conscientious saver, and one of your (very general) financial goals is to accumulate a $1 million retirement nest egg. As a matter of fact, if you can put $33 a month into an account that pays 12 percent interest compounded[38], you can have your $1 million by age sixty-seven. That is, *if you start at age twenty*. As you can see from Table 12.4 "Why to Start Saving Early (II)", if you wait until you're twenty-one to start saving, you'll need $37 a month. If you wait until you're thirty, you'll have to save $109 a month, and if you procrastinate until you're forty, the ante goes up to $366 a month.[39]

Table 12.4 Why to Start Saving Early (II)[40]

First Payment When You Turn	Required Monthly Payment	First Payment When You Turn	Required Monthly Payment
20	$33	30	$109
21	$37	31	$123
22	$42	32	$138
23	$47	33	$156
24	$53	34	$176
25	$60	35	$199
26	$67	40	$366
27	$76	50	$1,319
28	$85	60	$6,253
29	$96		

The moral here should be fairly obvious: a dollar saved today not only starts earning interest sooner than one saved tomorrow (or ten years from now) but also can ultimately earn a lot more money in the long run. Starting early means in your twenties—early in stage 1 of your financial life cycle. As one well-known financial advisor puts it, "If you're in your 20s and you haven't yet learned how to delay gratification, your life is likely to be a constant financial struggle".[41]

Key Takeaways

- The principle of **compound interest** refers to the effect of earning interest on your interest.
- The principle of the **time value of money** is the principle whereby a dollar received in the present is worth more than a dollar received in the future.
- The principle of the time value of money also states that a dollar received today starts earning interest sooner than one received tomorrow.
- Together, these two principles give a significant financial advantage to individuals who begin saving early during the financial-planning life cycle.

Exercise

(AACSB) Analysis

Everyone wants to be a millionaire (except those who are already billionaires). To find out how old you'll be when you become a millionaire, go to http://www.youngmoney.com/calculators/savings_calculators/millionaire_calculator and input these assumptions:

Age: your actual age

Amount currently invested: $10,000

Expected rate of return (interest rate): 5 percent

Millionaire target age: 65

Savings per month: $500

Expected inflation rate: 3 percent

Click "calculate" and you'll learn when you'll become a millionaire (given the previous assumptions).

Now, let's change things. We'll go through this process three times. Change only the items described. Keep all other assumptions the same as those listed previously.

1. Change the interest rate to 3 percent and then to 6 percent.
2. Change the savings amount to $200 and then to $800.
3. Change your age from "your age" to "your age plus 5" and then to "your age minus 5."

Write a brief report describing the sensitivity of becoming a millionaire, based on changing interest rates, monthly savings amount, and age at which you begin to invest.

The Financial Planning Process

Learning Objectives

1. Identify the three stages of the *personal-finances planning process*.
2. Explain how to draw up a personal *net-worth statement*, a personal *cash-flow statement*, and a personal *budget*.

We've divided the financial planning process into three steps:

1. Evaluate your current financial status by creating a net worth statement and a cash flow analysis.
2. Set short-term, intermediate-term, and long-term financial goals.
3. Use a budget to plan your future cash inflows and outflows and to assess your financial performance by comparing budgeted figures with actual amounts.

Step 1: Evaluating Your Current Financial Situation

Just how are you doing, financially speaking? You should ask yourself this question every now and then, and it should certainly be your starting point when you decide to initiate a more or less formal financial plan. The first step in addressing this question is collecting and analyzing the records of what you *own* and what you *owe* and then applying a few accounting terms to the results:

- Your personal *assets* consist of what you *own*.
- Your personal *liabilities* are what you *owe*—your obligations to various creditors, big and small.

Preparing Your Net-Worth Statement

Your net worth (accounting term for your *wealth*) is the difference between your assets and your liabilities. Thus the formula for determining net worth is:

Assets − Liabilities = Net worth

If you own more than you owe, your net worth will be *positive*; if you owe more than you own, it will be *negative*. To find out whether your net worth is on the plus or minus side, you can prepare a personal net worth statement like the one in Figure 12.6 "Net Worth Statement", which we've drawn up for a fictional student named Joe College (Note that we've included lines for items that may be relevant to some people's net worth statements but left them blank when they don't apply to Joe).

Figure 14.6 Net Worth Statement

Joe College's Personal Net Worth Statement as of August 31, 2012	
ASSETS (what you own)	**Value**
Cash	$ 200
Checking accounts	1,000
Savings accounts/CDs/money market accounts	400
Market value of investments (stocks, bonds, mutual funds)	—
Retirement accounts	—
Market value of real estate	—
Cars	8,000
Furniture and appliances	1,500
Computers	900
Stereo/video equipment/cell phones	400
Jewelry	—
Clothing	300
Other assets	—
Total Assets	**12,700**
LIABILITIES (what you owe)	**Amount**
Credit card balances	1,200
Charge account balances	200
Student loans	7,000
Car loans	2,300
Home mortgage	—
Other liabilities	—
Total Liabilities	**10,700**
Assets – Liabilities = Net worth	
Total Net Worth	**$ 2,000**

Assets

Joe has two types of assets:

- First are his *monetary* or *liquid assets*—his cash, the money in his checking accounts, and the value of any savings, CDs, and money market accounts. They're called *liquid* because either they're cash or they can readily be turned into cash.
- Everything else is a *tangible asset*—something that Joe can use, as opposed to an investment. (We haven't given Joe any *investments*—such financial assets as stocks, bonds, or mutual funds—because people usually purchase these instruments to meet such long-term goals as buying a house or sending a child to college.)

Note that we've been careful to calculate Joe's assets in terms of their fair market value—the price he could get by selling them at present, not the price he paid for them or the price that he could get at some future time.

Liabilities

Joe's net worth statement also divides his liabilities into two categories:

- Anything that Joe owes on such items as his furniture and computer are *current liabilities*—debts that must be paid within one year. Much of this indebtedness no doubt ends up on Joe's credit card balance, which is regarded as a current liability because he *should* pay it off within a year.
- By contrast, his car payments and student-loan payments are *noncurrent liabilities*—debt payments that extend for a period of more than one year. Joe is in no position to buy a house, but for most people, their mortgage is their most significant noncurrent liability.

Finally, note that Joe has positive net worth. At this point in the life of the average college student, positive net worth may be a little unusual. If you happen to have negative net worth right now, you're technically *insolvent*, but remember that a major goal of getting a college degree is to enter the workforce with the best possible opportunity for generating enough wealth to reverse that situation.

Preparing Your Cash-Flow Statement

Now that you know something about your financial status *on a given date*, you need to know more about it *over a period of time*. This is the function of a cash-flow or income statement, which shows where your money has come from and where it's slated to go.

Figure 12.7 "Cash-Flow Statement" is Joe College's cash-flow statement. As you can see, Joe's *income* (his cash *inflows*—money coming in) is derived from two sources: student loans and income from a part-time job. His expenditures (cash *outflows*—money going out) fall into several categories: housing, food, transportation, personal and health care, recreation/entertainment, education, insurance, savings, and other expenses. To find out Joe's *net cash flow*, we subtract his expenditures from his income:

$25,700 – $25,300 = $400

Figure 12.7 Cash-Flow Statement

Joe College's Personal Cash-Flow Statement
as of August 31, 2012

CASH INFLOWS (cash coming in)	
Wages (full time in summer/part time during semester)	$ 18,700
Student loan	7,000
Total inflow of cash	**25,700**
CASH OUTFLOWS (cash going out)	
Housing	
Rent	5,400
Utilities (electricity, heat, water, cable)	700
Communication (phone and internet access)	900
Food	
Groceries	2,300
Eating out	1,200
Transportation	
Gas and maintenance	1,400
Car loan payments	1,400
Personal and healthcare	
Medical co-payments and dental	200
Clothing	200
Laundry/cleaning supplies/miscellaneous	100
Recreation/Entertainment	
Night life/movies/concerts	900
Magazines/music/miscellaneous	200
Education	
Tuition	5,500
Books	1,000
Student loan payments	—
Insurance	
Car, health, renter's	1,900
Savings	1,200
Other expenses	800
Total outflow of cash	**25,300**
Cash inflow – Cash outflow = Net cash flow	
Net Cash Flow	**$ 400**

Joe has been able to maintain a positive cash flow for the year ending August 31, 2012, but he's cutting it close. Moreover, he's in the black only because of the inflow from student loans—income that, as you'll recall from his net worth statement, is also a noncurrent liability. We are, however, willing to give Joe the benefit of the doubt: Though he's incurring the high costs of an education, he's willing to commit himself to the debt (and, we'll assume, to careful spending) because he regards education as an investment that will pay off in the future.

Remember that when constructing a cash-flow statement, you must record only income and expenditures that pertain to a given period, whether it be a month, a semester, or (as in Joe's case) a year. Remember, too, that you must figure both inflows and outflows *on a cash basis*: you record income only when you receive money, and you record expenditures only when you pay out money. When, for example, Joe used his credit card to purchase his computer, he didn't actually pay out any money. Each monthly payment on his credit card balance, however, is an outflow that must be recorded on his cash-flow statement (according to the type of expense—say, recreation/entertainment, food, transportation, and so on).

Your cash-flow statement, then, provides another perspective on your *solvency*: if you're *insolvent*, it's because you're spending more than you're earning. Ultimately, your net worth and cash-flow statements are most valuable when you use them together. While your net worth statement lets you know what you're worth—how much wealth you have—your cash-flow statement lets you know precisely what effect your spending and saving habits are having on your wealth.

Step 2: Set Short-Term, Intermediate-Term, and Long-Term Financial Goals

We know from Joe's cash-flow statement that, despite his limited income, he feels that he can save $1,200 a year. He knows, of course, that it makes sense to have some cash in reserve in case of emergencies (car repairs, medical needs, and so forth), but he also knows that by putting away some of his money (probably each week), he's developing a habit that he'll need if he hopes to reach his long-term financial goals.

Just what are Joe's goals? We've summarized them in Figure 12.8 "Joe's Goals", where, as you can see, we've divided them into three time frames: short-term (less than two years), intermediate-term (two to five years), and long-term (more than five years). Though Joe is still in an early stage of his financial life cycle, he has identified and structured his goals fairly effectively. In particular, they satisfy four criteria of well-conceived goals: they're *realistic* and *measurable*, and Joe has designated both *definite time frames* and *specific courses of action*.[42]

Figure 12.8 Joe's Goals

Short-term goals (less than 2 years)	Intermediate-term goals (2-5 years)	Long-term goals (more than 5 years)
• Pay off car loan • Pay off credit card and charge account debt	• Complete college • Take one-month vacation after completing college	• Pay off student loans • Buy a home • Save for retirement

They're also sensible. Joe sees no reason, for example, why he can't pay off his car loan, credit card, and charge account balances within two years. Remember that, with no income other than student-loan money and wages from a part-time job, Joe has decided (rightly or wrongly) to use his credit cards to pay for much of his personal consumption (furniture, electronics equipment, and so forth). It won't be an easy task to pay down these balances, so we'll give him some credit (so to speak) for regarding them as important enough to include paying them among his short-term goals. After finishing college, he'll splurge and take a month-long vacation. This might not be the best thing to do from a financial point of view, but he knows this could be his only opportunity to travel extensively. He is realistic in his classification of student loan repayment and the purchase of a home as long-term. But he might want to revisit his decision to classify saving for his retirement as a long-term goal. This is something we believe he should begin as soon as he starts working full-time.

Step 3: Develop a Budget and Use It to Evaluate Financial Performance

Once he has reviewed his cash-flow statement, Joe has a much better idea of what cash flowed in for the year that ended August 31, 2012, and a much better idea of where it went when it flowed out. Now he can ask himself whether he's satisfied with his annual inflow (income) and outflow (expenditures). If he's anything like most people, he'll want to make some changes—perhaps to increase his income, to cut back on his expenditures, or, if possible, both. The first step in making these changes is drawing up a personal budget—a document that itemizes the sources of his income and expenditures for the coming year, along with the relevant money amounts for each.

Having reviewed the figures on his cash-flow statement, Joe did in fact make a few decisions:

- Because he doesn't want to jeopardize his grades by increasing his work hours, he'll have to reconcile himself to just about the same wages for another year.
- He'll need to apply for another $7,000 student loan.
- If he's willing to cut his spending by $1,200, he can pay off his credit cards. Toward this end, he's targeted the following expenditures for reduction: rent (get a cheaper apartment), phone costs (switch plans), auto insurance (take advantage of a "good-student" discount), and gasoline (pool rides or do a little more walking). Fortunately, his car loan will be paid off by midyear.

Revising his figures accordingly, Joe developed the budget in Figure 12.9 "Joe's Budget" for the year ending August 31, 2013. Look first at the column headed "Budget." If things go as planned, Joe expects a cash surplus of $1,600 by the end of the year—enough to pay off his credit card debt and leave him with an extra $400.

Figure 12.9 Joe's Budget

Joe College's Budget
for year ending August 31, 2013.

Item	Budget	Actual	Variance (actual vs. budgeted)
CASH INFLOW			
Wages	$ 18,700	$ 19,000	$ 300 favorable
Student loan	7,000	7000	—
Total	**25,700**	**26,000**	**300 favorable**
CASH OUTFLOW			
Housing			
Rent	5,100	5,100	—
Utilities (electricity, heat, water, TV cable)	700	800	100 unfavorable
Communication (phone and internet)	800	800	—
Food			
Groceries	2,300	2,100	200 favorable
Eating out	1,200	1,300	100 unfavorable
Transportation			
Gas and maintenance	1,300	1,400	100 unfavorable
Car loan payments	900	900	—
Personal and healthcare			
Medical co-payments and dental	200	300	100 unfavorable
Clothing	200	300	100 unfavorable
Laundry/cleaning supplies/miscellaneous	100	100	—
Recreation/Entertainment			
Night life/movies/concerts	900	1,000	100 unfavorable
Magazines/music/miscellaneous	200	200	—
Education			
Tuition	5,500	5,500	—
Books	1,000	1,000	—
Insurance			
Car, health, renter's	1,700	1,700	—
Savings	1,200	1,200	—
Other expenses	800	600	200 favorable
Total	**24,100**	**24,300**	**200 unfavorable**
Surplus (Deficit)	**$ 1,600**	**$ 1,700**	**$ 100 favorable**

Figuring the Variance

Now we can examine the two remaining columns in Joe's budget. Throughout the year, Joe will keep track of his actual income and actual expenditures and will enter the totals in the column labeled "Actual." Like most reasonable people, however, Joe doesn't really expect his actual figures to match with his budgeted figures. So whenever there's a difference between an amount in his "Budget" column and the corresponding amount in his "Actual" column, Joe records the difference, whether plus or minus, as a variance. Two types of variances appear in Joe's budget:

- *Income variance*. When actual *income* turns out to be higher than expected or budgeted income, Joe records the variance as "favorable." (This makes sense, as you'd find it favorable if you earned more income than expected.) When it's just the opposite, he records the variance as "unfavorable."
- *Expense variance*. When the actual amount of an *expenditure* is more than he had budgeted for, he records it as an "unfavorable" variance. (This also makes sense, as you'd find it unfavorable if you spent more than the budgeted amount.) When the actual amount is less than budgeted, he records it as a "favorable" variance.

Setting Mature Goals

Before we leave the subject of the financial-planning process, let's revisit the topic of Joe's goals. Another look at Figure 12.8 "Joe's Goals" reminds us that, at the current stage of his financial life cycle, Joe has set fairly simple goals. We know, for example, that Joe wants to buy a home, but when does he want to take this major financial step? And of course, Joe wants to retire, but what kind of lifestyle does he want in retirement? Does he expect, like most people, a retirement lifestyle that's more or less comparable to that of his peak earning years? Will he be able to afford both the cost of a comfortable retirement and, say, the cost of sending his children to college? As Joe and his financial circumstances mature, he'll have to express these goals (and a few others) in more specific terms.

Levels of Mature Goals

Let's fast-forward a decade or so, when Joe's picture of stages 2 and 3 of his financial life cycle have come into clearer focus. If he hasn't done so already, Joe is now ready to identify a primary goal to guide him in identifying and meeting all his other goals.[43] Suppose that because Joe's investment in a college education has paid off the way he'd planned ten years ago, he's in a position to target a primary goal of financial independence—by which he means a certain financially secure life not only for himself but for his children, as well. Now that he's set this *primary* goal, he can identify a more specific set of goals—say, the following:

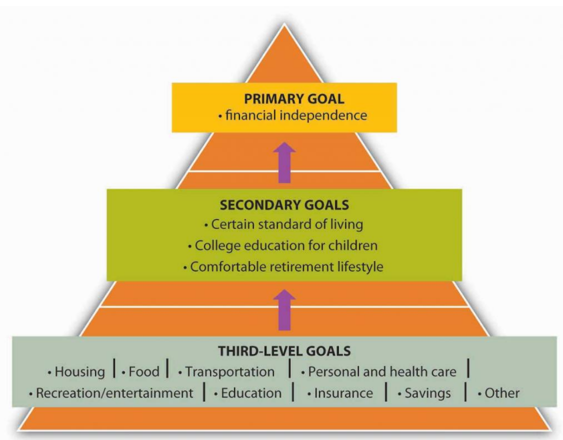
- A standard of living that reflects a certain level of comfort—a level associated with the possession of certain assets, both tangible and intangible.
- The ability to provide his children with college educations.
- A retirement lifestyle comparable to that of his peak earning years.

Having set this *secondary* level of goals, Joe's now ready to make specific plans for reaching them. As we've already seen, Joe understands that plans are far more likely to work out when they're focused on specific goals. His next step, therefore, is to determine the goals on which he should focus this next level of plans.

As it turns out, Joe already knows what these goals are, because he's been setting the appropriate goals every year since he drew up the cash-flow statement in Figure 12.7 "Cash-Flow Statement". In drawing up that statement, Joe was careful to create several line items to identify his various expenditures: *housing*, *food*, *transportation*, *personal and health care*, *recreation/entertainment*, *education*, *insurance*, *savings*, and *other expenses*. When we introduced these items, we pointed out that each one represents a cash outflow—something for which Joe expected to pay. They are, in other words, things that Joe intends to *buy* or, in the language of economics, *consume*. As such, we can characterize them as *consumption goals*. These "purchases"—what Joe wants in such areas as housing, insurance coverage, recreation/entertainment, and so forth—make specific his secondary goals and are therefore his *third-level* goals.

Figure 12.10 "Three-Level Goals/Plans" gives us a full picture of Joe's three-level hierarchy of goals.

Figure 12.10 Three-Level Goals/Plans



Present and Future Consumption Goals

A closer look at the list of Joe's consumption goals reveals that they fall into two categories:

1. We can call the first category *present* goals because each item is intended to meet Joe's present needs and those (we'll now assume) of his family—housing, health care coverage, and so forth. They must be paid for as Joe and his family take possession of them—that is, when they use or consume them. All these things are also necessary to meet the first of Joe's secondary goals—a certain standard of living.
2. The items in the second category of Joe's consumption goals are aimed at meeting his other two secondary goals: sending his children to college and retiring with a comfortable lifestyle. He won't take possession of these purchases until sometime in the *future*, but (as is so often the case) there's a catch: they must be paid for out of *current* income.

A Few Words about Saving

Joe's desire to meet this second category of consumption goals—*future* goals such as education for his kids and a comfortable retirement for himself and his wife—accounts for the appearance on his list of the one item that, at first glance, may seem misclassified among all the others: namely, *savings*.

Paying Yourself First

It's tempting to glance at Joe's budget and cash-flow statement and assume that he shares with most of us a common attitude toward saving money: when you're done allotting money for various spending needs, you can decide what to do with what's left over—save it or spend it. In reality, however, Joe's budgeting reflects an entirely different approach. When he made up the budget in Figure 12.9 "Joe's Budget", Joe *started out* with the decision to save $1,600—or at least to avoid spending it. Why? Because he had a goal: to be free of credit card debt. To meet this goal, he planned to use $1,200 of his *current* income to pay off what would continue to hang over his head as a *future* expense (his credit card debt). In addition, he *planned* to have $400 left over after he'd paid his credit card balance. Why? Because he had still longer-term goals, and he intended to get started on them early—as soon as he finished college. Thus his intention from the outset was to put $400 into savings.

In other words, here's how Joe went about budgeting his money for the year ending August 31, 2013 (as shown in Figure 12.9 "Joe's Budget"):

1. He calculated his income—total cash inflows from his student loan and his part-time job ($25,700).
2. He subtracted from his total income two targeted consumption goals—credit card payments ($1,200) and savings ($400).
3. He allocated what was left ($24,100) to his remaining consumption goals: housing ($6,600), food ($3,500), education ($6,500), and so forth.

If you're concerned that Joe's sense of delayed gratification is considerably more mature than your own, think of it this way: *Joe has chosen to pay himself first*. It's one of the key principles of personal-finances planning and an important strategy in doing something that we recommended earlier in this chapter—starting early.[44]

Key Takeaways

- The financial planning process consists of three steps:
  1. Evaluate your current financial status by creating a net worth statement and a cash flow analysis.
  2. Set short-term, intermediate-term, and long-term financial goals.
  3. Use a budget to plan your future cash inflows and outflows and to assess your financial performance by comparing budgeted figures with actual amounts.
- In step 1 of the financial planning process, you determine what you *own* and what you *owe*:
  1. Your personal *assets* consist of what you own.
  2. Your personal *liabilities* are what you owe—your obligations to various creditors.
- Most people have two types of assets:
  1. *Monetary* or *liquid assets* include cash, money in checking accounts, and the value of any savings, CDs, and money market accounts. They're called *liquid* because either they're cash or they can readily be turned into cash.
  2. Everything else is a *tangible asset*—something that can be used, as opposed to an investment.
- Likewise, most people have two types of liabilities:
  1. Any debts that should be paid within one year are *current liabilities*.
  2. *Noncurrent liabilities* consist of debt payments that extend for a period of more than one year.
- Your **net worth** is the difference between your assets and your liabilities. **Your net worth statement** will show whether your net worth is on the plus or minus side on a given date.
- In step 2 of the financial planning process, you create a **cash-flow** or **income statement**, which shows where your money has come from and where it's slated to go. It reflects your financial status over a period of time. Your cash *inflows*—the money you have coming in—are recorded as *income*. Your cash *outflows*—money going out—are itemized as *expenditures* in such categories as housing, food, transportation, education, and savings.
- A good way to approach your financial goals is by dividing them into three time frames: short-term (less than two years), intermediate-term (two to five years), and long-term (more than five years). Goals should be realistic and measurable, and you should designate definite time frames and specific courses of action.
- Net worth and cash-flow statements are most valuable when used together: while your net worth statement lets you know what you're worth, your cash-flow statement lets you know precisely what effect your spending and saving habits are having on your net worth.
- If you're not satisfied with the effect of your spending and saving habits on your net worth, you may want to make changes in future inflows (income) and outflows (expenditures). You make these changes in step 3 of the financial planning process, when you draw up your personal **budget**—a document that itemizes the sources of your income and expenditures for a future period (often a year).
- In addition to the itemized lists of inflows and outflows, there are three other columns in the budget:
  1. The "Budget" column tracks the amounts of money that you *plan* to receive or to pay out over the budget period.
  2. The "Actual" column records the amounts that did in fact come in or go out.
  3. The final column records the **variance** for each item—the difference between the amount in the "Budget" column and the corresponding amount in the "Actual" column.
- There are two types of variance:
  1. An *income variance* occurs when actual income is higher than budgeted income (or vice versa).
  2. An *expense variance* occurs when the actual amount of an expenditure is higher than the budgeted amount (or vice versa).

Exercise

(AACSB) Analysis

Using your own information (or made-up information if you prefer), go through the three steps in the financial planning process:

1. Evaluate your current financial status by creating a net worth statement and a cash flow analysis.
2. Identify short-term, intermediate-term, and long-term financial goals.
3. Create a budget (for a month or a year). Estimate future income and expenditures. Make up “actual” figures and calculate a variance by comparing budgeted figures with actual amounts.

A House Is Not a Piggy Bank: A Few Lessons from the Subprime Crisis

Learning Objectives

1. Discuss the trend in the U.S. savings rate.
2. Define a *subprime loan* and explain the difference between a *fixed-rate mortgage* and an *adjustable-rate mortgage*.
3. Discuss what can go wrong with a subprime loan at an adjustable rate. Discuss what can go wrong with hundreds of thousands of subprime loans at adjustable rates.
4. Define *risk* and explain some of the risks entailed by personal financial transactions.

Joe isn’t old enough to qualify, but if his grandfather had deposited $1,000 in an account paying 7 percent interest in 1945, it would now be worth $64,000. That’s because money invested at 7 percent compounded will double every ten years. Now, $64,000 may or may not seem like a significant return over fifty years, but after all, the money did all the heavy lifting, and given the miracle of compound interest, it’s surprising that Americans don’t take greater advantage of the opportunity to multiply their wealth by saving more of it, even in modest, interest-bearing accounts. Ironically, with $790 billion in credit card debt, it’s obvious that a lot of American families are experiencing the effects of compound interest—but in reverse.[45]

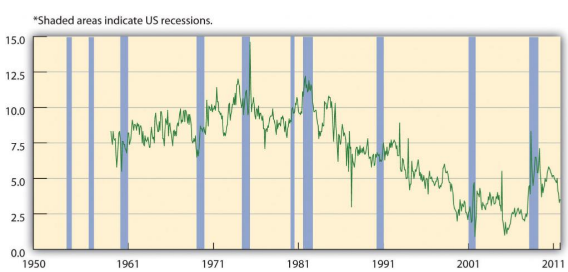
As a matter of fact, though Joe College appears to be on the right track when it comes to saving, many people aren’t. A lot of Americans, it seems, do indeed set savings goals, but in one recent survey, nearly 70 percent of the respondents reported that they fell short of their monthly goals because their money was needed elsewhere. About one-third of Americans say that they’re putting away something but not enough, and another third aren’t saving anything at all. Almost one-fifth of all Americans have net worth of zero—or less.[46][47]

As we indicated in the opening section of this chapter, this shortage of savings goes hand in hand with a surplus in spending. “My parents,” says one otherwise gainfully employed American knowledge worker, “are appalled at the way I justify my spending. I think, ‘Why work and make money unless you’re going to enjoy it?’ That’s a fine theory,” she adds, “until you’re sixty, homeless, and with no money in the bank”.[48] And indeed, if she doesn’t intend to alter her personal-finances philosophy, she has good reason to worry about her “older adult” years. Sixty percent of Americans over the age of sixty-five have less than $100,000 in savings, and only 30 percent of this group have more than $25,000; 45 percent have less than $15,000. As for income, 75 percent of people over age sixty-five generate less than $35,000 annually, and 30 percent are in the “poverty to near-poverty” range of $10,000 to $20,000 (as compared to 12 percent of the under-sixty-five population).[49]

Disposing of Savings

Figure 12.11 “U.S. Savings Rate” shows the U.S. *savings rate*—which measures the percentage of disposable income devoted to savings for the period 1960 to 2010. As you can see, it suffered a steep decline from 1980 to 2005 and remained at this negligible savings rate until it started moving up in 2008. The recent increase in the savings rate, however, is still below the long-term average of 7 percent.[50][51]

Figure 12.11 U.S. Savings Rate



Now, a widespread tendency on the part of Americans to spend rather than save doesn’t account entirely for the downward shift in the savings rate. In late 2005, the Federal Reserve cited at least two other (closely related) factors in the decline of savings:[52]

- An increase in the ratio of stock-market wealth to disposable income
- An increase in the ratio of residential-property wealth to disposable income

Assume, for example, that, in addition to your personal savings, you own some stock and have a mortgage on a home. Both your stock and your home are (supposedly) *appreciable assets*—their value used to go up over time. (In fact, if you had taken out your mortgage in 2000, by the end of 2005 your home would have appreciated at double the rate of your disposable personal income.) The decline in the personal savings rate during the mid-2000s, suggested the Fed, resulted in part from people's response to "long-lived bull markets in stocks and housing"; in other words, a lot of people had come to rely on the appreciation of such assets as stocks and residential property as "a substitute for the practice of saving out of wage income."

Subprime Rates and Adjustable Rate Mortgages

Let's assume that you weren't ready to take advantage of the boom in mortgage loans in 2000 but did set your sights on 2005. You may not have been ready to buy a house in 2005 either, but there's a good chance that you got a loan anyway. In particular, some lender might have offered you a so-called subprime mortgage loan. Subprime loans are made to borrowers who don't qualify for market-set interest rates because of one or more risk factors—income level, employment status, credit history, ability to make only a very low down payment. As of March 2007, U.S. lenders had written $1.3 trillion in mortgages like yours.[53]

Granted, your terms might not have been very good. For one thing, interest rates on subprime loans may run from 8 percent to 10 percent and higher.[54] In addition, you probably had to settle for an adjustable-rate mortgage (ARM)—one that's pegged to the increase or decrease of certain interest rates that your lender has to pay. When you signed your mortgage papers, you knew that if those rates went up, your mortgage rate—and your monthly payments—would go up, too. Fortunately, however, you had a plan B: with the value of your new asset appreciating even as you enjoyed living in it, it wouldn't be long before you could refinance it at a more manageable and more predictable rate.

The Meltdown

Now imagine your dismay when housing prices started to go *down* in 2006 and 2007. As a result, you weren't able to refinance, your ARM was set to adjust upward in 2008, and foreclosures were already happening all around you—1.3 million in 2007 alone.[55] By April 2008, one in every 519 American households had received a foreclosure notice.[56] By August, 9.2 percent of the $12 trillion in U.S. mortgage loans was delinquent or in foreclosure.[57][58]

Figure 12.12 Foreclosure

In 2008, nearly one out of five hundred households in the United States received a foreclosure notice.[59]

The repercussions? Banks and other institutions that made mortgage loans were the first sector of the financial industry to be hit. Largely because of mortgage-loan defaults, profits at more than 8,500 U.S. banks dropped from $35 billion in the fourth quarter of 2006 to $650 million in the corresponding quarter of 2007 (a decrease of 89 percent). Bank earnings for the year 2007 declined 31 percent and dropped another 46 percent in the first quarter of 2008.[60][61]

Losses in this sector were soon felt by two publicly traded government-sponsored organizations, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Both of these institutions are authorized to make loans and provide loan guarantees to banks, mortgage companies, and other mortgage lenders; their function is to make sure that these lenders have enough money to lend to prospective home buyers. Between them, Fannie Mae and Freddie Mac backed approximately half of that $12 trillion in outstanding mortgage loans, and when the mortgage crisis hit, the stock prices of the two corporations began to drop steadily. In September 2008, amid fears that both organizations would run out of capital, the U.S. government took over their management.

Freddie Mac also had another function: to increase the supply of money available for mortgage loans and new home purchases, Freddie Mac bought mortgages already written by lenders, pooled them, and sold them as mortgage-backed securities to investors on the open market. Many major investment firms did much the same thing, buying individual subprime mortgages from original lenders (such as small banks), pooling the projected revenue—payments made by the original individual home buyers—and selling securities backed by the pooled revenue.

But when their rates went too high and home buyers couldn't make these payments, these securities plummeted in value. Institutions that had invested in them—including investment banks—suffered significant losses.[62] In September 2008, one of these investment banks, Lehman Brothers, filed for bankruptcy protection; another, Merrill Lynch, agreed to sell itself for $50 billion. Next came American International Group (AIG), a giant insurance company that insured financial institutions against the risks they took in loaning and investing money. As its policyholders buckled under the weight of defaulted loans and failed investments, AIG, too, was on the brink of bankruptcy, and when private efforts to bail it out failed, the U.S. government stepped in with a loan of $85 billion.[63] The U.S. government also agreed to buy up risky mortgage-backed securities from teetering financial institutions at an estimated cost of "hundreds of billions".[64]

Subprime Directives: A Few Lessons from the Subprime Crisis

If you were one of the millions of Americans who took out subprime mortgages in the years between 2001 and 2005, you probably have some pressing financial problems. If you defaulted on your subprime ARM, you may have suffered foreclosure on your newly acquired asset, lost any equity that you'd built up in it, and taken a hit in your credit rating. (We'll assume that you're not one of the people whose eagerness to get on the subprime bandwagon caused fraudulent mortgage applications to go up by 300 percent between 2002 and 2006.) [65]

On the other hand, you've probably learned a few lessons about financial planning and strategy. Let's conclude with a survey of three lessons that you should have learned from your hypothetical adventure in the world of subprime mortgages.

Lesson 1: All mortgages are not created equal. Despite (or perhaps because of) the understandable enticement of home ownership, your judgment may have been faulty in this episode of your financial life cycle. Generally speaking, you're better off with a fixed-rate mortgage—one on which the interest rate remains the same regardless of changes in market interest rates—than with an ARM.[66] As we've explained at length in this chapter, planning is one of the cornerstones of personal-finances management, and ARMs don't lend themselves to planning. How well can you plan for your future mortgage payments if you can't be sure what they're going to be?

In addition, though interest rates may go up or down, planning for them to go *down* and to take your mortgage payments with them doesn't make much sense. You can wait around to get lucky, and you can even try to get lucky (say, by buying a lottery ticket), but you certainly can't *plan* to get lucky. Unfortunately, the only thing you can really *plan* for is higher rates and higher payments. An ARM isn't a good idea if you don't know whether you can meet payments higher than your initial payment. In fact, if you have reason to believe that you can't meet the *maximum* payment entailed by an ARM, you probably shouldn't take it on.

Lesson 2: It's risky out there. You now know—if you hadn't suspected it already—that planning your personal finances would be a lot easier if you could do it in a predictable economic environment. But you can't, of course, and virtually constant instability in financial markets is simply one economic fact of life that you'll have to deal with as you make your way through the stages of your financial life cycle.

In other words, any foray into financial markets is risky. Basically, *risk* is the possibility that cash flows will be variable.[67] Unfortunately, volatility in the overall economy is directly related to just one category of risks. There's a second category—risks related to the activities of various organizations involved in your financial transactions. You've already been introduced to the effects of these forms of financial risk, some of which have affected you directly, some of which have affected you indirectly, and some of which may affect you in the future:[68]

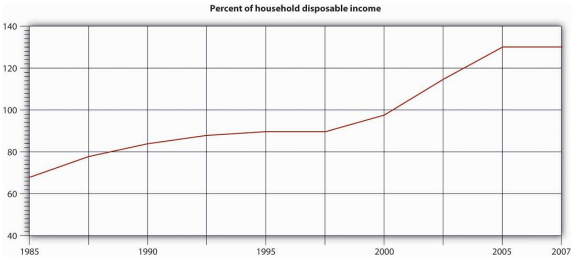
- *Management risk* is the risk that poor management of an organization with which you're dealing may adversely affect the outcome of your personal-finances planning. If you couldn't pay the higher rate on your ARM, managers at your lender probably failed to look deeply enough into your employment status and income.
- *Business risk* is the risk associated with a product that you've chosen to buy. The fate of your mortgagor, who issued the original product—your subprime ARM—and that of everyone down the line who purchased it in some form (perhaps Freddy Mac and Merrill Lynch) bear witness to the pitfalls of business risk.
- *Financial risk* refers to the risk that comes from ill-considered indebtedness. Freddie Mac, Fannie Mae, and several investment banks have felt the repercussions of investing too much money in financial instruments that were backed with shaky assets (namely, subprime mortgages).

In your own small way, of course, you, too, underestimated the pitfalls of all three of these forms of risk.

Lesson 3: Not all income is equally disposable. Figure 12.13 "Debt-Income Ratio" shows the increase in the ratio of debt to disposable income among American households between 1985 and 2007. As you can see, the increase was dramatic—from 80 percent in the early 1990s to about 130 percent in 2007.[69] This rise was made possible by greater access to credit—people borrow money in order to spend it, whether on consumption or on investments, and the more they can borrow, the more they can spend.

In the United States, greater access to credit in the late 1990s and early 2000s was made possible by rising housing prices: the more valuable your biggest asset, the more lenders are willing to lend you, even if what you're buying with your loan—your house—*is* your biggest asset. As the borrower, your strategy is twofold: (1) Pay your mortgage out of your wage income, and (2) reap the financial benefits of an asset that appreciates in value. On top of everything else, you can count the increased value of your asset as *savings*: when you sell the house at retirement, the difference between your mortgage and the current value of your house is yours to support you in your golden years.

Figure 12.13 Debt-Income Ratio



As we know, however, housing prices had started to fall by the end of 2006. From a peak in mid-2006, they had fallen 8 percent by November 2007, and by April 2008 they were down from the 2006 peak by more than 19 percent—the worst rate of decline since the Great Depression. And most experts expected it to get worse before it gets better, and unfortunately they were right. Housing prices have declined by 33 percent from the mid-2006 peak to the end of 2010.[70][71]

So where do you stand? As you know, your house is worth no more than what you can get for it on the open market; thus the asset that you were counting on to help provide for your retirement has *depreciated* substantially in little more than a decade. If you're one of the many Americans who tried to substitute equity in property for traditional forms of income savings, one financial specialist explains the unfortunate results pretty bluntly: your house "is a place to live, not a brokerage account".[72] If it's any consolation, you're not alone: a recent study by the Security Industries Association reports that, for many Americans, nearly half their net worth is based on the value of their home. Analysts fear that many of these people—a significant proportion of the baby-boom generation—won't be able to retire with the same standard of living that they've been enjoying during their wage-earning years.[73]

Key Takeaways

- Personal saving suffered a steep decline from 1980 to 2005 and remained at this negligible savings rate until it started moving up in 2008. The recent increase in the savings rate, however, is still below the long-term average of 7 percent.
- In addition to Americans' tendency to spend rather than save, the Federal Reserve observed that a lot of people had come to rely on the appreciation of such assets as stocks and residential property as a substitute for the practice of saving out of wage income.
- **Subprime loans** are made to would-be home buyers who don't qualify for market-set interest rates because of one or more risk factors —income level, employment status, credit history, ability to make only a very low down payment. Interest rates may run from 8 percent to 10 percent and higher.
- An **adjustable-rate mortgage (ARM)** is a home loan pegged to the increase or decrease of certain interest rates that the lender has to pay. If those rates go up, the mortgage rate and the home buyer's monthly payments go up, too. A **fixed-rate mortgage** is a home loan on which the interest rate remains the same regardless of changes in market interest rates.
- In the years between 2001 and 2005, lenders made billions of dollars in subprime ARM loans to American home buyers. In 2006 and 2007, however, housing prices started to go down. Homeowners with subprime ARM loans weren't able to refinance, their mortgage rates began going up, and foreclosures became commonplace.
- In 2006 and 2007, largely because of mortgage-loan defaults, banks and other institutions that made mortgage loans began losing huge sums of money. These losses carried over to Fannie Mae and Freddie Mac, publicly traded government-sponsored organizations that make loans and provide loan guarantees to banks and other mortgage lenders.
- Next to be hit were major investment firms that had been buying subprime mortgages from banks and other original lenders, pooling the projected revenue—payments made by the original individual home buyers—and selling securities backed by the pooled revenue. When their rates went too high and home buyers couldn't make their house payments, these securities plummeted in value, and the investment banks and other institutions that had invested in them suffered significant losses.
- *Risk* is the possibility that cash flows will be variable. Three types of risk are related to the activities of various organizations that may be involved in your financial transactions:
    1. *Management risk* is the risk that poor management of an organization with which you're dealing may adversely affect the outcome of your personal-finances planning.
    2. *Business risk* is the risk associated with a product that you've chosen to buy.
    3. *Financial risk* refers to the risk that comes from ill-considered indebtedness.

Exercise

(AACSB) Analysis

Write a report giving your opinion on how we got into the subprime mortgage crisis and how we'll get out of it

Cases and Problems

Learning on the Web (AACSB)

Go to https://www.quizzle.com and request a free copy of your credit report. Review the report. If you identify any errors, get them fixed. Write a brief report explaining the value of good credit.

Ethics Angle (AACSB)

Go online and read this article at Forbes.com: "Most Common Resume Lies," by Kate DuBose Tomassi at http://www.forbes.com/workspecial/2006/05/20/resume-lies-work_cx_kdt_06work_0523lies.html. View the slide show of common résumé lies. Answer these questions: What are the most common lies made in résumés? Why is it a bad idea to lie on such a document? What are the potential consequences of misstating facts on your résumé?

Team-Building Skills (AACSB)

It's becoming more difficult for individuals to buy homes. This has meant that many people who would have bought a home have remained in apartments. In big cities, such as New York, sharing an apartment with roommates is a good way to save money. Yet it has some disadvantages. Get together as a team and identify the pros and cons of sharing housing. Pretend that each member of the group has agreed to share one apartment. Create a document that details each member's rights and responsibilities. Decide as a group whether the lease should be in one person's name or in all your names. Explain the pros and cons of both approaches.

The Global View (AACSB)

You're looking forward to taking a month-long vacation to Australia when you graduate from college in two years. Create a budget for this trip after researching likely costs. Determine how much you'll need for the trip and calculate how much you'd have to save each month to afford the trip.

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CHAPTER OVERVIEW

4: Human Resources

4.1: Chapter 13- People and Organization

The idea for Unnamed Publisher , the publisher of this book, started on a business trip to Chicago in 2006. Co-founders Jeff Shelstad and Eric Frank, who were both working at a large educational publisher at the time, decided they wanted to move away from the limitations and the frustrations of the traditional publishing industry. Veterans of the higher education publishing industry. Their vision was to create a new publishing company that offered a lot more choices to students, professors, and authors.

"Students can't afford to pay $200 for a textbook. The old business model wasn't adapting fast enough to the Internet, where so much information was available for free or low-cost," says Jeff, referring to traditional publishers. "We knew there had to be a better way to publish high-quality material and eliminate price and access barriers."

Since its beginning in 2007, more than thirty employees have joined this fast-growing start-up, located just north of New York City, in Irvington, New York. The company has become a recognized pioneer in transforming higher educational publishing and textbook affordability.

FWK is upending the $8 billion college textbook industry with a new business model that focuses on affordability and personalization. Professors who assign FWK books are free to revise and edit the material to match their course and help improve student success. Students have a choice of affordable print and digital formats that they can access online or on a laptop, tablet, e-reader or smartphone for a fraction of the price that most traditional publishers charge.

Rather than hamper the company's growth, the economic downturn has actually highlighted the value of its products and the viability of its business model. Despite the bad economy, FWK has been able to raise over $30 million in venture capital. Clearly, they are doing something right.

The numbers tell the story. Since the launch of their first ten books in spring 2009 (there are more than one hundred fifteen books to date), faculty at more than two thousand institutions in forty-four countries have adopted FWK books. As a result, more than 600,000 students have benefited from affordable textbook choices that lower costs, increase access and personalize learning.

In 2010, 2011 and 2012, EContent magazine named FWK as one of the top one hundred companies that matter most in the digital content industry. FWK was also named 2010 Best Discount Textbook Provider by the Education Resources People's Choice Awards.

What is particularly refreshing is Jeff's philosophy about people and work. "Give talented people an opportunity to build something meaningful, the tools to do it, and the freedom to do one's best." He believes in flexibility with people and their jobs, and, to that end, employees have the option to work remotely. There is no question that FWK is an innovator in the educational publishing industry, but it also knows how to treat people well and provide a challenging environment that fosters personal growth.

[1] [2] [3]

Principles of Management and Organization

Learning Objectives

1. Understand the functions of management.
2. Explain the three basic leadership styles.
3. Explain the three basic levels of management.
4. Understand the management skills that are important for a successful small business.
5. Understand the steps in ethical decision making.

All small businesses need to be concerned about management principles. Management decisions will impact the success of a business, the health of its work environment, its growth if growth is an objective, and customer value and satisfaction. Seat-of-the-pants management may work temporarily, but its folly will inevitably take a toll on a business. This section discusses management principles, levels, and skills—all areas that small business owners should understand so that they can make informed and effective choices for their businesses.

What Is Management?

There is no universally accepted definition for management. The definitions run the gamut from very simple to very complex. For our purposes, we define management as "the application of planning, organizing, staffing, directing, and controlling functions in the most efficient manner possible to accomplish meaningful organizational objectives."[4] Put more simply, management is all about achieving organizational objectives through people and other resources.[5]

Management principles apply to all organizations—large or small, for-profit or not-for-profit. Even one-person small businesses need to be concerned about management principles because without a fundamental understanding of how businesses are managed, there can be no realistic expectation of success. Remember that the most common reason attributed to small business failure is failure on the part of management.

Management Functions

On any given day, small business owners and managers will engage in a mix of many different kinds of activities—for example, deal with crises as they arise, read, think, write, talk to people, arrange for things to be done, have meetings, send e-mails, conduct performance evaluations, and plan. Although the amount of time that is spent on each activity will vary, all the activities can be assigned to one or more of the five management functions: planning, organizing, staffing, directing, and controlling (Figure 13.1 "Management Functions").

Figure 13.1 Management Functions

Planning

Planning "is the process of anticipating future events and conditions and determining courses of action for achieving organizational objectives."[6] It is the one step in running a small business that is most commonly skipped, but it is the one thing that can keep a business on track and keep it there.[7] Planning helps a business realize its vision, get things done, show when things cannot get done and why they may not have been done right, avoid costly mistakes, and determine the resources that will be needed to get things done.[8] [9]

Organizing

Organizing consists of grouping people and assigning activities so that job tasks and the mission can be properly carried out.[10] Establishing a management hierarchy is the foundation for carrying out the organizing function.

Contrary to what some people may believe, the principle of organizing is not dead. Rather, it is clearly important "to both the organization and its workers because both the effectiveness of organizations and worker satisfaction require that there be clear and decisive direction from leadership; clarity of responsibilities, authorities, and accountabilities; authority that is commensurate with responsibility and accountability; unified command (each employee has one boss); a clear approval process; and, rules governing acceptable employee behavior."[11] Except for a small business run solely by its owner, every small business needs a management hierarchy—no matter how small. Each person in the business should know who is responsible for what, have the authority to carry out his or her responsibilities, and not get conflicting instructions from different bosses. The absence of these things can have debilitating consequences for the employees in particular and the business in general.[12]

Video Link 13.1 Glassblowing Business Thrives

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

www.cnn.com/video/#/video/living/2010/10/15/mxp.sbs.glass.business.hln?iref=videosearch

Staffing

The ***staffing*** function involves selecting, placing, training, developing, compensating, and evaluating (the performance appraisal) employees.[13] Small businesses need to be staffed with competent people who can do the work that is necessary to make the business a success. It would also be extremely helpful if these people could be retained. Many of the issues associated with staffing in a small business are discussed in Section 13.4 "People".

Directing

Directing is the managerial function that initiates action: issuing directives, assignments, and instructions; building an effective group of subordinates who are motivated to do what must be done; explaining procedures; issuing orders; and making sure that mistakes are corrected.[14][15] Directing is part of the job for every small business owner or manager. ***Leading***"is the process of influencing people to work toward a common goal [and] ***motivating*** is the process of providing reasons for people to work in the best interests of an organization." [16]

Different situations call for different leadership styles. In a very influential research study, Kurt Lewin established three major leadership styles: autocratic, democratic, and laissez-faire.[17] Although good leaders will use all three styles depending on the situation, with one style normally dominant, bad leaders tend to stick with only one style.[18]

Autocratic leadership occurs when a leader makes decisions without involving others; the leader tells the employees what is to be done and how it should be accomplished.[19][20] Lewin et al. found that this style creates the most discontent.[21] However, this style works when all the information needed for a decision is present, there is little time to make a decision, the decision would not change as a result of the participation of others, the employees are well motivated, and the motivation of the people who will carry out subsequent actions would not be affected by whether they are involved in the decision or not.[22][23] This leadership style should not be used very often.

Democratic leadership involves other people in the decision making—for example, subordinates, peers, superiors, and other stakeholders—but the leader makes the final decision. Rather than being a sign of weakness, this participative form of leadership is a sign of strength because it demonstrates respect for the opinions of others. The extent of participation will vary depending on the leader's strengths, preferences, beliefs, and the decision to be made, but it can be as extreme as fully delegating a decision to the team.[24] This leadership style works well when the leader has only part of the information and the employees have the other part. The participation is a win-win situation, where the benefits are mutual. Others usually appreciate this leadership style, but it can be problematic if there is a wide range of opinions and no clear path for making an equitable, final decision.[25][26] In experiments that Lewin et al. conducted with others, the democratic leadership style was revealed as the most effective.[27]

Laissez-faire leadership (or delegative or free-reign leadership) minimizes the leader's involvement in decision making. Employees are allowed to make decisions, but the leader still has responsibility for the decisions that are made. The leader's role is that of a contact person who provides helpful guidance to accomplish objectives.[28] This style works best when employees are self-motivated and competent in making their own decisions, and there is no need for central coordination; it presumes full trust and confidence in the people below the leader in the hierarchy.[29][30] However, this is not the style to use if the leader wants to blame others when things go wrong.[31] This style can be problematic because people may tend not to be coherent in their work and not inclined to put in the energy they did when having more visible and active leadership.[32][33]

Good leadership is necessary for all small businesses. Employees need someone to look up to, inspire and motivate them to do their best, and perhaps emulate. In the final analysis, leadership is necessary for success. Without leadership, "the ship that is your small business will aimlessly circle and eventually run out of power or run aground."[34]

Don't Be This Kind of Leader or Manager

Here are some examples of common leadership styles that should be avoided.

- **Post-hoc management.** As judge and jury, management is always right and never to blame. This approach ensures security in the leader's job. This style is very common in small companies where there are few formal systems and a general autocratic leadership style.[35]
- **Micromanagement.** Alive and well in businesses of all sizes, this style assumes that the subordinate is incapable of doing the job, so close instruction is provided, and everything is checked. Subordinates are often criticized and seldom praised; nothing is ever good enough. It is really the opposite of leadership.[36]
- **Seagull management.** This humorous term is used to describe a management style whereby a person flies in, poops on you, and then flies away.[37] When present, such people like to give criticism and direction in equal quantities—with no real understanding of what the job entails. Before anyone can object or ask what the manager really wants, he or she is off to an important meeting. Everyone is actively discouraged from saying anything, and eye contact is avoided.[38]
- **Mushroom management.** This manager plants you knee-deep (or worse) in the smelly stuff and keeps you in the dark.[39] Mushroom managers tend to be more concerned about their own careers and images. Anyone who is seen as a threat may be deliberately held back. These managers have their favorites on whom they lavish attention and give the best jobs. Everyone else is swept away and given the unpopular work. Oftentimes, mushroom managers are incompetent and do not know any better. We have all seen at least one manager of this type.
- **Kipper management.** This is the manager who is, like a fish, two-faced because employees can see only one face at a time. To senior managers, this person is typically a model employee who puts business first and himself last. To subordinates, however, the reverse is often the case. The subordinates will work hard to get things done in time, but they are blamed when things go wrong—even if it is not their fault. The kipper will be a friend when things need to get done and then stab the subordinates in the back when glory or reward is to be gained.[40] We have all seen this kind of manager, perhaps even worked for one.

Controlling

Controlling is about keeping an eye on things. It is "the process of evaluating and regulating ongoing activities to ensure that goals are achieved."[41] Controlling provides feedback for future planning activities and aims to modify behavior and performance when deviations from plans are discovered.[42] There are four commonly identified steps in the controlling process[43][44]. (See Figure 13.2 "The Controlling Function".) **Setting performance standards** is the first step. Standards let employees know what to expect in terms of time, quality, quantity, and so forth. The second step is **measuring performance**, where the actual performance or results are determined. **Comparing performance** is step three. This is when the actual performance is compared to the standard. The fourth and last step, **taking corrective action**, involves making whatever actions are necessary to get things back on track. The controlling functions should be circular in motion, so all the steps will be repeated periodically until the goal is achieved.

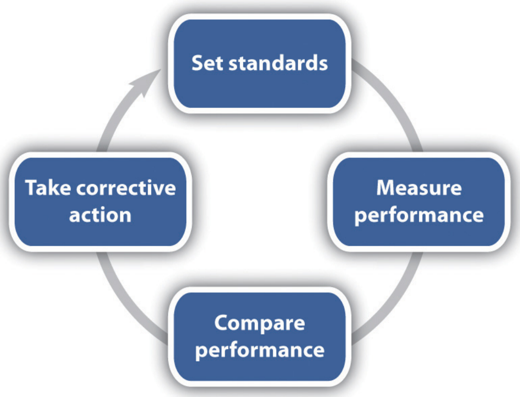


Figure 13.2 The Controlling Function

Levels of Management

As a small business grows, it should be concerned about the levels or the layers of management. Also referred to as the ***management hierarchy***, (Figure 13.3 "The Management Hierarchy") there are typically three levels of management: top or executive, middle, and first-line or supervisory. To meet a company's goals, there should be coordination of all three levels.

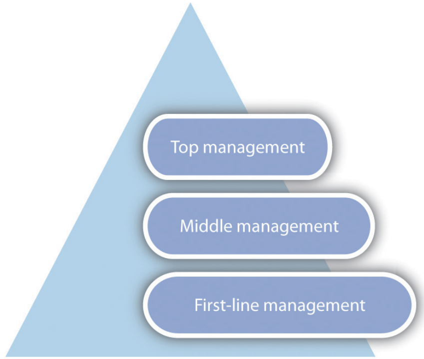


Figure 13.3 The Management Hierarchy

Top management also referred to as the executive level, guides and controls the overall fortunes of a business.[45] This level includes such positions as the president or CEO, the chief financial officer, the chief marketing officer, and executive vice presidents. Top managers devote most of their time to developing the mission, long-range plans, and strategy of a business—thus setting its direction. They are often asked to represent the business in events at educational institutions, community activities, dealings with the government, and seminars and sometimes as a spokesperson for the business in advertisements. It has been estimated that top managers spend 55 percent of their time planning.[46]

Middle management is probably the largest group of managers. This level includes such positions as regional manager, plant manager, division head, branch manager, marketing manager, and project director. Middle managers, a conduit between top management and first-line management, focus on specific operations, products, or customer groups within a business. They have responsibility for developing detailed plans and procedures to implement a firm's strategic plans.[47]

First-line or ***supervisory management*** is the group that works directly with the people who produce and sell the goods and/or the services of a business; they implement the plans of middle management.[48] They coordinate and supervise the activities of operating employees, spending most of their time working with and motivating their employees, answering questions, and solving day-to-day problems.[49] Examples of first-line positions include supervisor, section chief, office manager, foreman, and team leader.[50][51]

In many small businesses, people often wear multiple hats. This happens with management as well. One person may wear hats at each management level, and this can be confusing for both the person wearing the different hats and other employees. It is common for the small business owner to do mostly first-level management work, with middle or top management performed only in response to a problem or a crisis, and top-level strategic work rarely performed.[52] This is not a good situation. If the small business is large enough to have three levels of management, it is important that there be clear distinctions among them—and among the people who are in those positions. The small business owner should be top management only. This will eliminate confusion about responsibility and accountability.

Management Skills

Management skill "is the ability to carry out the process of reaching organizational goals by working with and through people and other organizational resources."[53] Possessing management skill is generally considered a requirement for success.[54] An effective manager is the manager who is able to master four basic types of skills: technical, conceptual, interpersonal, and decision making.

Technical skills "are the manager's ability to understand and use the techniques, knowledge, and tools and equipment of a specific discipline or department."[55] These skills are mostly related to working with processes or physical objects. Engineering, accounting, and computer programming are examples of technical skills.[56] Technical skills are particularly important for first-line managers and are much less important at the top management level. The need for technical skills by the small business owner will depend on the nature and the size of the business.

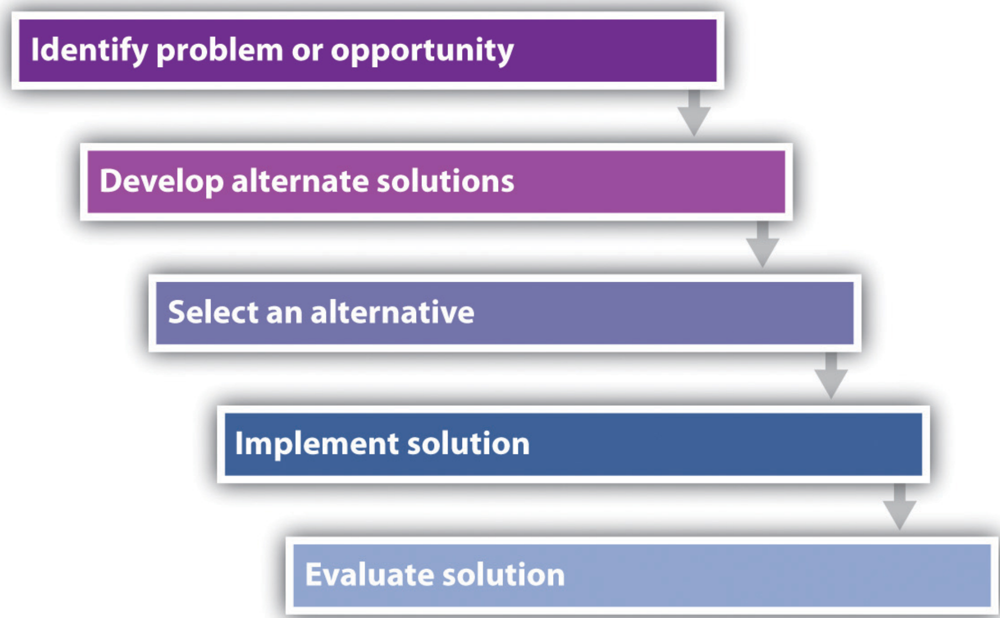
Conceptual skills "determine a manager's ability to see the organization as a unified whole and to understand how each part of the overall organization interacts with other parts."[57] These skills are of greatest importance to top management because it is this level that must develop long-range plans for the future direction of a business. Conceptual skills are not of much relevance to the first-line manager but are of great importance to the middle manager. All small business owners need such skills.

Interpersonal skills, "include the ability to communicate with, motivate, and lead employees to complete assigned activities,"[58] hopefully building cooperation within the manager's team. Managers without these skills will have a tough time succeeding.

Interpersonal skills are of greatest importance to middle managers and are somewhat less important for first-line managers. They are of least importance to top management, but they are still very important. They are critical for all small business owners.

The fourth basic management skill is ***decision making*** (Figure 13.4 "Management Decision Making"), the ability to identify a problem or an opportunity, creatively develop alternative solutions, select an alternative, delegate authority to implement a solution, and evaluate the solution.[59]

Figure 13.4 Management Decision Making



Making good decisions is never easy, but doing so is clearly related to small business success. "Decisions that are based on a foundation of knowledge and sound reasoning can lead the company into long-term prosperity; conversely, decisions that are made on the basis of flawed logic, emotionalism, or incomplete information can quickly put a small business out of commission."[60]

A Framework for Ethical Decision Making

Small business decisions should be ethical decisions. Making ethical decisions requires that the decision maker(s) be sensitive to ethical issues. In addition, it is helpful to have a method for making ethical decisions that, when practiced regularly, becomes so familiar that it is automatic. The Markkula Center for Applied Ethics recommends the following framework for exploring ethical dilemmas and identifying ethical courses of action.[61] However, in many if not most instances, a small business owner or manager and an employee will usually know instinctively whether a particular decision is unethical.

Recognize an Ethical Issue

- Could this decision or situation be damaging to someone or some group? Does this decision involve a choice between a good and a bad alternative or perhaps between two "goods" or between two "bads"?
- Is this issue about more than what is legal or most efficient? If so, how?

Get the Facts

- What are the relevant facts of the case? What facts are not known? Can I learn more about the situation? Do I know enough to make a decision?
- What individuals and groups have an important stake in the outcome? Are some concerns more important? Why?
- What are the options for acting? Have all the relevant persons and groups been consulted? Have I identified creative options?

Evaluate Alternative Actions

- Which option will produce the most good and do the least harm?
- Which option best respects the rights of all who have a stake?
- Which option treats people equally or proportionately?

- Which option best serves the community as a whole, not just some members?
- Which option leads me to act as the sort of person I want to be?

Make a Decision and Test It

- Considering all these approaches, which option best addresses the situation?
- If I told someone I respect—or told a television audience—which option I have chosen, what would they say?

Act and Reflect on the Outcome

- How can my decision be implemented with the greatest care and attention to the concerns of all stakeholders?
- How did my decision turn out, and what have I learned from this specific situation?

Key Takeaways

- Management principles are important to all small businesses.
- Management decisions will impact the success of a business, the health of its work environment, its growth if growth is an objective, and customer value and satisfaction.
- Management is about achieving organizational objectives through people.
- The most common reason attributed to small business failure is failure on the part of management.
- On any given day, a typical small business owner or manager will be engaged in some mix of planning, organizing, staffing, directing, and controlling.
- Different situations call for different leadership styles. The three major styles are autocratic, democratic, and laissez-faire. Bad leaders typically stick with one style.
- The management hierarchy is typically composed of three levels: top or executive, middle, and first-line or supervisory. If a small business is large enough to have these three levels, it is important that there be a clear distinction between them.
- Management skills are required for success. Technical, conceptual, interpersonal, and decision-making skills will be of differing importance depending on the management level.

Exercises

1. Apply the four steps in the controlling function for Frank's BarBeQue. Identify and discuss examples of performance standards that Frank might use. Indicate which standards should be numerically based. How could he measure performance? What corrective action should he take if performance does not meet the established performance standards?

Organizational Design

Learning Objectives

1. Understand why an organizational structure is necessary.
2. Understand organizational principles.
3. Explain the guidelines for organizing a small business.
4. Describe the different forms of organizational structure and how they apply to small businesses.

Organizing consists of grouping people and assigning activities so that job tasks and the mission of a business can be properly carried out. The result of the organizing process should be an overall structure that permits interactions among individuals and departments needed to achieve the goals and objectives of a business.[62] Although small business owners may believe that they do not need to adhere to the organizing principles of management, nothing could be farther from the truth.

Principles represent guidelines that managers can use in making decisions. They are not laws etched in stone. At times, principles can be used exactly as the way they are stated; at other times they should be modified or even completely ignored. **Small business owners must learn through experience when and where to use [the] principles or to modify them [emphasis added]**. Principles when used effectively and in the right context often bring organizational efficiencies and thus result in the growth of the business. Some organizing principles…would apply to small businesses as well as they would to large enterprises and would lead to similar benefits. [63]

There is no single best way to organize. Rather, the organization decision is based on a multitude of factors, including business size, market, product mix, competition, the number of employees, history, objectives and goals, and available financial resources. [64] Each small business must decide what organizational design best fits the business.

Fundamentals of Organization

Ivancevich and Duening maintain that there are several fundamental issues that managers need to consider when making any kind of organizational decision: clear objectives, coordination, formal and informal organization, the organization chart, formal authority, and centralization versus decentralization. Understanding these fundamentals can facilitate the creation of an organizational structure that is a good fit for a small business. [65]

Clear Objectives

Objectives "give meaning to the business—and to the work done by employees—by determining what it is attempting to accomplish."[66] Objectives provide direction for organizing a firm, helping to identify the work that must be done to accomplish the objectives. This work, in turn, serves as the basis on which to make staffing decisions.

Coordination

The resources of a small business and its employees must be coordinated to minimize duplication and maximize effectiveness.[67] Coordination requires informal communication with and among employees every day. All businesses must continually coordinate the activities of others—an effort that should never be underestimated. Business leaders must make sure that employees have the answers to six fundamental questions:[68]

1. What is my job?
2. How am I doing?
3. Does anyone care?
4. How are we doing?
5. What are our vision, mission, and values?
6. How can I help?

Formal and Informal Organization

When a one-person small business adds employees, some kind of hierarchy will be needed to indicate who does what. This hierarchy often becomes the **formal organization** —that is, the details of the roles and responsibilities of all employees.[69] Formal organization tends to be static, but it does indicate who is in charge of what. This helps to prevent chaos. The formal organizational structure helps employees feel safe and secure because they know exactly what their chain of command is. The downside of a formal organizational structure is that it typically results in a slower decision-making process because of the numerous groups and people who have to be involved and consulted.[70]

The ***informal organization*** is almost never explicitly stated. It consists of all the connections and relationships that relate to how people throughout the organization actually network to get a job done. The informal organization fills the gaps that are created by the formal organization.[71] Although the informal organization is not written down anywhere, it has a tremendous impact on the success of a small business because it is "composed of natural leaders who get things done primarily through the power granted to them by their peers."[72] Informal groups and the infamous grapevine are firmly embedded in the informal organization. The **grapevine (or water cooler)** "is the informal communications network within an organization,…completely separate from—and sometimes much faster than—the organization's formal channels of communication."[73] Small business owners must acknowledge the existence of the grapevine and figure out how to use it constructively.

Video Clip 13.1 Leading Outside the Lines

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

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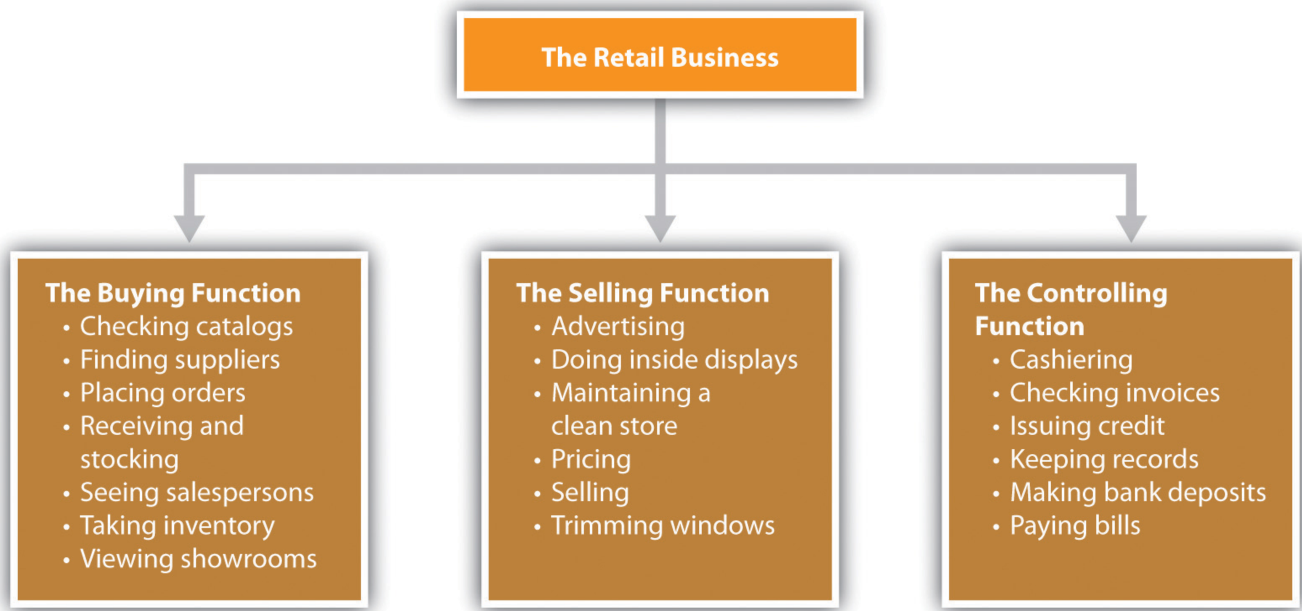
Organization Chart

The ***organization chart*** is a visual representation of the formal organization of a business. The chart shows the structure of the organization and the relationships and relative ranks of its positions; it helps organize the workplace while outlining the direction of management control for subordinates.[74] Even the one-person small business can use some kind of organization chart to see what functions need to be performed; this will help ensure that everything that should be done is getting done.[75] Figure 13.5 "Organization Chart for a One-Person Small Business" illustrates a simple organization chart for a one-person retail business.[76]

Figure 13.5 Organization Chart for a One-Person Small Business



Organization charts offer the following benefits:[77] [78]

- Effectively communicate organizational, employee, and enterprise information
- Allow managers to make decisions about resources, provide a framework for managing change, and communicate operational information across the organization
- Are transparent and predictable about what should happen in a business
- Provide a quick snapshot about the formal hierarchy in a business
- Tell everyone in the organization who is in charge of what and who reports to whom

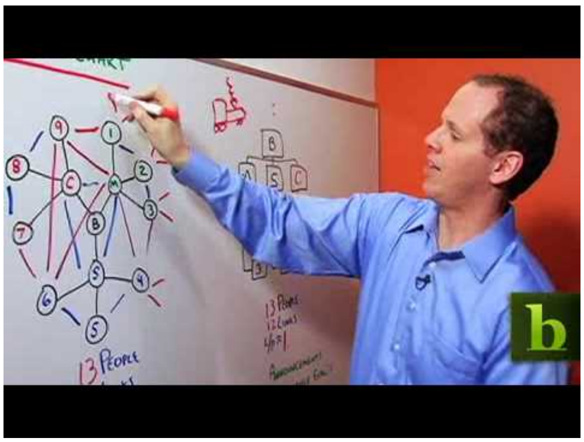
There are, of course, several limitations to organization charts:[79]

- They are static and inflexible, often being out of date as organizations change and go through growth phases.
- They do not aid in understanding what actually happens within the informal organization. The reality is that organizations are often quite chaotic.
- They cannot cope with changing boundaries of firms due to outsourcing, information technology, strategic alliances, and the network economy.

In its early stages, a small business may choose not to create a formal organization chart. However, organization must exist even without a chart so that the business can be successful. Most small businesses find organization charts to be useful because they help the owner or the manager track growth and change in the organizational structure.[80] The real challenge is to create an organizational chart that reflects the real world. Small businesses have a definite advantage here because their size allows for more flexibility and manageability.

Video Clip 13.2 Burn Your Org Chart

Not all organizational charts reflect the real world.



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Formal authority is "the right to give orders and set policy."[81] It is organized according to a hierarchy, typically expressed in the organization chart, where one manager may have authority over some employees while being subject to the formal authority of a superior at the same time. Formal authority also encompasses the allocation of an organization's resources to achieve its objectives.[82][83] The position on the organization chart will be indicative of the amount of authority and formal power held by a particular individual.

Two major types of authority that the small business owner should understand are line and staff. These authorities reflect the existing relationships between superiors and subordinates.[84]***Line authority*** refers to having direct authority over lower positions in the hierarchy. "A manager with line authority is the unquestioned superior for all activities of his or her subordinates."[85] The day-to-day tasks of those with line authority involve working directly toward accomplishing an organization's mission, goals, and objectives.[86] Examples of positions with line authority are the president, the vice president of operations, and the marketing manager. In a small business, the owner or the top manager will have line authority over his or her subordinates. The extent of line authority beyond the owner or the top manager will depend on the size of the business and the organizational vision of the owner.

Staff authority is advisory only. There is no authority to take action (except when someone is a manager of a staff function, e.g., human resources), and there is no responsibility for revenue generation. Someone with staff authority assists those with line authority as well as others who have staff authority. Examples of staff authority are human resources, legal, and accounting, each of which is relevant to a small business. Staff personnel can be extremely helpful in improving the effectiveness of line personnel. Unfortunately, staff personnel are often the first to go when cutbacks occur. As a small business grows, a decision may be made to add staff personnel because the most significant factor in determining whether or not to add personnel is the size of a business. The larger the organization, the greater the need and the ability to hire staff personnel to provide specialized expertise.[87] Small businesses, however, may prefer to hire outside service providers for staff functions such as legal and accounting services because it would be difficult to keep such people busy full time. Remember, cash flow is king.

Centralization and Decentralization

Centralization and decentralization are about the amount of authority to delegate. ***Centralization*** means that little or no authority and job activities are delegated to subordinates. A relatively small number of line managers make the decisions and hold most of the authority and power. ***Decentralization*** is the opposite. Authority and job activities are delegated rather than being held by a small management group.[88] [89]

Depending on various factors, organizations move back and forth on the centralization-decentralization continuum. For example, managing a crisis requires more centralized decision making because decisions need to be made quickly.[90] A noncrisis or a normal work situation would favor decentralized decision making and encourages employee empowerment and delegated authority.[91] There are no universally accepted guidelines for determining whether a centralized or a decentralized approach should be used. It has been noted, however, that, "the best organizations are those that are able to shift flexibly from one level of centralization to another in response to changing external conditions." [92] Given the flexibility and the responsiveness of small businesses that originate from their size, any movement that is needed along the centralization-decentralization continuum will be much easier and quicker.

Guidelines for Organizing

Several management principles can be used as guidelines when designing an organizational structure. Although there are many principles to consider, the focus here is on unity of command, division of work, span of control, and the scalar principle. These principles are applicable to small businesses although, as has been said earlier, they should not be seen as etched in stone. They can be modified or ignored altogether depending on the business, the situation at hand, and the experience of management.[93] [94]

Unity of Command

Unity of command means that no subordinate has more than one boss. Each person in a business should know who gives him or her the authority to make decisions and do the job. Having conflicting orders from multiple bosses will create confusion and frustration about which order to follow and result in contradictory instructions.[95] In addition, violating the unity of command will undermine authority, divide loyalty, and create a situation in which responsibilities can be evaded and work efforts will be duplicated and overlapping. Abiding by the unity of command will provide discipline, stability, and order, with a harmonious relationship—relatively speaking, of course—between superior and subordinate.[96] Unity of command makes the most sense for everyone, but it is violated on a regular basis.

Division of Labor

The ***division of labor*** is a basic principle of organizing that maintains that a job can be performed much more efficiently if the work is divided among individuals and groups so that attention and effort are focused on discrete portions of the task—that is, the jobholder is allowed to specialize.[97] [98] The result is a more efficient use of resources and greater productivity. As mentioned earlier, small businesses are commonly staffed with people who wear multiple hats, including the owner. However, the larger the business, the more desirable it will be to have people specialize to improve efficiency and productivity. To do otherwise will be to slow down processes and use more resources than should be necessary. This will have a negative impact on the bottom line.

Span of Control

Span of control (span of management) refers to the number of people or subordinates that a manager supervises. The span of control typically becomes smaller as a person moves up the management hierarchy. There is no magic number for every manager. Instead, the number will vary based on "The abilities of both the manager and the subordinates, the nature of the work being done, the location of the employees, and the need for planning and coordination."[99] The growing trend is to use wider spans of control. Companies are flattening their structures by reducing their layers of management, particularly middle management. This process has increased the decision-making responsibilities that are given to employees.[100][101] [102] As a small business grows, there will likely be more management hierarchy unless the small business owner is committed to a flatter organization. Either approach will have implications for span of control.

Scalar Principle

The ***scalar principle*** maintains "that authority and responsibility should flow in a clear, unbroken line from the highest to the lowest manager."[103] Abiding by this principle will result in more effective decision making and communication at various levels in the organization. Breaking the chain would result in confusion about relationships and employee frustration. Following this principle is particularly important to small businesses because the tendency may otherwise be to operate on a more informal basis because of the size of the business. This would be a mistake. Even a two-person business should pay attention to the scalar principle.

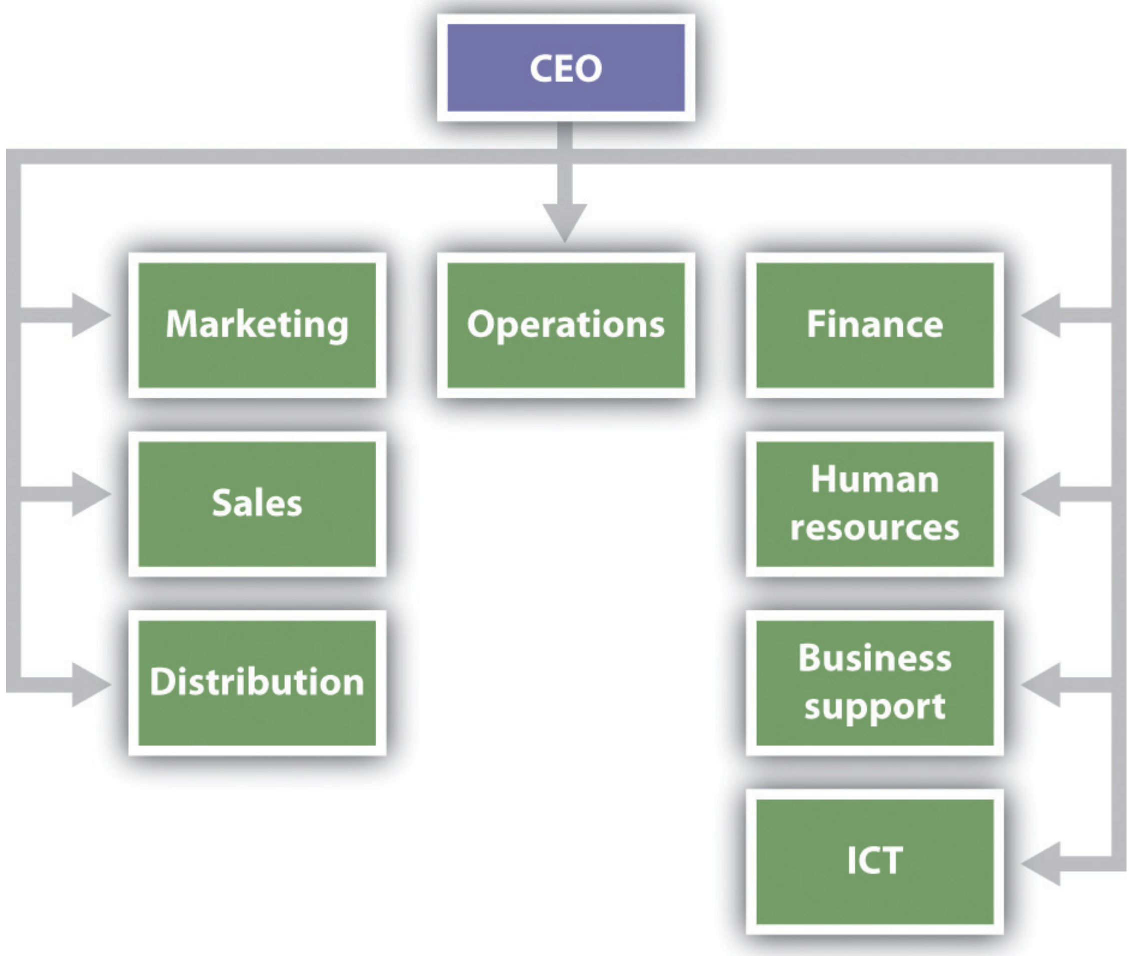
Types of Organization Structures

Knowledge about organization structures is important for a small business that is already up and running as well as a small business in its early stages. Organizations are changing every day, so small business owners should be flexible enough to change the structure over time as the situation demands, perhaps by using the ***contingency approach***. "The contingency approach to the structure of current organizations suggests there is no 'one best' structure appropriate for every organization. Rather, this approach contends the 'best' structure for an organization fits its needs for the situation at the time."[104] If a small business employs fewer than fifteen people, it may not be necessary to worry too much about its organizational structure. However, if the plans for the business include hiring more than fifteen people, having an organizational structure makes good sense because it will benefit a company's owner, managers, employees, investors, and lenders.[105] There are many structure options. Functional, divisional, matrix, and network or virtual structures are discussed here.

Functional Structure

The ***functional structure*** is overwhelmingly the choice of business start-ups and is probably the most common structure used today. This structure organizes a business according to job or purpose in the organization and is most easily recognized by departments that focus on a single function or goal. (See Figure 13.6 "An Example of a Functional Structure" for an example of a functional structure.) A start-up business is not likely to have an organization that looks like this. There may be only one or two boxes on it, representing the founder and his or her partner (if applicable).[106] As a small business grows, the need for additional departments will grow as well.

Figure 13.6 An Example of a Functional Structure [107]



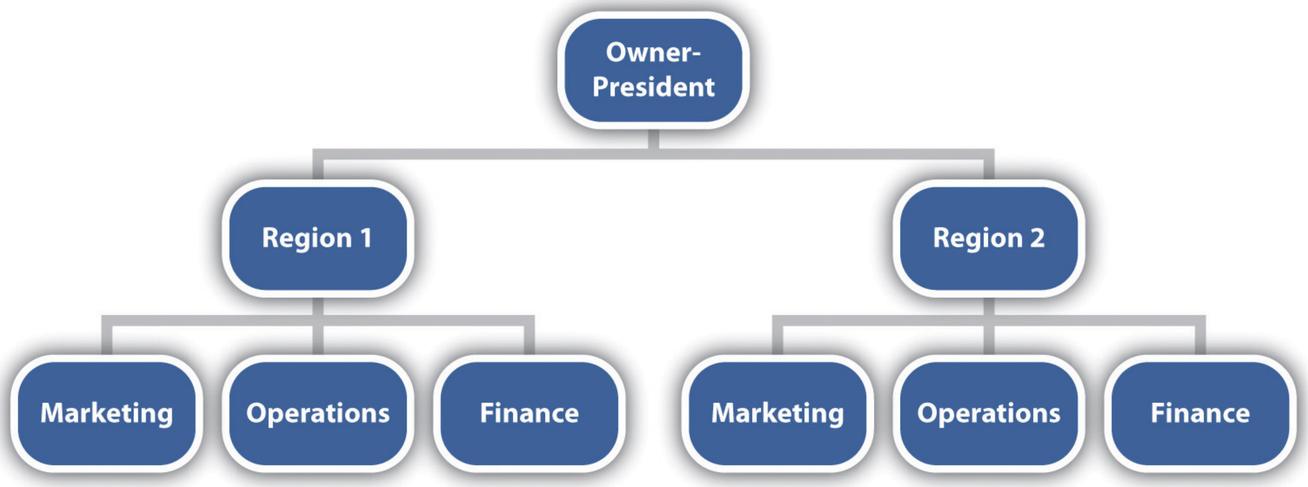
The functional structure gives employees and their respective departments clear objectives and purpose for their work. People in accounting can focus on improving their knowledge and skills to perform that work. This structure has also been shown to work well for businesses that operate in a relatively stable environment.[108] [109]

At the same time, the functional structure can create divisions between departments if conflict occurs,[110] and it can become an obstruction if the objectives and the environment of the business require coordination across departments.[111]

Divisional Structure

The ***divisional structure*** can be seen as a decentralized version of the functional structure. The functions still exist in the organization, but they are based on product, geographic area or territory, or customer. Each division will then have its own functional department(s).[112] (See Figure 13.7 "An Example of a Divisional Structure" for an example of a divisional structure.)

Figure 13.7 An Example of a Divisional Structure



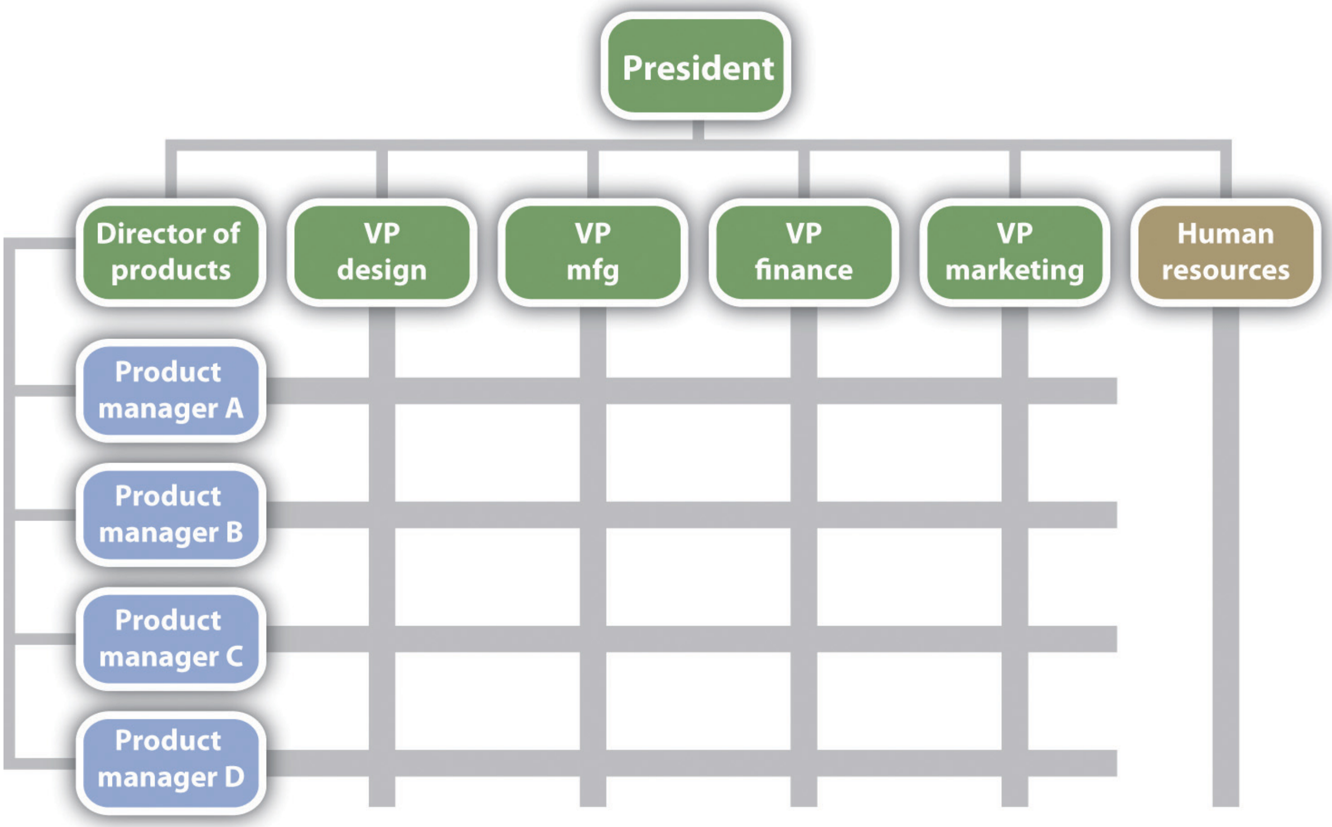
The divisional structure can work well because it focuses on individual geographic regions, customers, or products. This focus will enable greater efficiencies of operation and the building of “A common culture and esprit de corps that contributes both to higher morale and a better knowledge of the division’s portfolio.” [113] There are, of course, disadvantages to this structure. Competing divisions may turn to office politics, rather than strategic thinking, to guide their decision making, and divisions may become so compartmentalized as to lead to product incompatibilities. [114]

As a small business starts to grow in the diversity of its products, in the geographic reach of its markets, or in its customer bases, there is an evolution away from the functional structure to the divisional structure. However, significant growth would be needed before the divisional structure should be put into place.

Matrix Structure

The ***matrix structure*** combines elements of the functional and the divisional structures, bringing together specialists from different areas of a business to work on different projects on a short-term basis. Each person on the project team reports to two bosses: a line manager and a project manager. (See Figure 13.8 “An Example of a Matrix Structure” for an example of a matrix structure.) The matrix structure, popular in high-technology, multinational, consulting, and aerospace firms and hospitals, offers several key advantages, including the following: flexibility in assigning specialists, flexibility in adapting quickly to rapid environmental changes, the ability to focus resources on major products and problems, and creating an environment where there is a higher level of motivation and satisfaction for employees.[115] [116] [117] The disadvantages include the following: the violation of the “one boss” principle (unity of command) because of the dual lines of authority, responsibility, and accountability;[118] employee confusion and frustration from reporting to two bosses; power struggles between the first-line and the project managers; too much group decision making; too much time spent in meetings; personality clashes; and undefined personal role.s[119] [120] The disadvantages notwithstanding, many companies with multiple business units, operations in multiple countries, and distribution through multiple channels have discovered that the effective use of a matrix structure is their only choice.[121]

Figure 13.8 An Example of a Matrix Structure [122]

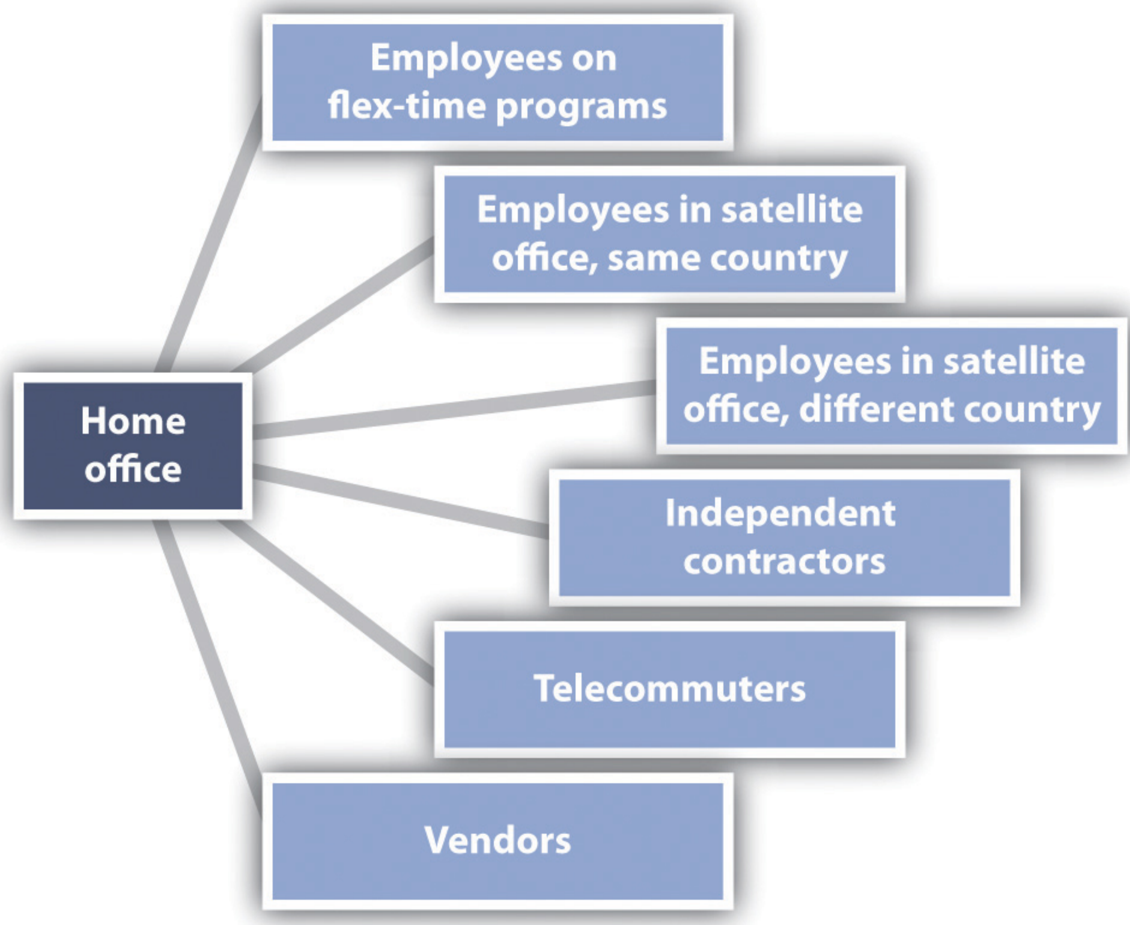


The matrix structure is for project-oriented businesses, such as aerospace, construction, or small manufacturers of the job-shop variety (producers of a wide diversity of products made in small batches).

Virtual Organization

The **virtual organization** (or network organization) is becoming an increasingly popular business structure as a means of addressing critical resource, personnel, and logistical issues. (See Figure 13.9 "An Example of a Virtual Organization" for an example of a virtual organization.) Administration is the primary function performed; other functions—such as marketing, engineering, production, and finance—are outsourced to other organizations or individuals. Individual professionals may or may not share office space, the organization is geographically distributed, the members of the organization communicate and coordinate their work through information technology, and there is a high degree of informal communication. The barriers of time and location are removed. [123] [124] [125]

Figure 13.9 An Example of a Virtual Organization [126]



The positives associated with a virtual organization include reduced real-estate expenses, increased productivity, higher profits, improved customer service, access to global markets, environmental benefits (such as reduced gas mileage for employees, which contributes to reduced auto emissions), a wider pool of potential employees, and not needing to have all or some of the relevant employees in the same place at the same time for meetings or delivering services.[127][128] The negatives include setup costs; some loss of cost efficiencies; cultural issues (particularly when working in the global arena); traditional managers not feeling secure when their employees are working remotely, particularly in a crisis; feelings of isolation because of the loss of the camaraderie of the traditional office environment; and a lack of trust.[129] [130]

The virtual organization can be quite attractive to small businesses and start-ups. By outsourcing much of the operations of a business, costs and capital requirements will be significantly reduced and flexibility enhanced. Given the lower capital requirements of a virtual business, some measures of profitability (e.g., return on investment [ROI] and return on assets [ROA]), would be significantly increased. This makes a business much more financially attractive to potential investors or banks, which might provide funding for future growth. **ROI** "is a performance measure used to evaluate the efficiency of an investment or to compare the efficiency of a number of investments."[131]**ROA** is "an indicator of how profitable a company is relative to its assets…[giving] an idea as to how efficient management is at using its assets to generate earnings."[132]

Creating an Effective Business Organization Structure

Thinking and rethinking the business organization structure is important for all businesses—large or small. Conditions, products, and markets change. It is important to be flexible in creating a business structure that will best allow a business to operate effectively and efficiently. Each of the following should be considered:

- **Competitors.** Make an educated guess of the structure of competitors. Try to find out what works for them. Look at their reporting line structures and their procurement, production, marketing, and management systems. Perhaps there are some good ideas to be had.

- **Industry.** Is there a standard in an industry? Perhaps an industry lends itself to flexible organization structures, or perhaps more hierarchical structures are the norm. For example, auto manufacturers are usually set up regionally.
- **Compliance or legal requirements.** If an industry is regulated, certain elements may be required in the business structure. Even if an industry is not regulated, there may be compliance issues associated with employing a certain number of employees.
- **Investors and lending sources.** Having a business organization structure will give potential investors and funding institutions a window into how the business organizes its operations. The structure also lets investors and lenders know what kind of talent is needed, how soon they will be needed, and how the business will find and attract them.[133]

Key Takeaways

- Organizations are changing every day, so small business owners should be flexible enough to change their structure over time as the situation demands.
- The functional structure is overwhelmingly the choice of business start-ups and is probably the most commonly used structure today.
- The functional structure organizes a business according to the job or the purpose in the organization and is most easily recognized by departments that focus on a single function or goal.
- The divisional structure is a decentralized version of the functional structure. The functions still exist, but they are based on product, geographic area or territory, or customer.
- As a small business starts to grow, there is an evolution away from the functional to the divisional structure. However, significant growth is required before the divisional structure is put into place.
- The matrix structure brings specialists from different areas of a business together to work on different projects for a short-term basis. This structure is for project-oriented businesses, such as aerospace, construction, or small manufacturers.
- In the virtual structure, administration is the primary function performed, with other functions—such as marketing, engineering, production, and finance—outsourced to other companies or individuals. This structure can be quite attractive to small businesses and start-ups.
- Creating an effective business organization structure should take the competition, the industry, compliance or legal requirements, investors, and lending sources into consideration.

Exercises

1. Select two small businesses that market two very different products, for example, a small manufacturer and a restaurant. Contact the manager of each business and conduct a fifteen-minute interview about the organizational structure that has been chosen. Ask each manager to describe the existing organizational structure (drawing an organization chart), explain why that structure was chosen, and reflect on the effectiveness and efficiency of the structure. Also ask each manager whether any thoughts have been given to changing the existing structure.
2. Frank Rainsford has been, in effect, the CEO of Frank's All-American BarBeQue since its inception. His major role has been that of restaurant manager, receiving support from his assistant manager Ed Tobor for the last fourteen years. Frank has two children, a son and daughter, who both worked in the restaurant as teenagers. His daughter has worked periodically at the restaurant since she graduated from high school. Frank's son, who recently lost his job, has returned to work for his father. The son produced several plans to expand the business, including the opening of a second restaurant and the extensive use of social media. After careful consideration, Frank has decided to open a second restaurant, but this has presented him with a major problem—how to assign responsibilities to personnel. His son wants to be designated the restaurant manager of the second restaurant and made the vice president of marketing. Ed Tobor also wants to be the manager of the new restaurant. His daughter has expressed an interest in being the manager of either restaurant. How should Frank resolve this problem?

Legal Forms of Organization for the Small Business

Learning Objectives

1. Understand the different legal forms that a small business can take.
2. Explain the factors that should be considered when choosing a legal form.
3. Understand the advantages and disadvantages of each legal form.
4. Explain why the limited liability company may be the best legal structure for many small businesses.

Every small business must select a legal form of ownership. The most common forms are sole proprietorship, partnership, and corporation. A limited liability company (LLC) is a relatively new business structure that is now allowed by all fifty states. Before a legal form is selected, however, several factors must be considered, not the least of which are legal and tax options.

Factors to Consider

The legal form of the business is one of the first decisions that a small business owner will have to make. Because this decision will have long-term implications, it is important to consult an attorney and an accountant to help make the right choice. The following are some factors the small business owner should consider before making the choice:[134][135]

- **The owner's vision.** Where does the owner see the business in the future (size, nature, etc.)?
- **The desired level of control.** Does the owner want to own the business personally or share ownership with others? Does the owner want to share responsibility for operating the business with others?
- **The level of structure.** What is desired—a very structured organization or something more informal?
- **The acceptable liability exposure.** Is the owner willing to risk personal assets? Is the owner willing to accept liability for the actions of others?
- **Tax implications.** Does the owner want to pay business income taxes and then pay personal income taxes on the profits earned?
- **Sharing profits.** Does the owner want to share the profits with others or personally keep them?
- **Financing needs.** Can the owner provide all the financing needs or will outside investors be needed? If outside investors are needed, how easy will it be to get them?
- **The need for cash.** Does the owner want to be able to take cash out of the business?

The final selection of a legal form will require consideration of these factors and tradeoffs between the advantages and disadvantages of each form. No choice will be perfect. Even after a business structure is determined, the favorability of that choice over another will always be subject to changes in the laws.[136]

Sole Proprietorship

A ***sole proprietorship*** is a business that is owned and usually operated by one person. It is the oldest, simplest, and cheapest form of business ownership because there is no legal distinction made between the owner and the business (see Table 13.1 "Sole Proprietorships: A Summary of Characteristics"). Sole proprietorships are very popular, comprising 72 percent of all businesses and nearly $1.3 trillion in total revenue.[137] Sole proprietorships are common in a variety of industries, but the typical sole proprietorship owns a small service or retail operation, such as a dry cleaner, accounting services, insurance services, a roadside produce stand, a bakery, a repair shop, a gift shop, painters, plumbers, electricians, and landscaping services.[138] Clearly, the sole proprietorship is the choice for most small businesses.

Table 13.1 Sole Proprietorships: A Summary of Characteristics [139] [140] [141] [142]

Liability	Taxes	Advantages	Disadvantages
Unlimited: owner is responsible for all the debts of the business.	No special taxes; owner pays taxes on profits; not subject to corporate taxes	• Tax breaks • Owner retains all profits • Easy to start and dissolve • Flexibility of being own boss • No need to disclose business information • Pride of ownership	• Owner absorbs all losses • Unlimited liability • Difficult to get financing • Management deficiencies • Lack of stability in case of injury, death, or illness • Time demands • Difficult to hire and keep highly motivated employees

Partnership

A ***partnership*** is two or more people voluntarily operating a business as co-owners for profit. Partnerships make up more than 8 percent of all businesses in the United States and more than 11 percent of the total revenue.[143] Like the sole proprietorship, the partnership does not distinguish between the business and its owners (see Table 13.2 "Partnerships: A Summary of Characteristics"). There should be a legal agreement that "sets forth how decisions will be made, profits will be shared, disputes will be resolved, how future partners will be admitted to the partnership, how partners can be bought out, and what steps will be taken to dissolve the partnership when needed."[144]

There are two types of partnerships. In the ***general partnership***, all the partners have unlimited liability, and each partner can enter into contracts on behalf of the other partners. A ***limited partnership*** has at least one general partner and one or more limited partners whose liability is limited to the cash or property invested in the partnership. Limited partnerships are usually found in professional firms, such as dentists, lawyers, and physicians, as well as in oil and gas, motion-picture, and real-estate companies. However, many medical and legal partnerships have switched to other forms to limit personal liability.[145] [146] [147]

Before creating a partnership, the partners should get to know each other. According to Michael Lee Stallard, cofounder and president of E Pluribis Partners, a consulting firm in Greenwich, Connecticut, "The biggest mistake business partners make is jumping into business before getting to know each other…You must be able to connect to feel comfortable expressing your opinions, ideas and expectations."[148]

Table 13.2 Partnerships: A Summary of Characteristics [149] [150] [151] [152] [153]

Liability	Taxes	Advantages	Disadvantages
Unlimited for general partner; limited partners risk only their original investment.	Individual taxes on business earnings; no income taxes as a business	• Owner(s) retain all profits • Unlimited for general partner; limited partners risk only their original investment. Individual taxes on business earnings; no income taxes as a business • Easy to form and dissolve • Greater access to capital • No special taxes • Clear legal status • Combined managerial skills • Prospective employees may be attracted to a company if given incentive to become a partner	• Unlimited financial liability for general partners • Interpersonal conflicts • Financing limitations • Management deficiencies • Partnership terminated if one partner dies, withdraws, or is declared legally incompetent • Shared decisions may lead to disagreements

Corporation

A ***corporation*** "is an artificial person created by law, with most of the legal rights of a real person. These include the rights to start and operate a business, to buy or sell property, to borrow money, to sue or be sued, and to enter into binding contracts".[154] (see Table 13.3 "Corporations: A Summary of Characteristics"). Corporations make up 20 percent of all businesses in the United States, but they account for almost 90 percent of the revenue.[155] Although some small businesses are incorporated, many corporations are extremely large businesses—for example, Walmart, General Electric, Procter & Gamble, and Home Depot. Recent data show that only about one-half of the small business owners in the United States run incorporated businesses.[156]

Scott Shane, author of *The Illusions of Entrepreneurship* (Yale University Press, 2010), argues that small businesses that are incorporated have a much higher rate of success than sole proprietorships, outperforming unincorporated small businesses in terms of profitability, employment growth, sales growth, and other measures.[157] Shane maintains that being incorporated may not make sense for "tiny little businesses" because the small amount of risk may not be worth the complexity. However, Deborah Sweeney, incorporation expert for Intuit, disagrees, saying that "even the smallest eBay business has a risk of being sued" because shipping products around the country or the world can create legal problems if a shipment is lost.[158] Ultimately, it is the small business being successful that may be the biggest factor for the owner to move from a sole proprietorship to a corporation.

Table 13.3 Corporations: A Summary of Characteristics [159] [160] [161] [162]

Liability	Taxes	Advantages	Disadvantages
Limited;	multiple taxation	• Limited liability • Skilled management team • Ease of raising capital • Easy to transfer ownership by selling stock • Perpetual life • Legal-entity status • Economies of large-scale operations	• Double taxation • Difficult and expensive to start • Individual stockholder has little control over operations • Financial disclosure • Lack of personal interest unless managers are also stockholders • Credit limitations • Government regulation and increased paperwork

Limited Liability Company

The ***limited liability company (LLC)*** is a relatively new form of business ownership that is now permitted in all fifty states, although the laws of each state may differ. The LLC is a blend of a sole proprietorship and a corporation: the owners of the LLC have limited liability and are taxed only once for the business.[163] The LLC provides all the benefits of a partnership but limits the liability of each investor to the amount of his or her investment (see Table 13.4 "Limited Liability Companies: A Summary of Characteristics"). "LLCs were created to provide business owners with the liability protection that corporations enjoy without the double taxation."[164]

According to Carter Bishop, a professor at Suffolk University Law School, who helped draft the uniform LLC laws for several states, "There's virtually no reason why a small business should file as a corporation, unless the owners plan to take the business public in the near future."[165] In the final analysis, the LLC business structure is the best choice for most small businesses. The owners will have the greatest flexibility, and there is a liability shield that protects all owners. [166]

Table 13.4 Limited Liability Companies: A Summary of Characteristics [167] [168][169] [170] [171]

Liability	Taxes	Advantages	Disadvantages
Limited;	owners taxed at individual income tax rate	• Limited liability • Taxed at individual tax rate • Shareholders can participate fully in managing company • No limit on number of shareholders • Easy to organize • LLC members can agree to share profits and losses disproportionately	• Difficult to raise money • No perpetual life • Is dissolved at death, withdrawal, resignation, expulsion, or bankruptcy of one member unless there is a vote to continue • No transferability of membership without the majority consent of other members

Key Takeaways

- Every small business must select a legal form of ownership. It is one of the first decisions that a small business owner must make.
- The most common forms of legal structure are the sole proprietorship, the partnership, and the corporation. An LLC is a relatively new business structure.
- When deciding on a legal structure, every small business owner must consider several important factors before making the choice.
- The sole proprietorship is the oldest, simplest, and cheapest form of business ownership. This business structure accounts for the largest number of businesses but the lowest amount of revenue. This is the choice for most small businesses.
- A partnership is two or more people voluntarily operating a business as co-owners for profit. There are general partnerships and limited partnerships.
- A corporation is an artificial person with most of the legal rights of a real person. Corporations make up about 20 percent of all businesses in the United States, but they account for almost 90 percent of the revenue.
- Small businesses that are incorporated outperform unincorporated small businesses in terms of profitability, employment growth, sales growth, and other measures.
- The LLC is a hybrid of a sole proprietorship and a corporation. It is the best choice for most small businesses.

Exercises

1. Select three small businesses of different sizes: small, medium, and large. Interview the owners, asking each about the legal structure that the owner chose and why. If any of the businesses are sole proprietorships, ask the owner if an LLC was considered. If not, try to find out why it was not considered.
2. Frank's BarBeQue is currently a sole proprietorship. Frank's son, Robert, is trying to persuade his father to either incorporate or become an LLC. Assume that you are Robert. Make a case for each legal structure and then make a recommendation to Frank. It is expected that you will go beyond the textbook in researching your response to this assignment.

People

Learning Objectives

1. Understand the complexities of hiring, retaining, and terminating employees.
2. Be aware of the laws that apply to businesses of all sizes and specifically to small businesses of certain sizes.
3. Understand outsourcing: what it is; when it is a good idea; and when it is a bad idea.
4. Describe ways to improve office productivity.

The term *human resources* has been deliberately avoided in this section. This term is more appropriate for large bureaucratic organizations that tend to view their personnel as a problem to be managed. Smaller and midsize enterprise personnel, however, are not mere resources to be managed. They should not be seen as cogs in a machine that are easily replaceable. Rather, they are people to be cultivated because they are the true lifeblood of the organization.

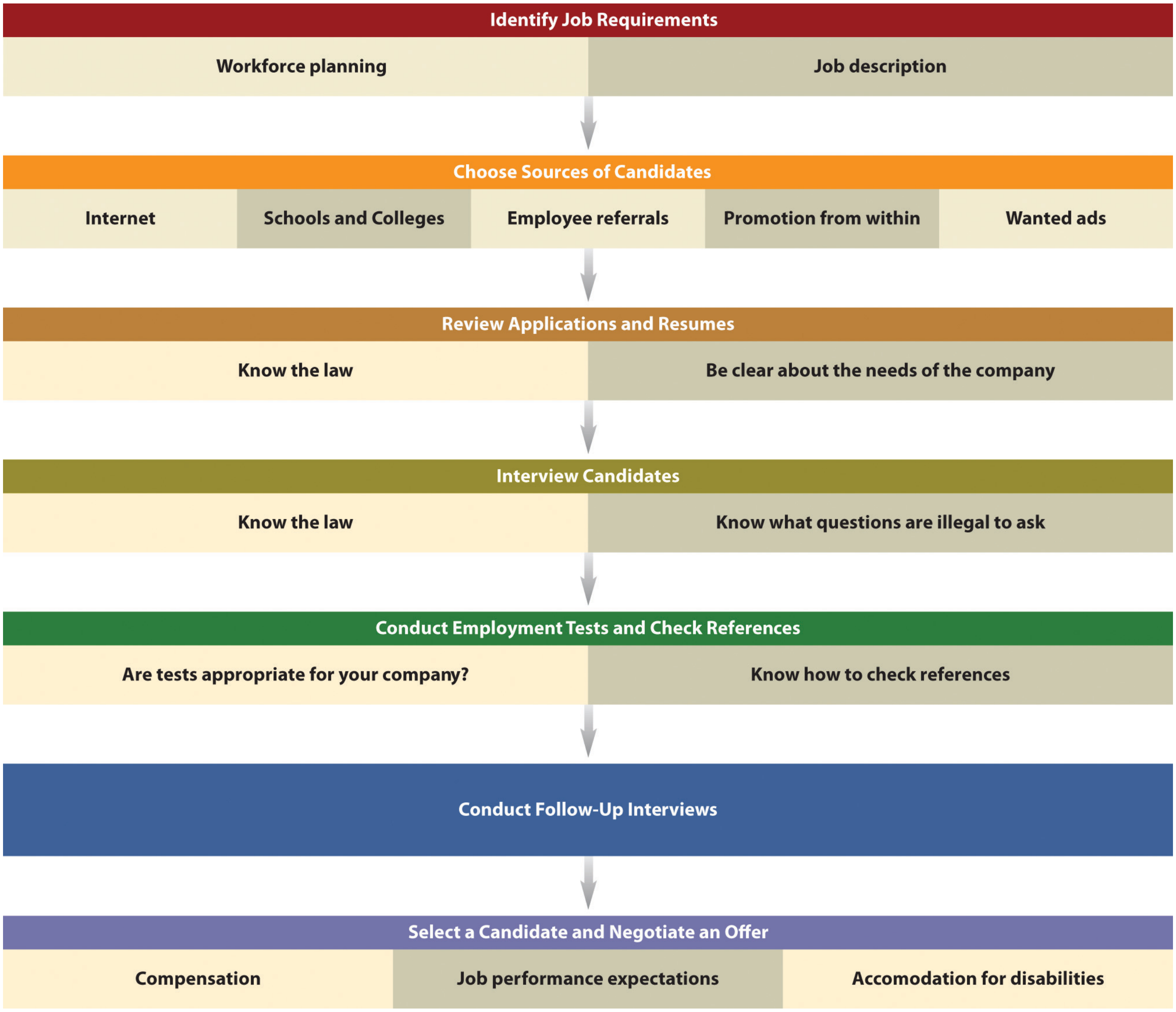
Many small businesses operate with no employees. The sole proprietor handles the whole business individually, perhaps with help from family or friends from time to time. Deciding to hire someone will always be a big leap because there will be an immediate need to worry about payroll, benefits, unemployment, and numerous other details.[172] A small business that looks to grow will face the hiring decision again and again, and additional decisions about compensation, benefits, retention, training, and termination will become necessary. Other issues of concern to a growing small business or a small business that wants to stay pretty much where it is include things such as outsourcing, how to enhance and improve productivity, and legal matters.

Hiring New People

All businesses want to attract, develop, and retain enough qualified employees to perform the activities necessary to accomplish the organizational objectives of the business.[173] Although most small businesses will not have a department dedicated to performing these functions, these functions must be performed just the same. The hiring of the first few people may end up being pretty simple, but as the hiring continues, there should be a more formal hiring process in place.

Figure 13.10 "Steps in the Hiring Process" illustrates the basics of any hiring process, whether for a sole proprietorship or a large multinational corporation.

Figure 13.10 Steps in the Hiring Process [174]



Identify Job Requirements

A small business owner should not proceed with hiring anyone until he or she has a clear idea of what the new hire will do and how that new hire will help attain the objectives of the business. ***Workforce planning***, the "process of placing the right number of people with the right skills, experiences, and competencies in the right jobs at the right time,"[175] is a way to do that. The scope of this planning will be very limited when a business is very small, but as a business grows, it will take on much greater importance. Doing things right with the first new hire will establish a strong foundation for hiring in the future. Forecasting needs for new people, both current and future, is part of workforce planning. No forecast is perfect, but it will provide a basis on which to make hiring decisions.

As an employer, every small business should prepare a ***job description*** before initiating the recruitment process. A good job description describes the major areas of an employee's job or position: the duties to be performed, who the employee will report to, the working conditions, responsibilities, and the tools and equipment that must be used on the job.[176] It is important not to create an inflexible job description because it will prevent the small business owner and the employees from trying anything new and learning how to perform their jobs more productively.[177]

Choose Sources of Candidates

Because hiring a new employee is an expensive process, it is important to choose sources that have the greatest potential for reaching the people who will most likely be interested in what a small business has to offer. Unfortunately, it is not always possible to know what those sources are, so selecting a mix of sources makes good sense.

- **Internet.** The Internet offers a wealth of places to advertise a job opportunity. Monster.com, CareerBuilder.com, and LinkedIn.com are among the largest and most well-known sites, but there may be local or regional job sites that might work better, particularly if a business is very small. A business will not have the resources to bring people in from great distances. If a business has a Facebook or a Twitter presence, this is another great place to let people know about job openings. There may also be websites that specialize in particular occupations.
- **Schools and colleges.** Depending on the nature of the job, local schools and colleges are great sources for job candidates, particularly if the job is part time. Full-time opportunities may be perfect for the new high school or college graduate. It would be worth checking out college alumni offices as well because they often offer job services.
- **Employee referrals.** Referrals are always worth consideration, if only on a preliminary basis. The employee making the referral knows the business and the person being referred. Going this route can significantly shorten the search process…if there is a fit.
- **Promotion from within.** Promoting from within is a time-honored practice. The owner sends a positive signal to employees that there is room for advancement and management cares about its employees. It is significantly less costly and quicker than recruiting outside, candidates are easier to assess because more information is available, and it improves morale and organization loyalty.[178] On the downside, there may be problems between the person who is promoted and former coworkers, and the organization will not benefit from the fresh ideas of someone hired from the outside.
- **Want ads.** Want ads can be very effective for a small business, especially if a business is looking locally or regionally. The more dynamic the want ad, the more likely it will attract good candidates. Newspapers and local-reach magazines might be a business's first thoughts but also consider advertising in the newsletters of relevant professional organizations and at the career services offices of local colleges, universities, and technical colleges.

Review Applications and Résumés

When looking for the best qualified candidates, be very clear about the objectives of the business and the associated reason(s) for hiring someone new. It is also critical to know the law. Some examples are provided here. This would be a good time to consult with a lawyer to make sure that everything is done properly.

1. **Employee registration requirement.** All US employers must complete and retain Form I-9 for each individual, whether a citizen or a noncitizen, hired for employment in the United States. The employer must verify employment eligibility and identity documents presented by the employee.[179]
2. **The Civil Rights Act of 1964, the Civil Rights Act of 1991, and the Equal Employment Opportunity Act of 1972.** Attempt to provide equal opportunities for employment with regard to race, religion, age, creed, gender, national origin, or disability.[180] The closest Equal Employment Opportunity Commission (EEOC) district office should be contacted for specific information.
3. **Immigration Reform and Control Act of 1986.** This law places a major responsibility on employers for stopping illegal immigration.

Labor Laws Governing Employers

The following is a brief synopsis of some of the federal statutes governing employers that may apply to a small business. In many instances, they are related to the size of the business.[181] There are definite advantages to staying small.

The following laws apply no matter the size of the business:

- Fair Labor Standards Act
- Social Security
- Federal Insurance Contributions Act
- Medicare
- Equal Pay Act
- Immigration Reform and Control Act
- Federal Unemployment Tax Act

This additional law applies if a business has more than ten employees:

- Occupational Safety and Health Administration Act

The following additional laws apply if a business has more than fourteen employees:

- Title VII Civil Rights Act
- Americans with Disabilities Act (ADA)
- Pregnancy Discrimination Act

The following additional laws apply if a business has more than nineteen employees:

- Age Discrimination in Employment Act
- Older Worker Benefit Protection Act
- Consolidated Omnibus Budget Reconciliation Act

This additional law applies if a business has more than forty-nine employees:

- Family Medical Leave Act

The following additional laws apply if a business has more than ninety-nine employees:

- Worker Adjustment and Retraining Notification Act
- Employee Retirement Income Security Act

Interview Candidates

Just as knowing the law is important when reviewing applications and résumés, it is also important when interviewing candidates. Several interview questions are illegal to ask—for example, "Do you have dependable child care in place?" and "Do you rent or own your own home?"[182] In general, the off-limit topics in most employment interviews include religion, national origin, race, marital status, parental status, age, disability, gender, political affiliation, criminal records, and other personal information such as financial and credit history.[183] In short, keep the interview focused on the job, its requirements, and the qualifications of the candidate.[184]

Conduct Employment Tests and Check References

Selection tests have been used to screen applicants for more than one hundred years.[185] An effective testing program can improve accuracy in selecting employees; provide an objective means for comparing candidates; and provide information about training, development, or counseling needs. These advantages must be carefully weighed against the disadvantages: the fallibility of tests, the fact that tests can never measure everything, and many tests discriminate against minorities.[186] Each small business owner must decide whether employment tests make sense for his or her business. However, Daniel Kehrer of Work.com claims that employee testing is essential to reducing employee turnover for small businesses because preemployment screens are four times greater at predicting employee success than interviews. He notes further that high turnover rates are much more expensive for small businesses than large companies.[187] Just be sure that all employment tests can be linked to a business necessity.[188]

Checking references is a much more difficult proposition. It is a good idea to check references after the interview to objectively evaluate the candidate's qualifications, experience, and other information presented during the interview. Not checking references can result in poor hiring choices.[189]

Unfortunately, many former employers are reluctant to reveal anything other than an employee's date of hire and departure and job title,[190] but others may be willing to discuss an employee's job performance, work ethic, attendance, attitude, and other things that may be important to the prospective employer.[191]

As important as it is to check references, it is a process that is fraught with legal risk, so check with an attorney before moving forward.

Select a Candidate and Negotiate an Offer

After any desired follow-up interviews are conducted, it is time to select a candidate and negotiate an offer. There are three main issues to consider: compensation, job performance and expectations, and accommodations for disabilities.

Wages and salaries are often used interchangeably, however they are different. ***Wages*** are payments based on an hourly pay rate or the amount of output. Production employees, maintenance workers, retail salespeople (sometimes), and part-time workers are examples of employees who are paid wages.[192] ***Salaries*** are typically calculated weekly, biweekly, or monthly. They are usually paid to office personnel, executives, and professional employees.[193] Every small business should do its best to offer competitive wages and salaries, but a small business will generally not be able to offer wages and salaries that are comparable to those offered by large corporations and government. ***Employee benefits*** such as health and disability insurance, sick leave, vacation time, child and elder care, and retirement plans, are paid entirely or in part by the company; they represent a large component of each employee's compensation.[194] Most employees have come to expect a good benefits program, even in a small business, so "the absence of a program or an inadequate program can seriously hinder a company's ability to attract and keep good personnel."[195] Not surprisingly, small businesses are also not in a position to offer the same level of benefits that can be offered by large corporations and the government. However, small businesses can still offer a good benefits program if it includes some or all the following elements: health insurance, disability insurance, life insurance, a retirement plan, flexible compensation, leave, and perks.[196] In addition, small businesses can offer benefits that only a small business can offer—for example, the flexibility to dress casually, half days on Friday, and bringing one's pet to work. Other ideas include gym memberships or lunch programs. These things have proven to increase employee loyalty, and they will fit the budget of even the smallest business.[197]

Set Performance Expectations

It is in the best interests of a business for prospective new employees to know and understand their performance expectations. This means that a business must determine what these expectations are. New employees should understand the goals of the organization and, as applicable, the department in which they will be working. It should also be made clear how the employee's work can positively impact the achievement of these goals.[198]

Make Accommodations for Disabilities

If a business is hiring someone with a disability and has fifteen or more employees, it is required by the ADA (enacted in 1990) to make reasonable workplace accommodations for employees with disabilities. Though not required, businesses with fewer than fifteen employees should consider accommodations as well.

Reasonable accommodations are adjustments or modifications which range from making the physical work environment accessible to restructuring a job, providing assistive equipment, providing certain types of personal assistants (e.g., a reader for a person who is blind, an interpreter for a person who is deaf), transferring an employee to a different job or location, or providing flexible scheduling. Reasonable accommodations are tools provided by employers to enable employees with disabilities to do their jobs. For example, employees are provided with desks, chairs, phones, and computers. An employee who is blind or who has a visual impairment might need a computer which operates by voice command or has a screen that enlarges print.[199]

A tax credit is available to an eligible small business, and businesses may deduct the costs (up to $15,000) of removing an architectural barrier. Small businesses should check with the appropriate government agency before making accommodations to make sure that everything is done correctly.

Is a Business Hiring and Breeding Greedy and Selfish Employees?

If a business is worried about hiring a bunch of jerks, the EGOS Survey (Evaluation Gauge for Obnoxious Superstars) from *Fast Company* will help it find out. If a business owner answers truthfully, the owner can learn whether he or she is a leader of obnoxious superstars. Hiring jerks can happen in any size business.[200]

Retention and Termination

Acquiring skilled, talented, and motivated employees will be a continuing concern for all small businesses. But the concerns do not end there. There will be issues concerning **retention** and **termination** of employment.

Retention

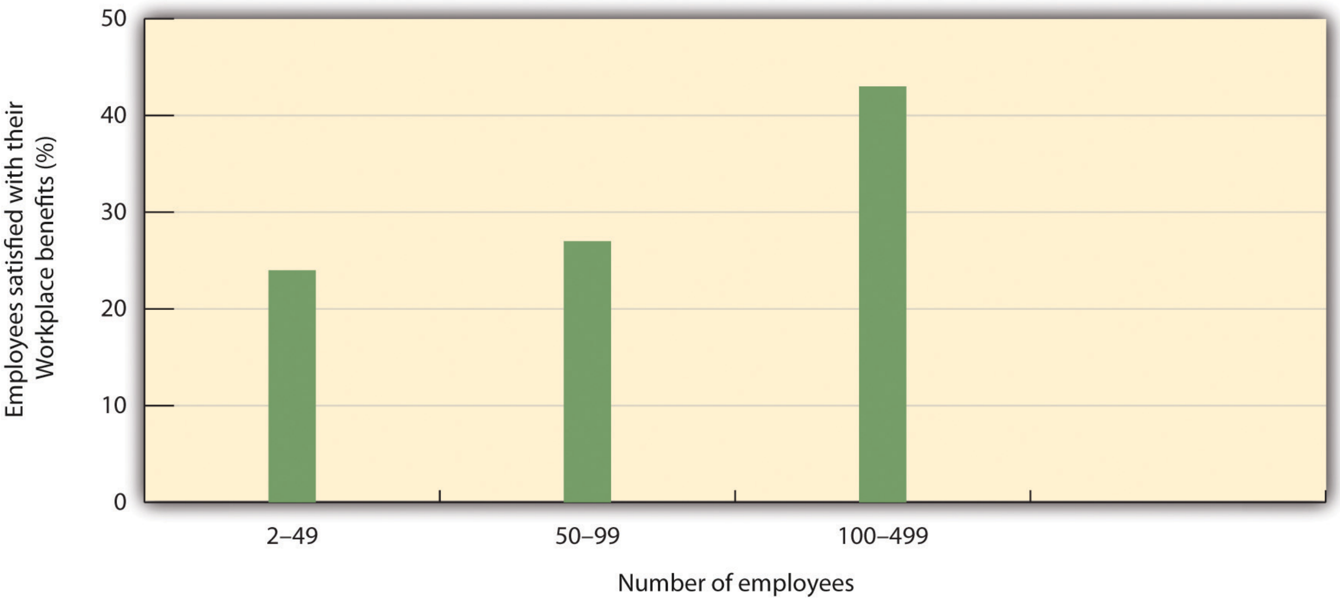
Employee retention rates play an important role in the cost of running a business. The first few years of an employee's service are the most costly because money will be spent on recruiting and training the employee. It is only after the employee has been working for some time that he or she will start making money for the business.[201]

Because of the costly and time-consuming nature of hiring new employees, many companies today increasingly emphasize retaining productive people.[202] Even the smallest of businesses should be concerned about retention because high turnover will be disruptive to the operations of the business and, as a result, may lessen the quality of the customer experience and customer satisfaction.

A good training and orientation program at the outset of employment can set the stage for increased retention. ***Training*** "is a continual process of providing employees with skills and knowledge they need to perform at a high level."[203] This continuing process is important. According to *Inc.com*, "the quality of employees and the continual improvement of their skills and productivity through training, are now widely recognized as vital factors in ensuring the long-term success and profitability of small businesses."[204] Training programs will vary greatly depending on the size and the nature of the business. However, all training programs must be based on both organizational and individual needs, spell out the problems that will be solved, and be based on sound theories of learning.[205] Many training and management development programs are not for amateurs, but the extent to which a small business can provide professionally delivered programs will be budget and needs related. In some instances, training is performed by someone who is currently doing the job—for example, using a particular machine, operating the cash register, stocking merchandise, and learning office procedures and protocols. Nothing additional is required.

Employee incentive programs are particularly important for small businesses because benefits satisfaction in small businesses typically lags behind benefits satisfaction in large corporations. A recent study[206] revealed that 81 percent of employees who are satisfied with their benefits are also satisfied with their jobs, whereas 23 percent of employees who are dissatisfied with their benefits are very satisfied with their jobs (Figure 13.11 "Benefits Satisfaction in Small Businesses").

Figure 13.11 Benefits Satisfaction in Small Businesses [207]



Given the importance of benefits to employees, small businesses need to be very creative about what kinds of incentives are offered to their employees. One of the biggest incentives may be the flexibility and camaraderie that are not available in larger businesses,[208] but to increase employee retention and attract the best and brightest, there will need to be more.[209] Creating a sense of community, offering leadership opportunities, creating a culture of recognition, and constantly offering opportunity can be powerful incentives.[210] They can be very effective at increasing employee retention, particularly when there is insufficient money to provide large raises. People want to enjoy their jobs as well as earn money, and they may care about their community and passions equally as much as their salaries. This is an opportunity for small businesses because "smaller companies may be better positioned to provide work-life balance that makes for happier, healthier employees."[211]

Video Clip 13.3 Keeping Small Business Employees

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

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=144

Video Clip 13.4 Why Your Best Employees Want to Leave

Seven reasons why your best employees want to leave.

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Termination

Termination or firing will always be unavoidably painful,[212] but it is a managerial duty that is sometimes necessary. In small businesses, terminations are usually carried out by the owner. They should be done promptly to preserve the health of the business.[213] Terminations can be ***termination at-will***or ***termination for cause***.

- **Termination at-will.** Employment at will means that a person does not have an employment contract. The person is employed "at the will" of the employer for as little or as long as the owner desires. It also means that a person can stop working for an employer at any time. An employer "doesn't need to give a reason for termination of an 'at will' employee, as long as the termination isn't unlawful or discriminatory…Termination can be due to a merger, workforce reduction, change in company direction and business focus, poor company performance, or any number of other legitimate reasons."[214]
- **Termination for cause.** When someone is terminated for cause, that person is being fired for a specific reason,[215] one of which may be behavior. Common causes for termination include but are not limited to stealing, lying, falsifying records, embezzlement, insubordination, deliberately violating company policies or rules, absenteeism and tardiness, unsatisfactory performance, changed job requirements, sexual harassment, and failing a drug or alcohol test.[216][217] Sexual harassment is a form of sex discrimination that violates Title VII of the Civil Rights Act of 1964. According to the EEOC, sexual harassment is "unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature constitutes sexual harassment when submission to or rejection of this conduct explicitly or implicitly affects an individual's employment,

unreasonably interferes with an individual's work performance or creates an intimidating, hostile or offensive work environment."[218]

When an employee has been terminated, the small business owner should inform the other employees. As a general rule, the less said to coworkers and other employees about an employee's termination, the better. People will be curious, but do not infringe on the terminated employee's privacy or say something that might leave a person open to legal action.[219] The best approach is to inform immediate coworkers, subordinates, and clients by simply telling them that the company no longer employs the employee. Do not mention any details but do include an explanation of how the terminated employee's duties will be carried out in the future.[220]

Outsourcing

Outsourcing is the practice of using outside firms, some of which may be offshore, to handle work that is normally performed within a company.[221] Small business owners routinely outsource a range of services, such as landscaping; building, utility, and furniture maintenance; distribution; and cleaning.[222][223] Consistent with the trend set by larger corporations, small businesses are outsourcing a range of services, many of which were once considered fundamental internal functions.[224]

A major reason for outsourcing is cost reduction. Other benefits of outsourcing include increasing efficiency, enabling a company to start new projects quickly, allowing a company to focus on its core business, leveling the playing field with larger companies, and reducing risk.[225] There is no question that outsourcing can be a good idea, but outsourcing is not always a good idea.

When Is Outsourcing a Good Idea?

Outsourcing is a good idea when it allows a small business "to continue performing the functions it does best, while hiring other companies [many of which may be other small businesses] to do tasks that they can handle more competently and cost-effectively."[226] Traditionally, payroll and personnel services have been outsourced by small businesses, but small businesses now use outside providers for a much greater range of services, including the following:[227]

- **Accounting and bookkeeping.** A growth area here is outsourcing accounts receivable. This enables a small business to sell off its accounts receivable and invoices to a financing company.[228] As a small business grows, the process of collecting accounts receivable may become too cumbersome to handle without collection agencies becoming involved.[229]
- **Specialist and expert help.** Elance offers a range of services for small businesses. It has access to thousands of professionals around the world who can provide services such as graphic design, multimedia presentations, engineering, sales and marketing, writing, and translation.[230]
- **Public relations and marketing services.** These services are costly, require specialized expertise, and are not usually full-time needs.[231] Many service providers specialize in the needs of small businesses.
- **Virtual assistants.** These people are independent entrepreneurs who provide administrative, creative, or technical support. A growing phenomenon, they work on a contractual basis via online or electronic communications. Virtual Office Temps and VirtualAssistants.com are examples of companies that can connect virtual assistants with any company that is interested.[232]
- **Creating benefits package.** A tremendous amount of time and creativity would be required for a smaller company to create a benefits package that is competitive in the marketplace.[233] Given the vast complexities of health care, including health-care laws that differ by state, outsourcing this activity makes good sense.
- **Legal services.** A small business may need to consult an attorney for a variety of reasons, including the following:
  - Choosing the business structure
  - Constructing a partnership agreement
  - Obtaining a corporate charter
  - Registering a corporation's stock
  - Obtaining a trademark, a patent, or a copyright or intellectual property
  - Filing for licenses or permits at the local, state, and federal levels
  - Purchasing an existing business or real estate
  - Hiring employees, independent contractors, and other external suppliers (outsourcing)
  - Extending credit and collecting debts
  - Creating valid contracts
  - Initiating or defending against lawsuits
  - Keeping current on and compliant with business law and regulations (e.g., advertising, employment and labor, finance, intellectual property, online business law, privacy law, environmental regulations, and the Uniform Commercial Code)

- Protecting intellectual property
- Protecting ideas or inventions from others' infringement[234] [235] [236]

However, the cost of a full-time attorney would probably be prohibitive. Outsourcing these services is an appropriate choice. Some legal firms offer small businesses a flat monthly fee instead of charging them by the hour,[237] a practice that is very helpful to the small business budget.

When Is Outsourcing a Bad Idea?

Although outsourcing has benefits, there are times when it is a bad idea. For example, sales and technology development are operations that are generally best handled in-house because they are full-time needs that are at the heart of any business.[238] Outsourcing might actually end up being the more expensive alternative, leading to a financial loss instead of a gain. An example would be the cost of a highly specialized expert.[239] In addition, when outsourcing overseas, the small business owner and/or managers may not be prepared to manage projects across time differences and cultural barriers and may not have clear guidelines, expectations, and processes in place to manage product or service quality.[240]

Office Productivity

All small businesses want their employees to work better and smarter. In fact, the smaller a business is, the more efficient and effective it must be. Productivity is an issue in two places: the office and in manufacturing. Office productivity (which applies to all levels in the organization) is discussed in this section, and the role of technology is the focus. "Office" is used broadly to include, for example, physical offices, virtual offices, work situations that involve in-the-car time (e.g., realtors and salespeople), restaurant kitchens, and people who work on the sales floor in retail establishments.

Even the smallest of businesses can improve productivity by using technology, even though such use may be very limited in some instances. For example, goods and services needed to run a business can often be ordered online; e-mail can be used for customer and supplier communication; taxes can be filed online; and a simple software package like *Microsoft Communicator* allows intra- and extracompany communication via e-mail, text, and video. It will be the rare business that uses no technology.

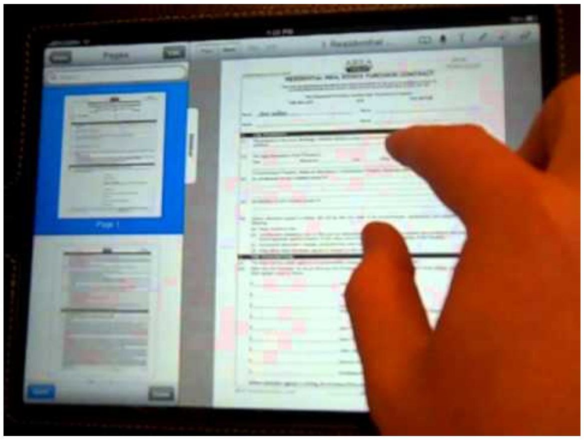
Some have referred to technology as the road map to small business success—helping grow the business, work smarter, attract more customers, enhance customer service, and stay ahead of the competition.[241] An important component of all this is high office productivity. Efficiency and effectiveness in the office will benefit the entire business.

With the proliferation of social networks, small businesses are implementing more Facebook-like applications into their day-to-day operations. [242]Yammer, for example, "enables a company's employees to gather inside a private and secure social network that can be controlled and monitored by the employer. The goal is to increase productivity…[It] is about making people work more productively using communication that's becoming very popular in the consumer space."[243] Other similar products include Conenza and Chatter.

Some see the iPad as changing how business relationships are built—providing opportunities to connect with prospects in a more meaningful way and allowing people to collaborate with others in real time from wherever they are.[244] The iPad is also changing the way people can work. The SoundNote application allows note taking and recording a meeting simultaneously; once written, the notes can be e-mailed directly to the participants.[245] Just want to take notes? Use Evernote.[246] The iPad can be used in the kitchen of a restaurant, a café, a hotel, or a bar for finding recipes and cooking instructions, displaying recipes as PDF files, and working on budgets and cost analyses.[247] In retailing, the iPad can be used as a virtual sales assistant. In a dress department, coordinating accessories from a jewelry store or the shoe department can be accessed and recommended to the customer. Car dealers could customize a car by showing colors and finishes to the customer—all while standing in the parking lot.[248] In real estate, the iPad can be used for buyer consultations, listing presentations, tracking properties, and chatting with clients—just to name a few.[249]

Video Clip 13.5 Using the iPad for Real Estate

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



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Although every small business owner may not see an immediate need for an iPad, it is a technology worth checking out. New applications for office productivity are coming out all the time.

A ***smartphone*** is a device that lets a person make phone calls but has other features found on a digital assistant or a computer, such as sending and receiving e-mail and editing Microsoft Office documents.[250] A popular brand is the Apple iPhone. Smartphones give a person access to company data that is normally not possible without a laptop; make it possible to accomplish more, faster; enable mobile workers to connect to company information while on the road; keep your calendar, address book, and task lists organized; and, perhaps most importantly, keep frustrations to a minimum because the technology is designed to work in tandem with a ***server***and a ***personal digital assistant (PDA)***. [251] A server is a computer or a series of computers that link other computers or electronic devices together.[252]. A PDA is a handheld computer that acts "as an electronic organizer or day planner that is portable, easy to use and capable of sharing information with your PC."[253] Blackberry is a popular brand of the PDA. The smartphone can be used for numerous business functions, such as tracking equipment and accounts, keeping calendars and address books, connecting to the Internet, acting as a global positioning system (GPS), and running multimedia software.[254]

Like everyone else, small businesses have to do more with less. This means that effective collaboration is increasingly critical to success. Because collaboration is a daily requirement for all small businesses, the question becomes how to have productive collaboration without using up too much time and costing too much money. What is needed is a way to "spur employees to share ideas and increase productivity while protecting work-life balance." [255] A recent study reported that among companies that used collaboration tools, 72 percent reported better business performance.[256] One popular collaboration tool is web conferencing: "Web conferencing services enable users to hold collaborative meetings with interactive whiteboard tools, give sales demonstrations with real-time efficacy, stage presentations with full and select moderator control or hold enhanced, multimedia roundtable discussions…And, with recording and playback tools available in the leading Web conferencing service providers, audience members and other authorized users can access meetings, presentations and demonstrations again and again or continually reference whiteboard sessions."[257]

Although Top Ten Reviews ranked Infinite Conferencing, Netviewer Meet, and Adobe Connect Pro as the 2011 top three web conferencing services, each small business should select the product that best serves its needs and its budget.

Virtual or Telecommuting Employees

Another boon to office productivity and adding to the bottom line is the **virtual or telecommuting employee**. This is an employee that works from a location other than the traditional office. They can work from anywhere.[258] There is no agreement on the number of US workers that are already telecommuting. However, it has been estimated that 40 percent of the US workforce hold jobs that lend themselves to telecommuting.[259] [260]

The advantages of virtual employees include the following:[261] [262] [263]

- Companies could save $6,500 annually per employee.
- Virtual employees tend to be happier, healthier, and less stressed compared to their office-bound coworkers.
- Virtual workers are significantly more productive than their office-bound colleagues. The differential is estimated at 15 percent.
- Virtual employees almost always give back more than 50 percent of the time they save by not commuting.

- Some virtual workers actually put in more time per week than those who commute.

From the perspective of the virtual employee, the advantages of telecommuting are as follows: no distractions from coworkers; no stress from office politics; spending more time with the family; saving money on transportation, parking, and clothing; and avoiding traffic or saving time by not commuting.[264]

Virtual employees offer terrific advantages to the small business owner who is always looking to cut costs and attract high-quality employees. However, it is not something that works for everyone and every kind of business. For example, a restaurant cannot have a virtual waiter…at least not yet. A small business that wants to use virtual employees must create the appropriate infrastructure—that is, technology, security, policies, behavioral protocols, performance management, and so forth—to provide the best support for telecommuting workers in how, where, and when they do their jobs.[265] For support with telecommuting challenges, small business owners can tap into The Alternative Board, an organization with three thousand small- and midsized-business owners.[266]

Video Link 13.2 Making Telecommuting Work

Looking at telecommuting from the employee and the employer perspectives.

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

Key Takeaways

- Deciding to hire someone will always be a big step because there will be an immediate need to worry about payroll, benefits, unemployment, and numerous other issues.
- The hiring process includes identifying job requirements, choosing sources of candidates, reviewing applications and résumés, interviewing candidates, conducting employment tests (if desired), checking references, conducting follow-up interviews if needed, selecting a candidate, and making an offer.
- It is very important to know employment law before proceeding with the hiring process. For example, several potential questions are illegal to ask.
- Whether it is required or not, small businesses should be willing to make accommodations for employees with disabilities.
- Retention is an important concern for all small businesses.
- When an employee is to be terminated, it is best to do it promptly.
- Outsourcing is about using outside firms, some of which may be offshore, to handle work that is normally performed within a company. Outsourcing can be either good or bad; it depends on the situation.
- Office productivity is about working smarter and better. Social networking, the iPad, smartphones, online collaboration tools, and virtual employees can all help increase productivity.

Exercises

1. As the owner of a one-hundred-employee business, you just learned that some of your employees were "dumpster diving" in the trash outside a competitor's offices. In other words, they were looking for information that could provide your company with a competitive advantage. With investigation, you found out that the head of the espionage operation was a personal friend. You have decided to fire your friend immediately, along with his dumpster divers. How should you proceed with the termination of your friend and his operatives so that you will not be held liable in a lawsuit? Would you reconsider the firing of the operatives? Why or why not?[267]
2. Robert is trying to convince his father, Frank of Frank's BarBeQue, to integrate more technology into his restaurant operations because it will increase productivity. Assuming the role of Robert, select technologies that you think would be a good fit for Frank's restaurant. Prepare your recommendations for Frank.

The Three Threads

Learning Objectives

1. Explain how people and organization can add to customer value.
2. Explain how decisions about people and organization can impact cash flow.
3. Explain how technology and the e-environment are impacting people and organization.

Customer Value Implications

By definition, a small business is small. The CEO and the top management team have a much greater understanding of the tasks and operations of the entire business and what their employees are doing. (Sometimes their employees wish they did not have such a good knowledge of the tasks they, the employees, are supposed to be performing.) In a small business, it is much more likely for the CEO and the top management team to have a personalized relationship with their customer base. Sometimes this functions on a one-to-one basis and is predicated on a true sense of personal friendship. This intimacy between those at the top of a small business and their customers or clientele can yield tremendous benefits for both the business and the customers. Knowing the true needs of the customer on a personalized level greatly enhances the value produced by a business.

Small business organizations are flatter and less bureaucratic. Sometimes they are less centralized. This enables frontline personnel to be closer to the customer, where they can better ascertain the needs of the customer and make decisions more quickly to satisfy those needs. This adds to the value of these businesses in the eyes of their customers because of a more positive customer experience.

In addition to being closer to the customers, the owner of a smaller business has a closer relationship with the employees. There generally is no need for a formal "human resources" department that bureaucratizes relationships. The owner knows the strengths and the weaknesses of the employees and will best use them in the business. The owner can develop personal relationships with employees that are impossible in larger organizations. This closeness can often translate into an intangible strength—loyalty. Employees who are happy with their employment will provide greater value to the customer.

Cash-Flow Implications

The simpler the organizational structure, the more positive will be the impact on cash flow. Having unnecessary positions will negatively impact small business operations in terms of not only costs but also efficiency and effectiveness.

Improper hiring and termination procedures will also adversely affect cash flow. Recruiting employees is an expensive process, so errors in the hiring process will be a drain on the cash flow of a business and, as a result, its profitability. Termination is a particularly sensitive process, so a careful and thoughtful procedure should be developed for carrying it out. Errors in either hiring or termination may open up a business to lawsuits, another major hit to cash flow and profitability.

Technology adoption for office productivity improvements (e.g., social networking, iPads, and smartphones) may adversely affect the cash flow in the short term, but (hopefully) the higher productivity should offset those losses in the longer term. As an example, recall Lloyd's Construction in Eagan, Minnesota, from Chapter 1 "Foundations for Small Business". The company switched to a smartphone system that allowed for integrated data entry and communication. The company reduced its routing and fuel costs by as much as 30 percent, and they estimated that they saved $1 million on a $50,000 investment.[268]

Implications of Technology and the E-Environment

New technology solutions are being introduced every day, many of them potentially very useful for small businesses. This chapter discussed the productivity enhancement possibilities offered by social networking, the iPad, smartphones, and collaboration tools, but the discussion was only the tip of the iceberg. Technology is so pervasive in today's workplace that ignoring it will be done at each business's peril. Mobile technology is now even pervading the hiring process; the world of recruiting via mobile technology is moving at the speed of light. The result? More and more organizations are trying to figure out how to start using mobile devices to recruit new employees.[269] The prospect of targeting all populations of people is an exciting—but certainly challenging—one.

Another interesting technology product is talent management software developed by Taleo, which is targeted to the small business to simplify recruiting, hiring, and performance management with "unmatched flexibility."[270] There are undoubtedly other similar products available. The point is that this is an example of the small business technology solutions that are available for exploration and consideration.

The e-environment is a small business facilitator extraordinaire. The web is a fabulous place, making collaboration and communication so much better and faster. It has opened the door to enhanced productivity, and a potentially important part of that is the virtual employee. Small businesses should seriously consider the advantages of virtual employees because they can help the small business expand its reach, increase employee morale, and contribute to a much better work-life balance.

Key Takeaways

- The less bureaucratic organizational structure of small businesses tends to open the door for more personalized relationships between the CEO and other top managers and customers. This adds considerable value to the business and the customer experience.

- The simpler the organizational structure, the more positive the impact on cash flow.
- Technology investments for increased productivity will be a drain on cash flow in the short term, but productivity improvements should offset the loss in the long term.
- New technology products are being introduced every day, many of them geared to the small business. Small businesses should make it a point to learn about what's available and keep an open mind about adopting a new solution to an old problem.
- The e-environment has opened the door to multiple ways to improve office productivity, not the least of which is the virtual employee.

Exercises

1. Select a small business with between fifty and seventy-five employees. Set up an interview with the president or one of the other members of top management. Ask the person to describe the organizational structure of the business, and then ask him or her to discuss whether the structure helps or hinders his or her relationships with customers. Lastly, ask if there is anything about the organizational structure he or she would change—and why.

Disaster Watch

John owns a very successful electronics business. He has been in business for only three years and already has several large stores. He has seventy-five part- and full-time employees. The business thrives on a sales force that must be able to close deals, particularly on high-priced items.

Jennifer is John's administrative assistant. She has been with him from the beginning, and John considers her to be a vital element in the success of the business. He had wooed her away from another large electronics chain. On Tuesday, Jennifer requested a private meeting with him. She arrived at the meeting clearly distressed. He asked her to sit down and tell him what was troubling her. She struggled not to cry but could not hold back the tears. She recounted the following story.

Ed Smith, a salesperson, had for the last five weeks been making inappropriate and suggestive comments to her. She told John that at first she tried to dismiss and deflect Ed's comments with humor, and the humor clearly indicated that she had no interest. The result was that the comments became more frequent, more aggressive, and more vulgar. At this point (last Friday), Jennifer indicated to Ed that she found his remarks offensive and harassing. He laughed and, in the intervening days, continued the remarks, which became even more progressively lewd. It was Jennifer's opinion that Ed was incapable of understanding how inappropriate his behavior was. She believes that his presence creates a significantly hostile working environment for her and other women. She thinks it would be best for the organization if Ed were fired immediately.

John expressed his profound sympathy to Jennifer and said that he would speak to Ed right away. This clearly was not what Jennifer wanted to hear. She left John's office simply stating, "It's either him or me."

Although John was extremely sympathetic to Jennifer's position, he recognized that he had to speak to Ed to protect himself. Further, John had to consider the fact that Ed was unquestionably his best salesperson. Two hours later, John called Ed into his office and related Jennifer's story. Ed laughed it off as harmless word play, even going as far as saying, "Could you possibly see me being interested in a woman who looks like she does?" He then countered with, "Look. You know I'm your best salesman, and if I'm fired because of some slanderous comments, I'll sue." He then stormed out of John's office.

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4.2: Chapter 14- Employees

The Grounds of a Great Work Environment

Howard Schultz has vivid memories of his father slumped on the couch with his leg in a cast.[1] The ankle would heal, but his father had lost another job—this time as a driver for a diaper service. It was a crummy job; still, it put food on the table, and if his father couldn't work, there wouldn't be any money. Howard was seven, but he understood the gravity of the situation, particularly because his mother was seven months pregnant, and the family had no insurance.

This was just one of the many setbacks that plagued Schultz's father throughout his life—an honest, hard-working man frustrated by a system that wasn't designed to cater to the needs of common workers. He'd held a series of blue-collar jobs (cab driver, truck driver, factory worker), sometimes holding two or three at a time. Despite his willingness to work, he never earned enough money to move his family out of Brooklyn's federally subsidized housing projects. Schultz's father died never having found fulfillment in his work life—or even a meaningful job. It was the saddest day of Howard's life.

Howard Schultz toasts at the launch of their new "everyday" brew, Pike Place Roast, April 8, 2008, in Bryant Park in New York City. CC BY 2.0.

As a kid, did Schultz ever imagine that one day he'd be the founder and chairman of Starbucks Coffee Company? Of course not. But he did decide that if he was ever in a position to make a difference in the lives of people like his father, he'd do what he could. Remembering his father's struggles and disappointments, Schultz has tried to make Starbucks the kind of company where he wished his father had worked. "Without even a high school diploma," Schultz admits, "my father probably could never have been an executive. But if he had landed a job in one of our stores or roasting plants, he wouldn't have quit in frustration because the company didn't value him. He would have had good health benefits, stock options, and an atmosphere in which his suggestions or complaints would receive a prompt, respectful response."[2]

Schultz is motivated by both personal and business considerations: "When employees have self-esteem and self-respect," he argues, "they can contribute so much more: to their company, to their family, to the world."[3][4] His commitment to his employees is embedded in Starbuck's mission statement, whose first objective is to "provide a great work environment and treat each other with respect and dignity."[5] Those working at Starbucks are called partners because Schultz believes working for his company is not just a job, it's a passion.[6]

Video Clip The Man Behind Starbucks Reveals How He Changed the World

A major piece of the Starbucks success story has been the superior service provided by its motivated employees.

Human Resource Management

Learning Objective

1. Define *human resource management* and explain how managers develop and implement a human resource plan.

Employees at Starbucks are vital to the company's success. They are its public face, and every dollar of sales passes through their hands.[7] According to Howard Schultz, they can make or break the company. If a customer has a positive interaction with an employee, the customer will come back. If an encounter is negative, the customer is probably gone for good. That's why it's crucial for Starbucks to recruit and hire the right people, train them properly, motivate them to do their best, and encourage them to stay with the company. Thus, the company works to provide satisfying jobs, a positive work environment, appropriate work schedules, and fair compensation and benefits. These activities are part of Starbucks's strategy to deploy human resources in order to gain competitive advantage. The process is called human resource management (HRM), which consists of all actions that an organization takes to attract, develop, and retain quality employees. Each of these activities is complex. Attracting talented employees involves the recruitment of qualified candidates and the selection of those who best fit the organization's needs. Development encompasses both new-employee orientation and the training and development of current workers. Retaining good employees means motivating them to excel, appraising their performance, compensating them appropriately, and doing what's possible to retain them.

Human Resource Planning

How does Starbucks make sure that its worldwide retail locations are staffed with just the right number of committed employees? How does Walt Disney World ensure that it has enough qualified "cast members" to provide visitors with a "magical" experience? How does Norwegian Cruise Lines make certain that when the *Norwegian Dawn* pulls out of New York harbor, it has a complete, fully trained crew on board to feed, entertain, and care for its passengers? Managing these tasks is a matter of strategic human resource planning—the process of developing a plan for satisfying an organization's human resources (HR) needs.

A strategic HR plan lays out the steps that an organization will take to ensure that it has the right number of employees with the right skills in the right places at the right times. HR managers begin by analyzing the company's mission, objectives, and strategies. Starbucks's objectives, for example, include the desire to "develop enthusiastically satisfied customers" as well as to foster an environment in which employees treat both customers and each other with respect.[8] Thus, the firm's HR managers look for people who are "adaptable, self-motivated, passionate, creative team members."[9] Likewise, Disney's overall objectives include not only making all visitors feel as if they're special in a special place but also ensuring that employees' appearance reflects a special image (there's even a forty-seven-page book on the subject).[10] Disney looks for people who best fulfill these job requirements. The main goal of Norwegian Cruise Lines—to lavish passengers with personal attention—determines not only the type of employee desired (one with exceptionally good customer-relation skills and a strong work ethic) but also the number needed (one for every two passengers on the *Norwegian Dawn*).[11]

Job Analysis

To develop an HR plan, HR managers must obviously be knowledgeable about the jobs that the organization needs performed. They organize information about a given job by performing a job analysis to identify the tasks, responsibilities, and skills that it entails, as well as the knowledge and abilities needed to perform it. Managers also use the information collected for the job analysis to prepare two documents:

- A job description, which lists the duties and responsibilities of a position
- A job specification, which lists the qualifications—skills, knowledge, and abilities—needed to perform the job

HR Supply and Demand Forecasting

Once they've analyzed the jobs within the organization, HR managers must forecast future hiring (or firing) needs. This is the three-step process summarized in Figure 14.1 "How to Forecast Hiring (and Firing) Needs".

Figure 14.1 How to Forecast Hiring (and Firing) Needs

Starbucks, for instance, might find that it needs three hundred new employees to work at stores scheduled to open in the next few months. Disney might determine that it needs two thousand new cast members to handle an anticipated surge in visitors. The

Norwegian Dawn might be short two dozen restaurant workers because of an unexpected increase in reservations.

After calculating the disparity between supply and future demand, HR managers must draw up plans for bringing the two numbers into balance. If the demand for labor is going to outstrip the supply, they may hire more workers, encourage current workers to put in extra hours, subcontract work to other suppliers, or introduce labor-saving initiatives. If the supply is greater than the demand, they may deal with overstaffing by not replacing workers who leave, encouraging early retirements, laying off workers, or (as a last resort) firing workers.

Recruiting Qualified Employees

Armed with information on the number of new employees to be hired and the types of positions to be filled, the HR manager then develops a strategy for recruiting potential employees. Recruiting is the process of identifying suitable candidates and encouraging them to apply for openings in the organization.

Before going any further, we should point out that, in recruiting and hiring, managers must comply with antidiscrimination laws; violations can have legal consequences. Discrimination occurs when a person is treated unfairly on the basis of a characteristic unrelated to ability. Under federal law, it's illegal to discriminate in recruiting and hiring on the basis of race, color, religion, sex, national origin, age, or disability. (The same rules apply to other employment activities, such as promoting, compensating, and firing).[12] The Equal Employment Opportunity Commission (EEOC) enforces a number of federal employment laws, including the following:

- Title VII of the Civil Rights Act of 1964, which prohibits employment discrimination based on race, color, religion, sex, or national origin. Sexual harassment is also a violation of Title VII.
- The Equal Pay Act of 1963, which protects both women and men who do substantially equal work from sex-based pay discrimination.
- The Age Discrimination in Employment Act of 1964, which protects individuals who are forty or older.
- Title I and Title V of the Americans with Disabilities Act of 1990, which prohibits employment discrimination against individuals with disabilities.[13]

Where to Find Candidates

The first step in recruiting is to find qualified candidates. Where do you look for them, and how do you decide whether they're qualified? Let's start with the second part of the question first. A qualified person must be able to perform the duties listed in the job description and must possess the skills, knowledge, and abilities detailed in the job specification. In addition, he or she must be a good "fit" for the company. A Disney recruiter, for example, wants a candidate who fits a certain image—someone who's clean-cut and "wholesome" looking. The same recruiter might also favor candidates with certain qualities—someone who has a "good attitude," who's a "go-getter" and a "team player," and who's smart, responsible, and stable.[14]

Internal versus External Recruiting

Where do you find people who satisfy so many criteria? Basically, you can look in two places: inside and outside your own organization. Both options have pluses and minuses. Hiring internally sends a positive signal to employees that they can move up in the company—a strong motivation tool and a reward for good performance. In addition, because an internal candidate is a known quantity, it's easier to predict his or her success in a new position. Finally, it's cheaper to recruit internally. On the other hand, you'll probably have to fill the promoted employee's position. Going outside gives you an opportunity to bring fresh ideas and skills into the company. In any case, it's often the only alternative, especially if no one inside the company has just the right combination of skills and experiences. Entry-level jobs usually have to be filled from the outside.

How to Find Candidates

Whether you search inside or outside the organization, you need to publicize the opening. If you're looking internally in a small organization, you can alert employees informally. In larger organizations, HR managers generally post openings on bulletin boards (often online) or announce them in newsletters. They can also seek direct recommendations from various supervisors.

Recruiting people from outside is more complicated. It's a lot like marketing a product to buyers: in effect, you're marketing the virtues of working for your company. Starbucks uses the following outlets to advertise openings:

- A dedicated section of the corporate Web site ("Job Center," which lists openings, provides information about the Starbucks experience, and facilitates the submission of online applications)

- College campus recruiting (holding on-campus interviews and information sessions and participating in career fairs)
- Internships designed to identify future talent among college students
- Announcements on employment Web sites like Monster.com, Vault.com, Glassdoor.com, and SimplyHired.com
- Newspaper classified ads
- Facebook and Twitter
- Local job fairs
- In-store recruiting posters
- Informative "business cards" for distribution to customers[15]

When asked what it takes to attract the best people, Starbucks's senior executive Dave Olsen replied, "Everything matters." Everything Starbucks does as a company bears on its ability to attract talent. Accordingly, everyone is responsible for recruiting, not just HR specialists. In fact, the best source of quality applicants is the company's own labor force.[16]

The Selection Process

Recruiting gets people to apply for positions, but once you've received applications, you still have to select the best candidate—another complicated process. The selection process entails gathering information on candidates, evaluating their qualifications, and choosing the right one. At the very least, the process can be time-consuming—particularly when you're filling a high-level position—and often involves several members of an organization.

Let's examine the selection process more closely by describing the steps that you'd take to become a special agent for the Federal Bureau of Investigation (FBI).[17] Most business students don't generally aspire to become FBI agents, but the FBI is quite interested in business graduates—especially if you have a major in accounting or finance. With one of these backgrounds, you'll be given priority in hiring. Why? Unfortunately, there's a lot of white-collar crime that needs to be investigated, and people who know how to follow the money are well suited for the task.

Application

The first step in becoming a gun-toting accountant is, obviously, applying for the job. Don't bother unless you meet the minimum qualifications: you must be a U.S. citizen, be age twenty-three to thirty-seven, be physically fit, and have a bachelor's degree. To provide factual information on your education and work background, you'll submit an application, which the FBI will use as an initial screening tool.

Employment Tests

Next comes a battery of tests (a lot more than you'd take in applying for an everyday business position). Like most organizations, the FBI tests candidates on the skills and knowledge entailed by the job. Unlike most businesses, however, the FBI will also measure your aptitude, evaluate your personality, and assess your writing ability. You'll have to take a polygraph (lie-detector) test to determine the truthfulness of the information you've provided, uncover the extent of any drug use, and disclose potential security problems.

Interview

Figure 7.2 Interviewing. Interviewing candidates is the main way to gather the information necessary to make good hiring decisions. Alan Cleaver – Interview – CC BY 2.0. Source: https://flic.kr/p/7zLoAG

If you pass all these tests (with sufficiently high marks), you'll be granted an interview. It serves the same purpose as it does for business recruiters: it allows the FBI to learn more about you and gives you a chance to learn more about your prospective employer and your possible future in the organization. The FBI conducts *structured interviews*—a series of standard questions. You're judged on both your answers and your ability to communicate orally.

Physical Exam and Reference Checks

Let's be positive and say you passed the interview. What's next? You still have to pass a rigorous physical examination (including a drug test), as well as background and reference checks. Given its mission, the FBI sets all these hurdles a little higher than the average retail clothing chain. Most businesses will ask you to take a physical exam, but you probably won't have to meet the fitness standards set by the FBI. Likewise, many businesses check references to verify that applicants haven't lied about (or exaggerated) their education and work experience. The FBI goes to great lengths to ensure that candidates are suitable for law-enforcement work.

Final Decision

The last stage in the process is out of your control. Will you be hired or rejected? This decision is made by one or more people who work for the prospective employer. For a business, the decision maker is generally the line manager who oversees the position being filled. At the FBI, the decision is made by a team at FBI headquarters. If you're hired as a special agent, you'll spend twenty-one weeks of intensive training at the FBI Academy in Quantico, Virginia.

Contingent Workers

Though most people hold permanent, full-time positions, there's a growing number of individuals who work at temporary or part-time jobs. Many of these are contingent workers hired to supplement a company's permanent workforce. Most of them are independent contractors, consultants, or freelancers who are paid by the firms that hire them. Others are *on-call workers* who work only when needed, such as substitute teachers. Still others are *temporary workers* (or "temps") who are employed and paid by outside agencies or contract firms that charge fees to client companies.

The Positives and Negatives of Temp Work

The use of contingent workers provides companies with a number of benefits. Because they can be hired and fired easily, employers can better control labor costs. When things are busy, they can add temps, and when business is slow, they can release unneeded workers. Temps are often cheaper than permanent workers, particularly because they rarely receive costly benefits. Employers can also bring in people with specialized skills and talents to work on special projects without entering into long-term employment relationships. Finally, companies can "try out" temps: if someone does well, the company can offer permanent employment; if the fit is less than perfect, the employer can easily terminate the relationship. There are downsides to the use of contingent workers, including increased training costs and decreased loyalty to the company. Also, many employers believe that because temps are usually less committed to company goals than permanent workers, productivity suffers.

What about you? Does temporary work appeal to you? On the plus side, you can move around to various companies and gain a variety of skills. You can see a company from the inside and decide up front whether it's the kind of place you'd like to work at permanently. If it is, your temporary position lets you showcase your skills and talents and grab the attention of management, which could increase the likelihood you'll be offered a permanent position. There are also some attractive lifestyle benefits. You might, for example, work at a job or series of jobs for, say, ten months and head for the beach for the other two. On the other hand, you'll probably get paid less, receive no benefits, and have no job security. For most people, the idea of spending two months a year on the beach isn't *that* appealing.

Key Takeaways

- The process of **human resource management** consists of all the actions that an organization takes to attract, develop, and retain quality employees.
- To ensure that the organization is properly staffed, managers engage in **strategic human resource planning**—the process of developing a plan for satisfying the organization's human resource needs.
- Managers organize information about a given job by performing a **job analysis**, which they use to prepare two documents: a **job description** listing the duties and responsibilities of a position and a **job specification**, which lists the qualifications—skills, knowledge, and abilities—needed to perform the job.
- After analyzing the jobs that must be performed, the HR manager forecasts future hiring needs and begins the **recruiting** process to identify suitable candidates and encourage them to apply.

- In recruiting and hiring, managers must comply with antidiscrimination laws enforced by the **Equal Employment Opportunity Commission (EEOC)**.
- **Discrimination** occurs when a person is treated unfairly on the basis of a characteristic unrelated to ability, such as race, color, religion, sex, national origin, age, or disability.
- Once a pool of suitable candidates has been identified, managers begin the **selection** process, reviewing information provided by candidates on employment **applications** and administering tests to assess candidates' skills and knowledge.
- Candidates who pass this stage may be granted an **interview** and, perhaps, offered a job.

Exercise

You're the chairperson of the management department at your college. Describe the steps you'd take to ensure that your department has enough qualified faculty to meet its needs.

Developing Employees

Learning Objective

1. Explain how companies train and develop employees, and discuss the importance of a diverse workforce.

Because companies can't survive unless employees do their jobs well, it makes economic sense to train them and develop their skills. This type of support begins when an individual enters the organization and continues as long as he or she stays there.

New-Employee Orientation

Have you ever started your first day at a new job feeling upbeat and optimistic only to walk out at the end of the day thinking that maybe you've taken the wrong job? If this happens too often, your employer may need to revise its approach to orientation—the way it introduces new employees to the organization and their jobs. Starting a new job is a little like beginning college; at the outset, you may be experiencing any of the following feelings:

- Somewhat nervous but enthusiastic
- Eager to impress but not wanting to attract too much attention
- Interested in learning but fearful of being overwhelmed with information
- Hoping to fit in and worried about looking new or inexperienced[18]

The employer who understands how common such feelings are is more likely not only to help newcomers get over them but also to avoid the pitfalls often associated with new-employee orientation:

- Failing to have a workspace set up for you
- Ignoring you or failing to supervise you
- Neglecting to introduce you to coworkers (or introducing you to so many people that you have no chance of remembering anybody's name)
- Assigning you no work or giving you busywork unrelated to your actual job
- Swamping you with facts about the company[19]

A good employer will take things slowly, providing you with information about the company and your job on a need-to-know basis while making you feel as comfortable as possible. You'll get to know the company's history, traditions, policies, and culture over time. You'll learn more about salary and benefits and how your performance will be evaluated. Most importantly, you'll find out how your job fits into overall operations and what's expected of you.

Training and Development

It would be nice if employees came preprogrammed with all the skills they need to do their jobs. It would also be nice if job requirements stayed the same: once you've learned how to do a job (or been preprogrammed), you'd know how to do it forever. In reality, new employees must be trained; moreover, as they grow in their jobs or as their jobs change, they'll need additional training. Unfortunately, training is costly and time-consuming.

How costly? On average, for every $1 in payroll, large companies spend close to $0.03 in employee training and development.[20] The consulting firm Booz Allen Hamilton invests almost $0.08 in employee training and development. At Pfizer, the world's largest pharmaceutical company, the total is $0.14 out of every payroll dollar.[21] What's the payoff? Why are such companies willing to spend so much money on their employees? Pfizer, whose motto is "Succeed through People," regards employee growth and development as its top priority. At Booz Allen Hamilton, consultants specialize in finding innovative solutions to client problems, and their employer makes sure that they're up-to-date on all the new technologies by maintaining a "technology petting zoo" at its training headquarters. It's called a "petting zoo" because employees get to see, touch, and interact with new and emerging technologies. For example, those attending the "petting zoo" several years ago got to try out the Segway Human Transporter even before it hit the market.[22]

At Booz Allen Hamilton's technology "petting zoo," employees are receiving off-the-job training. This approach allows them to focus on learning without the distractions that would occur in the office. More common, however, is informal on-the-job training, which may be supplemented with formal training programs. This is the method, for example, by which you'd move up from mere coffee maker to a full-fledged "barista" if you worked at Starbucks.[23] You'd begin by reading a large spiral book (titled *Starbucks University*) on the responsibilities of the barista. After you've passed a series of tests on the reading material, you'll move behind the coffee bar, where a manager or assistant manager will give you hands-on experience in making drinks. According to the rules, you can't advance to a new drink until you've mastered the one you're working on; the process, therefore, may take a few days (or even weeks). Next, you have to learn enough about different types of coffee to be able to describe them to customers. (Because this course involves drinking a lot of coffee, you don't have to worry about staying awake.) Eventually, you'll be declared a coffee connoisseur, but there's still one more set of skills to master: you must complete a customer-service course, which trains you in making eye contact with customers, anticipating their needs, and making them feel welcome.[24]

Diversity in the Workplace

The makeup of the U.S. workforce has changed dramatically over the past 50 years. In the 1950s, more than 60 percent was composed of white males.[25] Today's workforce, however, reflects the broad range of differences in the population—differences in gender, race, ethnicity, age, physical ability, religion, education, and lifestyle. As you can see in Table 14.1 "Employment by Gender and Ethnic Group", more women and minorities have entered the workforce, and white males now make up only 36 percent of the workforce.[26] Their percentage representation diminished as more women and minorities entered the workforce.

Most companies today strive for diverse workforces. HR managers work hard to recruit, hire, develop, and retain a workforce that's representative of the general population. In part, these efforts are motivated by legal concerns: discrimination in recruiting, hiring, advancement, and firing is illegal under federal law and is prosecuted by the EEOC.[27] Companies that violate antidiscrimination laws not only are subject to severe financial penalties but also risk damage to their reputations. In November 2004, for example, the EEOC charged that recruiting policies at Abercrombie & Fitch, a national chain of retail clothing stores, had discriminated against minority and female job applicants between 1999 and 2004. The employer, charged the EEOC, had hired a disproportionate number of white salespeople, placed minorities and women in less visible positions, and promoted a virtually all-white image in its marketing efforts. Six days after the EEOC filed a lawsuit, the company settled the case at a cost of $50 million, but the negative publicity will hamper both recruitment and sales for some time to come.[28]

Group	Total (%)	Males (%)	Females (%)
All employees	100	52	48
White	68	36	32
African American	14	6	8
Hispanic or Latino	13	7	5
Asian/Pacific Islander/Other	5	3	3

Table 14.1 Employment by Gender and Ethnic Group

There's good reason for building a diverse workforce that goes well beyond mere compliance with legal standards. It even goes beyond commitment to ethical standards. It's good business. People with diverse backgrounds bring fresh points of view that can be invaluable in generating ideas and solving problems. In addition, they can be the key to connecting with an ethnically diverse customer base. If a large percentage of your customers are Hispanic, it might make sense to have a Hispanic marketing manager. In short, capitalizing on the benefits of a diverse workforce means that employers should view differences as assets rather than liabilities.

Key Takeaways

- The process of introducing new employees to their jobs and to the company is called **orientation**.
- An effective approach is to take things slowly, providing new employees with information on a need-to-know basis while making them feel as comfortable as possible.
- New employees will need initial training to start their jobs, and they'll need additional training as they grow in or change their jobs.
- **Off-the-job training** allows them to focus on learning without the distractions that would occur in the office, but **on-the-job training** is more common.
- In addition to having well-trained employees, it's important that a workforce reflects the broad range of differences in the population.
- The efforts of HR managers to build a workforce that's representative of the general population are driven in part by legal concerns: discrimination is illegal, and companies that violate antidiscrimination laws are subject to prosecution.
- But ensuring a diverse workforce goes well beyond both legal compliance and ethical commitment. It's good business, because a diverse group of employees can bring fresh points of view that may be valuable in generating ideas and solving problems.
- Additionally, people from varied backgrounds can help an organization connect with an ethnically diverse customer base.

Exercises

1. **(AACSB) Reflective Skills**
2. **(AACSB) Diversity**

Motivating Employees

Learning Objective

1. Define *motivation* and describe several theories of motivation.

Motivation refers to an internally generated drive to achieve a goal or follow a particular course of action. Highly motivated employees focus their efforts on achieving specific goals; those who are unmotivated don't. It's the manager's job, therefore, to motivate employees—to get them to try to do the best job they can. But what motivates employees to do well? How does a manager encourage employees to show up for work each day and do a good job? Paying them helps, but many other factors influence a person's desire (or lack of it) to excel in the workplace. What are these factors? Are they the same for everybody? Do they change over time? To address these questions, we'll examine four of the most influential theories of motivation: *hierarchy-of-needs theory, two-factor theory, expectancy theory*, and *equity theory*.

Hierarchy-of-Needs Theory

Psychologist Abraham Maslow's hierarchy-of-needs theory proposed that we are motivated by the five unmet needs, arranged in the hierarchical order shown in Figure 7.3 "Maslow's Hierarchy-of-Needs Theory", which also lists examples of each type of need in both the personal and work spheres of life. Look, for instance, at the list of personal needs in the left-hand column. At the bottom are *physiological* needs (such life-sustaining needs as food and shelter). Working up the hierarchy we experience *safety* needs (financial stability, freedom from physical harm), *social* needs (the need to belong and have friends), *esteem* needs (the need for self-respect and status), and *self-actualization* needs (the need to reach one's full potential or achieve some creative success).

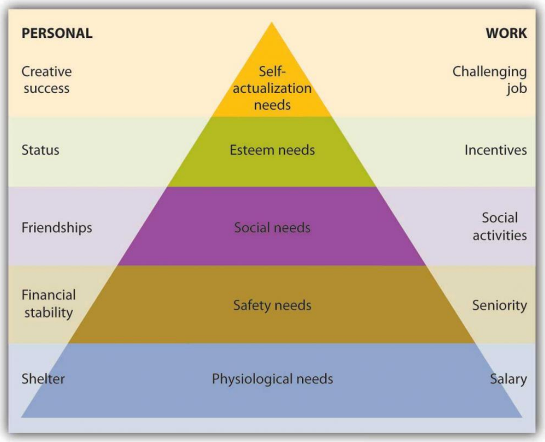

Figure 14.3 Maslow's Hierarchy-of-Needs Theory

There are two things to remember about Maslow's model:

1. We must satisfy lower-level needs before we seek to satisfy higher-level needs.
2. Once we've satisfied a need, it no longer motivates us; the next higher need takes its place.

Let's say, for example, that you've just returned to college and that for a variety of reasons that aren't your fault, you're broke, hungry, and homeless. Because you'll probably take almost any job that will pay for food and housing (*physiological* needs), you go to work repossessing cars. Fortunately, your student loan finally comes through, and with enough money to feed yourself, you can look for a job that's not so risky (a *safety* need). You find a job as a night janitor in the library, and though you feel secure, you start to feel cut off from your friends, who are active during daylight hours. You want to work among people, not books (a *social* need). So now you join several of your friends selling pizza in the student center. This job improves your social life, but even though you're very good at making pizzas, it's not terribly satisfying. You'd like something that will let you display your intellectual talents (an *esteem* need). So you study hard and land a job as an intern in the governor's office. On graduation, you move up through a series of government appointments and eventually run for state senator. As you're sworn into office, you realize that you've reached your full potential (a *self-actualization* need) and you comment to yourself, "It doesn't get any better than this."

Needs Theory and the Workplace

Figure 14.4 Teamwork. Employees are motivated by different factors. For some, the ability to have fun at work is a priority. ICMA Photos, Employee Meeting 5 – CC BY-SA 2.0, https://flic.kr/p/6wF82v

What implications does Maslow's theory have for business managers? There are two key points: (1) Not all employees are driven by the same needs, and (2) the needs that motivate individuals can change over time. Managers should consider which needs different employees are trying to satisfy and should structure rewards and other forms of recognition accordingly. For example, when you got your first job repossessing cars, you were motivated by the need for money to buy food. If you'd been given a choice between a raise or a plaque recognizing your accomplishments, you'd undoubtedly have opted for the money. As a state senator, by contrast, you may prefer public recognition of work well done (say, election to higher office) to a pay raise.

Two-Factor Theory

Another psychologist, Frederick Herzberg, set out to determine which work factors (such as wages, job security, or advancement) made people feel good about their jobs and which factors made them feel bad about their jobs. He surveyed workers, analyzed the results, and concluded that to understand employee *satisfaction* (or *dissatisfaction*), he had to divide work factors into two categories:

- *Motivation factors*. Those factors that are strong contributors to job satisfaction
- *Hygiene factors*. Those factors that are *not* strong contributors to satisfaction but that must be present to meet a worker's expectations and prevent job dissatisfaction

Figure 14.5 "Herzberg's Two-Factor Theory" illustrates Herzberg's two-factor theory. Note that motivation factors (such as promotion opportunities) relate to *the nature of the work itself and the way the employee performs it*. Hygiene factors (such as physical working conditions) relate to *the environment in which it's performed*. (Note, too, the similarity between Herzberg's motivation factors and Maslow's esteem and self-actualization needs).

Two-Factor Theory and the Workplace

We'll ask the same question about Herzberg's model as we did about Maslow's: What does it mean for managers? Suppose you're a senior manager in an accounting firm, where you supervise a team of accountants, each of whom has been with the firm for five years. How would you use Herzberg's model to motivate the employees who report to you? Let's start with hygiene factors. Are salaries reasonable? What about working conditions? Does each accountant have his or her own workspace, or are they crammed into tiny workrooms? Are they being properly supervised or are they left on their own to sink or swim? If hygiene factors like these don't meet employees' expectations, they may be dissatisfied with their jobs.

As you can see in Figure 14.5 "Herzberg's Two-Factor Theory", fixing problems related to hygiene factors may alleviate job *dissatisfaction*, but it won't necessarily improve anyone's job *satisfaction*. To increase

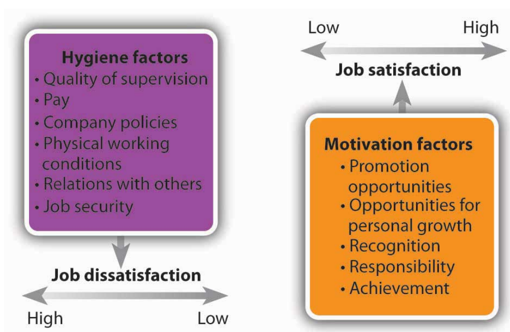

Figure 14.5 Herzberg's Two-Factor Theory

satisfaction (and motivate someone to perform better), you must address motivation factors. Is the work itself challenging and stimulating? Do employees receive recognition for jobs well done? Will the work that an accountant has been assigned help him or her to advance in the firm? According to Herzberg, motivation requires a twofold approach: eliminating dissatisfiers and enhancing satisfiers.

Expectancy Theory

If you were a manager, wouldn't you like to know how your employees decide to work hard or goof off? Wouldn't it be nice to know whether a planned rewards program will have the desired effect—namely, motivating them to perform better in their jobs? Wouldn't it be helpful if you could measure the effect of bonuses on employee productivity? These are the issues considered by psychologist Victor Vroom in his expectancy theory, which proposes that employees will work hard to earn rewards that they value and that they consider obtainable.

As you can see from Figure 14.6 "Vroom's Expectancy Theory", Vroom argues that an employee will be motivated to exert a high level of effort to obtain a reward under three conditions:

1. The employee believes that his or her efforts will result in acceptable performance.
2. The employee believes that acceptable performance will lead to the desired outcome or reward.
3. The employee values the reward.

Expectancy Theory and the Workplace

To apply expectancy theory to a real-world situation, let's analyze an automobile-insurance company with one hundred agents who work from a call center. Assume that the firm pays a base salary of $2,000 a month, plus a $200 commission on each policy sold above ten policies a month. In terms of expectancy theory, under what conditions would an agent be motivated to sell more than ten policies a month?

1. The agent would have to believe that his or her efforts

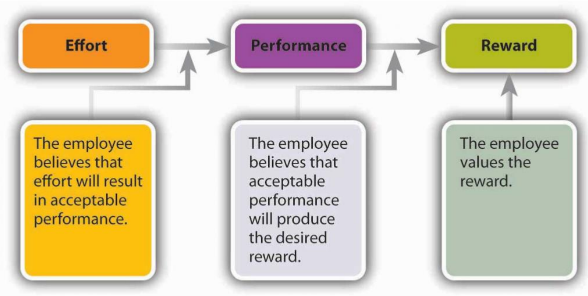

Figure 14.6 Vroom's Expectancy Theory

would result in policy sales (that, in other words, there's a positive link between effort and performance).

- The agent would have to be confident that if he or she sold more than ten policies in a given month, there would indeed be a bonus (a positive link between performance and reward).
- The bonus per policy—$200—would have to be of value to the agent.

Now let's alter the scenario slightly. Say that the company raises prices, thus making it harder to sell the policies. How will agents' motivation be affected? According to expectancy theory, motivation will suffer. Why? Because agents may be less confident that their efforts will lead to satisfactory performance. What if the company introduces a policy whereby agents get bonuses only if buyers don't cancel policies within ninety days? How will this policy affect motivation? Now agents may be less confident that they'll get bonuses even if they do sell more than ten policies. Motivation will decrease because the link between performance and reward has been weakened. Finally, what will happen if bonuses are cut from $200 to $25? Obviously, the reward would be of less value to agents, and, again, motivation will suffer. The message of expectancy theory, then, is fairly clear: managers should offer rewards that employees value, set performance levels that they can reach, and ensure a strong link between performance and reward.

Equity Theory

What if you spent thirty hours working on a class report, did everything you were supposed to do, and handed in an excellent assignment (in your opinion). Your roommate, on the other hand, spent about five hours and put everything together at the last minute. You know, moreover, that he ignored half the requirements and never even ran his assignment through a spell-checker. A week later, your teacher returns the reports. You get a C and your roommate gets a B+. In all likelihood, you'll feel that you've been treated unfairly relative to your roommate.

Your reaction makes sense according to the equity theory of motivation, which focuses on our perceptions of how fairly we're treated *relative to others*. Applied to the work environment, this theory proposes that employees analyze their contributions or job inputs (hours worked, education, experience, work performance) and their rewards or job outcomes (salary, benefits, recognition). Then they create a contributions/rewards ratio and compare it to those of other people. The basis of comparison can be any one of the following:

- Someone in a similar *position*
- Someone holding a different position in the same *organization*
- Someone with a similar *occupation*
- Someone who shares certain *characteristics* (such as age, education, or level of experience)
- Oneself at another point in time

When individuals perceive that the ratio of their contributions to rewards is comparable to that of others, they perceive that they're being treated equitably; when they perceive that the ratio is out of balance, they perceive inequity. Occasionally, people will perceive that they're being treated better than others. More often, however, they conclude that others are being treated better (and that they themselves are being treated worse). This is what you concluded when you saw your grade. You've calculated your ratio of contributions (hours worked, research and writing skills) to rewards (project grade), compared it to your roommate's ratio, and concluded that the two ratios are out of balance.

What will an employee do if he or she perceives an inequity? The individual might try to bring the ratio into balance, either by decreasing inputs (working fewer hours, refusing to take on additional tasks) or by increasing outputs (asking for a raise). If this strategy fails, an employee might complain to a supervisor, transfer to another job, leave the organization, or rationalize the situation (perhaps deciding that the situation isn't so bad after all). Equity theory advises managers to focus on treating workers fairly, especially in determining compensation, which is, naturally, a common basis of comparison.

Key Takeaways

- **Motivation** describes an internally generated drive that propels people to achieve goals or pursue particular courses of action.
- There are four influential theories of motivation: hierarchy-of-needs theory, two-factor theory, expectancy theory, and equity theory.
- **Hierarchy-of-needs theory** proposes that we're motivated by five unmet needs—physiological, safety, social, esteem, and self-actualization— and must satisfy lower-level needs before we seek to satisfy higher-level needs.
- **Two-factor theory** divides work factors into motivation factors (those that are strong contributors to job satisfaction) and hygiene factors (those that, though not strong contributors to satisfaction, must be present to prevent job dissatisfaction). To increase satisfaction (and motivate someone to perform better), managers must address motivation factors.
- **Expectancy theory** proposes that employees work hard to obtain a reward when they value the reward, believe that their efforts will result in acceptable performance, and believe that acceptable performance will lead to a desired outcome or reward.
- **Equity theory** focuses on our perceptions of how fairly we're treated relative to others. This theory proposes that employees create contributions/rewards ratios that they compare to those of others. If they feel that their ratios are comparable to those of others, they'll perceive that they're being treated equitably.

Exercise

This chapter describes four theories of motivation: hierarchy-of-needs theory, two-factor theory, expectancy theory, and equity theory. Briefly describe each theory. Which one makes the most intuitive sense to you? Why do you find it appealing?

What Makes a Great Place to Work?

Learning Objective

1. Identify factors that make an organization a good place to work, including competitive compensation and benefits packages.

Every year, the Great Places to Work Institute analyzes comments from thousands of employees and compiles a list of "The 100 Best Companies to Work for in America," which is published in *Fortune* magazine. Having compiled its list for more than twenty years, the institute concludes that the defining characteristic of a great company to work for is trust between managers and employees. Employees overwhelmingly say that they want to work at a place where employees "trust the people they work for, have pride in what they do, and enjoy the people they work with."[29] They report that they're motivated to perform well because they're challenged, respected, treated fairly, and appreciated. They take pride in what they do, are made to feel that they make a difference, and are given opportunities for advancement.[30] The most effective motivators, it would seem, are closely aligned with Maslow's higher-level needs and Herzberg's motivating factors.

Job Redesign

The average employee spends more than two thousand hours a year at work. If the job is tedious, unpleasant, or otherwise unfulfilling, the employee probably won't be motivated to perform at a very high level. Many companies practice a policy of job redesign to make jobs more interesting and challenging. Common strategies include *job rotation*, *job enlargement*, and *job enrichment*.

Job Rotation

Specialization promotes efficiency because workers get very good at doing particular tasks. The drawback is the tedium of repeating the same task day in and day out. The practice of job rotation allows employees to rotate from one job to another on a systematic basis, eventually cycling back to their original tasks. A computer maker, for example, might rotate a technician into the sales department to increase the employee's awareness of customer needs and to give the employee a broader understanding of the company's goals and operations. A hotel might rotate an accounting clerk to the check-in desk for a few hours each day to add variety to the daily workload. Rotated employees develop new skills and gain experience that increases their value to the company, which benefits management because cross-trained employees can fill in for absentees, thus providing greater flexibility in scheduling.

Job Enlargement

Instead of a job in which you performed just one or two tasks, wouldn't you prefer a job that gave you many different tasks? In theory, you'd be less bored and more highly motivated if you had a chance at job enlargement—the policy of enhancing a job by adding tasks at similar skill levels (see Figure 14.7 "Job Enlargement versus Job Enrichment"). The job of sales clerk, for example, might be expanded to include gift-wrapping and packaging items for shipment. The additional duties would add variety without entailing higher skill levels.

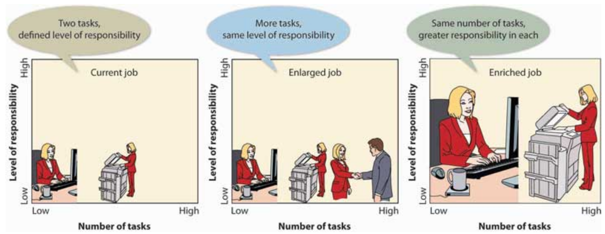

Figure 14.7 Job Enlargement versus Job Enrichment

Job Enrichment

As you can see from Figure 14.7 "Job Enlargement versus Job Enrichment", merely expanding a job by adding similar tasks won't necessarily "enrich" it by making it more challenging and rewarding. Job enrichment is the practice of adding tasks that increase both responsibility and opportunity for growth. It provides the kinds of benefits that, according to Maslow and Herzberg, contribute to job satisfaction: stimulating work, sense of personal achievement, self-esteem, recognition, and a chance to reach your potential.

Consider, for example, the evolving role of support staff in the contemporary office. Today, employees who used to be called "secretaries" assume many duties previously in the domain of management, such as project coordination and public relations. Information technology has enriched their jobs because they can now apply such skills as word processing, desktop publishing, creating spreadsheets, and managing databases. That's why we now hear such a term as *administrative assistant* instead of *secretary*.[31]

Work/Life Quality

Building a career requires a substantial commitment in time and energy, and most people find that they aren't left with much time for nonwork activities. Fortunately, many organizations recognize the need to help employees strike a balance between their work and home lives.[32] By helping employees combine satisfying careers and fulfilling personal lives, companies tend to end up with a happier, less-stressed, and more productive workforce. The financial benefits include lower absenteeism, turnover, and health care costs.

Alternative Work Arrangements

The accounting firm KPMG, which has made the list of the "100 Best Companies for Working Mothers" for twelve years, is committed to promoting a balance between its employees' work and personal lives.[33] KPMG offers a variety of work arrangements designed to accommodate different employee needs and provide scheduling flexibility.[34]

Flextime

Employers who provide for flextime set guidelines that allow employees to designate starting and quitting times. Guidelines, for example, might specify that all employees must work eight hours a day (with an hour for lunch) and that four of those hours must be between 10 a.m. and 3 p.m. Thus, you could come in at 7 a.m. and leave at 4 p.m., while coworkers arrive at 10 a.m. and leave at 7 p.m. With permission you could even choose to work from 8 a.m to 2 p.m., take two hours for lunch, and then work from 4 p.m. to 6 p.m.

Compressed Workweeks

Rather than work eight hours a day for five days a week, you might elect to earn a three-day weekend by working ten hours a day for four days a week.

Part-Time Work

If you're willing to have your pay and benefits adjusted accordingly you can work fewer than forty hours a week.

Job Sharing

Under job sharing, two people share one full-time position, splitting the salary and benefits of the position as each handles half the job. Often they arrange their schedules to include at least an hour of shared time during which they can communicate about the job.

Telecommuting

Telecommuting means that you regularly work from home (or from some other nonwork location). You're connected to the office by computer, fax, and phone. You save on commuting time, enjoy more flexible work hours, and have more opportunity to spend time with your family. A study of 5,500 IBM employees (one-fifth of whom telecommute) found that those who worked at home not only had a better balance between work and home life but also were more highly motivated and less likely to leave the organization.[35]

Though it's hard to count telecommuters accurately, some estimates put the number of people who work at home at least one day a week at 20 percent. This estimate includes 2 percent of workers who run home-based businesses and 2 percent who work exclusively at home for other companies.[36] Telecommuting isn't for everyone. Working at home means that you have to discipline yourself to avoid distractions, such as TV, personal phone calls, home chores, or pets, and some people feel isolated from social interaction in the workplace.

Family-Friendly Programs

In addition to alternative work arrangements, many employers, including KPMG, offer programs and benefits designed to help employees meet family and home obligations while maintaining busy careers. KPMG offers each of the following benefits.[37]

Dependent Care

Caring for dependents—young children and elderly parents—is of utmost importance to some employees, but combining dependent-care responsibilities with a busy job can be particularly difficult. KPMG provides on-site child care during tax season (when employees are especially busy) and offers emergency backup dependent care all year round, either at a provider's facility or in the employee's home. To get referrals or information, employees can call KPMG's LifeWorks Resource and Referral Service. KPMG is by no means unique in this respect: more than eight thousand companies maintain on-site day care[38] (Harris, 2000) and 18 percent of all U.S. companies offer child-care resources or referral services.[39]

Paid Parental Leave

Any employee (whether male or female) who becomes a parent can take two weeks of paid leave. New mothers also get time off through short-term disability benefits.

Caring for Yourself

Like many companies, KPMG allows employees to aggregate all paid days off and use them in any way they want. In other words, instead of getting, say, ten sick days, five personal days, and fifteen vacation days, you get a total of thirty days to use for anything. If you're having personal problems, you can contact the Employee Assistance Program. If staying fit makes you happier and more productive, you can take out a discount membership at one of more than nine thousand health clubs.

Unmarried without Children

You've undoubtedly noticed by now that many programs for balancing work and personal lives target married people, particularly those with children. Single individuals also have trouble striking a satisfactory balance between work and nonwork activities, but many single workers feel that they aren't getting equal consideration from employers (Collins & Hoover, 1995). They report that they're often expected to work longer hours, travel more, and take on difficult assignments to compensate for married employees with family commitments.

Needless to say, requiring singles to take on additional responsibilities can make it harder for them to balance their work and personal lives. It's harder to plan and keep personal commitments while meeting heavy work responsibilities, and establishing and maintaining social relations is difficult if work schedules are unpredictable or too demanding. Frustration can lead to increased stress and job dissatisfaction. In several studies of stress in the accounting profession, unmarried workers reported higher levels of stress than any other group, including married people with children.[40]

With singles, as with married people, companies can reap substantial benefits from programs that help employees balance their work and nonwork lives: they can increase job satisfaction and employee productivity and reduce turnover. PepsiCo, for example, offers a "concierge service," which maintains a dry cleaner, travel agency, convenience store, and fitness center on the premises of its national office in Somers, New York.[41] Single employees seem to find these services helpful, but what they value most of all is control over their time. In particular, they want predictable schedules that allow them to plan social and personal activities. They don't want employers assuming that being single means that they can change plans at the last minute. It's often more difficult for singles to deal with last-minute changes because, unlike married coworkers, they don't have the at-home support structure to handle such tasks as tending to elderly parents or caring for pets.

Compensation and Benefits

Though paychecks and benefits packages aren't the only reasons why people work, they do matter. Competitive pay and benefits also help organizations attract and retain qualified employees. Companies that pay their employees more than their competitors generally have lower turnover. Consider, for example, The Container Store, which regularly appears on *Fortune* magazine's list of "The 100 Best Companies to Work For."[42] The retail chain staffs its stores with fewer employees than its competitors but pays them more—in some cases, three times the industry average for retail workers. This strategy allows the company to attract extremely talented workers who, moreover, aren't likely to leave the company. Low turnover is particularly valuable in the retail industry because it depends on service-oriented personnel to generate repeat business.

In addition to salary and wages, compensation packages often include other financial incentives, such as bonuses and profit-sharing plans, as well as benefits, such as medical insurance, vacation time, sick leave, and retirement accounts.

Wages and Salaries

The largest, and most important, component of a compensation package is the payment of wages or salary. If you're paid according to the number of hours you work, you're earning wages. Counter personnel at McDonald's, for instance, get wages, which are determined by multiplying an employee's hourly wage rate by the number of hours worked during the pay period. On the other hand, if you're paid for fulfilling the responsibilities of a position—regardless of the number of hours required to do it—you're earning a salary. The McDonald's manager gets a salary for overseeing the operations of the restaurant. He or she is expected to work as long as it takes to get the job done, without any adjustment in compensation.

Piecework and Commissions

Sometimes it makes more sense to pay workers according to the quantity of product that they produce or sell. Byrd's Seafood, a crab-processing plant in Crisfield, Maryland, pays workers on piecework: Workers' pay is based on the amount of crabmeat that's picked from recently cooked crabs (A good picker can produce fifteen pounds of crabmeat an hour and earn about $100 a day.).[43][44] If you're working on commission, you're probably getting paid for quantity of sales. If you were a sales representative for an insurance company, like The Hartford, you'd get a certain amount of money for each automobile or homeowner policy that you sell. [45]

Incentive Programs

In addition to regular paychecks, many people receive financial rewards based on performance, whether their own, their employer's, or both. At computer-chip maker Texas Instruments (TI), for example, employees may be eligible for bonuses, profit sharing, and stock options. All three plans are incentive programs: programs designed to reward employees for good performance.[46]

Bonus Plans

TI's year-end bonuses—annual income given in addition to salary—are based on company-wide performance. If the company has a profitable year, and if you contributed to that success, you'll get a bonus. If the company doesn't do well, you're out of luck, regardless of what you contributed.

Bonus plans have become quite common, and the range of employees eligible for bonuses has widened in recent years. In the past, bonus plans were usually reserved for managers above a certain level. Today, however, companies have realized the value of extending plans to include employees at virtually every level. The magnitude of bonuses still favors those at the top. High-ranking officers (such as CEOs and CFOs) often get bonuses ranging from 30 percent to 50 percent of their salaries. Upper-level managers may get from 15 percent to 25 percent and middle managers from 10 percent to 15 percent. At lower levels, employees may expect bonuses from 3 percent to 5 percent of their annual compensation.[47]

Profit-Sharing Plans

TI also maintains a profit-sharing plan, which relies on a predetermined formula to distribute a share of the company's profits to eligible employees. Today, about 40 percent of all U.S. companies offer some type of profit-sharing program.[48] TI's plan, however, is a little unusual: while most plans don't allow employees to access profit-sharing funds until retirement or termination, TI employees get their shares immediately—in cash.

TI's plan is also pretty generous—as long as the company has a good year. Here's how it works. An employee's profit share depends on the company's operating profit for the year. If profits from operations reach 10 percent of sales, the employee gets a bonus worth 4 percent of his or her salary. If operating profit soars to 20 percent, the employee bonuses go up to 26 percent of salary. But if operating profits fall short of a certain threshold, nobody gets anything.[49]

Stock-Option Plans

Like most stock-option plans, the TI plan gives employees the right to buy a specific number of shares of company stock at a set price on a specified date. At TI, an employee may buy stock at its selling price at the time when he or she was given the option. So, if the price of the stock goes up, the employee benefits. Say, for example, that the stock was selling for $30 a share when the option was granted in 2007. In 2011, it was selling for $40 a share. Exercising his or her option, the employee could buy TI stock at the 2007 price of $30 a share—a bargain price.[50]

At TI, stock options are used as an incentive to attract and retain top people. Starbucks, by contrast, isn't nearly as selective in awarding stock options. At Starbucks, all employees can earn "Bean Stock"—the Starbucks employee stock-option plan. Both full- and part-time employees get options to buy Starbucks shares at a set price. If the company does well and its stock goes up, employees make a profit. CEO Howard Schultz believes that Bean Stock pays off: because employees are rewarded when the company does well, they have a stronger incentive to add value to the company (and so drive up its stock price). Shortly after the program was begun, the phrase "bean-stocking" became workplace lingo for figuring out how to save the company money.

Benefits

Another major component of an employee's compensation package is benefits—compensation other than salaries, hourly wages, or financial incentives. Types of benefits include the following:

- Legally required benefits (Social Security and Medicare, unemployment insurance, workers' compensation)
- Paid time off (vacations, holidays, sick leave)
- Insurance (health benefits, life insurance, disability insurance)
- Retirement benefits

Unfortunately, the cost of providing benefits is staggering. According to the Employee Benefit Research Institute, it costs an employer 30 percent of a worker's salary to provide the same worker with benefits. If you include pay for time not worked (while on vacation or sick and so on), the percentage increases to 41 percent. So if you're a manager making $100,000 a year, your employer is also paying out another $41,000 for your benefits. The most money goes for health care (8 percent of salary costs), paid time off (11 percent), and retirement benefits (5 percent).[51]

Some workers receive only benefits required by law, including Social Security, unemployment, and workers' compensation. Low-wage workers generally get only limited benefits and part-timers often nothing at all.[52] Again, Starbucks is generous in offering benefits. The company provides benefits even to the part-timers who make up two-thirds of the company's workforce; anyone working at least twenty hours a week gets medical coverage.

Key Takeaways

- Employees report that they're motivated to perform well when they're challenged, respected, treated fairly, and appreciated.
- Other factors may contribute to employee satisfaction. Some companies use **job redesign** to make jobs more interesting and challenging.
    - **Job rotation** allows employees to rotate from one job to another on a systematic basis.
    - **Job enlargement** enhances a job by adding tasks at similar skill levels.
    - **Job enrichment** adds tasks that increase both responsibility and opportunity for growth.
- Many organizations recognize the need to help employees strike a balance between their work and home lives and offer a variety of work arrangements to accommodate different employee needs.
- **Flextime** allows employees to designate starting and quitting times, compress workweeks, or perform part-time work.
- With **job sharing**, two people share one full-time position.
- **Telecommuting** means working from home. Many employers also offer dependent care, paid leave for new parents, employee-assistance programs, and on-site fitness centers.
- Competitive compensation also helps.
- Workers who are paid by the hour earn **wages**, while those who are paid to fulfill the responsibilities of the job earn **salaries**.
- Some people receive **commissions** based on sales or are paid for output, based on a **piecework** approach.
- In addition to pay, many employees can earn financial rewards based on their own and/or their employer's performance.
- They may receive year-end **bonuses**, participate in **profit-sharing plans** (which use predetermined formulas to distribute a share of company profits among employees), or receive **stock options** (which let them buy shares of company stock at set prices).
- Another component of many compensation packages is **benefits**—compensation other than salaries, wages, or financial incentives. Benefits may include paid time off, insurance, and retirement benefits.

Exercise

(AACSB) Analysis

1. Describe the ideal job that you'd like to have once you've finished college. Be sure to explain the type of work schedule that you'd find most satisfactory, and why. Identify family-friendly programs that you'd find desirable and explain why these appeal to you.
2. Describe a typical compensation package for a sales manager in a large organization. If you could design your own compensation package, what would it include?

Performance Appraisal

Learning Objective

1. Explain how managers evaluate employee performance and retain qualified employees.

Employees generally want their managers to tell them three things: what they should be doing, how well they're doing it, and how they can improve their performance. Good managers address these issues on an ongoing basis. On a semiannual or annual basis, they also conduct formal performance appraisals to discuss and evaluate employees' work performance.

The Basic Three-Step Process

Appraisal systems vary both by organization and by the level of the employee being evaluated, but as you can see in Figure 14.8 "How to Do a Performance Appraisal", it's generally a three-step process:

1. Before managers can measure performance, they must set goals and performance expectations and specify the criteria (such as quality of work, quantity of work, dependability, initiative) that they'll use to measure performance.
2. At the end of a specified time period, managers complete written evaluations that rate employee performance according to the predetermined criteria.
3. Managers then meet with each employee to discuss the evaluation. Jointly, they suggest ways in which the employee can improve performance, which might include further training and development.

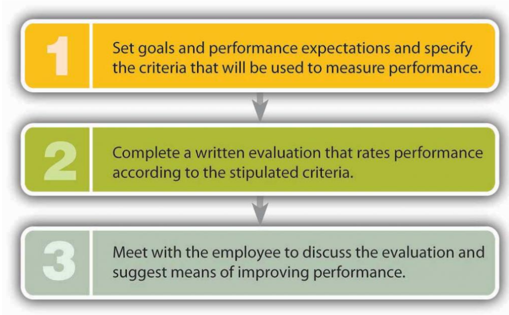

Figure 14.8 How to Do a Performance Appraisal

It sounds fairly simple, but why do so many managers report that, except for firing people, giving performance appraisals is their least favorite task?[53] To get some perspective on this question, we'll look at performance appraisals from both sides, explaining the benefits and identifying potential problems with some of the most common practices.

Among other benefits, formal appraisals provide the following:

- An opportunity for managers and employees to discuss an employee's performance and to set future goals and performance expectations
- A chance to identify and discuss appropriate training and career-development opportunities for an employee
- Formal documentation of the evaluation that can be used for salary, promotion, demotion, or dismissal purposes (Nelson & Economy, 2003)

As for disadvantages, most stem from the fact that appraisals are often used to determine salaries for the upcoming year. Consequently, meetings to discuss performance tend to take on an entirely different dimension: the manager appears judgmental (rather than supportive), and the employee gets defensive. It's the adversarial atmosphere that makes many managers not only uncomfortable with the task but also unlikely to give honest feedback. (They tend to give higher marks in order to avoid delving into critical evaluations.) HR professionals disagree about whether performance appraisals should be linked to pay increases. Some experts argue that the connection eliminates the manager's opportunity to use the appraisal to improve an employee's performance. Others maintain that it increases employee satisfaction with the process and distributes raises on the basis of effort and results.[54]

360-Degree and Upward Feedback

Instead of being evaluated by one person, how would you like to be evaluated by several people—not only those above you in the organization but those below and beside you? The approach is called *360-degree feedback*, and the purpose is to ensure that employees (mostly managers) get feedback from all directions—from supervisors, reporting subordinates, coworkers, and even customers. If it's conducted correctly, this technique furnishes managers with a range of insights into their performance in a number of roles.

Some experts, however, regard the 360-degree approach as too cumbersome. An alternative technique, called *upward feedback*, requires only the manager's subordinates to provide feedback. Computer maker Dell uses this approach as part of its manager-development plan. Every six months, forty thousand Dell employees complete a survey in which they rate their supervisors on a number of dimensions, such as practicing ethical business principles and providing support in balancing work and personal life. Like most companies using this technique, Dell uses survey results for development purposes only, not as direct input into decisions on pay increases or promotions.[55]

Retaining Valuable Employees

When a valued employee quits, the loss to the employer can be serious. Not only will the firm incur substantial costs to recruit and train a replacement, but it also may suffer temporary declines in productivity and lower morale among remaining employees who have to take on heavier workloads. Given the negative impact of turnover—the permanent separation of an employee from a company—most organizations do whatever they can to retain qualified employees. Compensation plays a key role in this effort: companies that don't offer competitive compensation packages (including benefits) tend to lose employees. But other factors come into play, some of which we discussed earlier, such as training and development, as well as helping employees achieve a satisfying work/nonwork balance. In the following sections, we'll look at a few other strategies for reducing turnover and increasing productivity.[56][57][58]

Creating a Positive Work Environment

Employees who are happy at work are more productive, provide better customer service, and are more likely to stay with the company. A study conducted by Sears, for instance, found a positive relationship between customer satisfaction and employee attitudes on ten different issues: a 5 percent improvement in employee attitudes results in a 1.3 percent increase in customer satisfaction and a 0.5 percent increase in revenue.[59]

The Employee-Friendly Workplace

What sort of things improve employee attitudes? The twelve thousand employees of software maker SAS Institute fall into the category of "happy workers." They choose the furniture and equipment in their own (private) offices; eat subsidized meals at one of three on-site restaurants; enjoy free soft drinks, fresh fruit on Mondays, M&M's on Wednesdays, and a healthy breakfast snack on Fridays in convenient break rooms; and swim and work out at a seventy-seven-thousand-square-foot fitness center. They set their own work hours, and they're encouraged to stay home with sick children. They also have job security: no one's ever been laid off because of an economic downturn. The employee-friendly work environment helps SAS employees focus on their jobs and contribute to the attainment of company goals.[60][61] Not surprisingly, it also results in very low 3 percent turnover.

Recognizing Employee Contributions

Thanking people for work done well is a powerful motivator. People who feel appreciated are more likely to stay with a company than those who don't.[62] While personal thank-yous are always helpful, many companies also have formal programs for identifying and rewarding good performers. The Container Store, a national storage and container retailer, rewards employee accomplishments in a variety of ways. Recently, for example, twelve employees chosen by coworkers were rewarded with a Colorado vacation with the company's owners, and the seven winners of a sales contest got a trip to visit an important supplier—in Sweden.[63] The company is known for its supportive environment and has frequently been selected as one of the top U.S. companies to work for.

Involving Employees in Decision Making

Companies have found that involving employees in decisions saves money, makes workers feel better about their jobs, and reduces turnover. Some have found that it pays to take their advice. When General Motors asked workers for ideas on improving manufacturing operations, management was deluged with more than forty-four thousand suggestions during one quarter. Implementing a few of them cut production time on certain vehicles by 15 percent and resulted in sizable savings.[64]

Similarly, in 2001, Edward Jones, a personal investment company, faced a difficult situation during the stock-market downturn. Costs had to be cut, and laying off employees was one option. Instead, however, the company turned to its workforce for solutions. As a group, employees identified cost savings of more than $38 million. At the same time, the company convinced experienced employees to stay with it by assuring them that they'd have a role in managing it.[65]

Why People Quit

As important as such initiatives can be, one bad boss can spoil everything. The way a person is treated by his or her boss may be the primary factor in determining whether an employee stays or goes. People who have quit their jobs cite the following behavior by superiors:

- Making unreasonable work demands
- Refusing to value their opinions
- Failing to be clear about what's expected of subordinates
- Rejecting work unnecessarily
- Showing favoritism in compensation, rewards, or promotions[66]

Figure 14.9 Work Demands. Trying to meet unreasonable work demands can be extremely stressful and is a major reason people quit their jobs. Source: Becky Wetherington – 31/365 – CC BY 2.0 – https://www.flickr.com/photos/macbeck/4003446559/

Holding managers accountable for excessive turnover can help alleviate the “bad-boss” problem, at least in the long run. In any case, whenever an employee quits, it’s a good idea for someone—someone other than the individual’s immediate supervisor—to conduct an exit interview to find out why. Knowing why people are quitting gives an organization the opportunity to correct problems that are causing high turnover rates.

Involuntary Termination

Before we leave this section, we should say a word or two about *termination*—getting fired. Though turnover—voluntary separations—can create problems for employers, they’re not nearly as devastating as the effects of involuntary termination on employees. Losing your job is what psychologists call a “significant life change,” and it’s high on the list of “stressful life events” regardless of the circumstances. Sometimes, employers lay off workers because revenues are down and they must resort to **downsizing**—to cutting costs by eliminating jobs. Sometimes a particular job is being phased out, and sometimes an employee has simply failed to meet performance requirements.

Employment at Will

Is it possible for you to get fired even if you’re doing a good job and there’s no economic justification for your being laid off? In some cases, yes—especially if you’re not working under a contract. Without a formal contract, you’re considered to be *employed at will*, which means that both you and your employer have the right to terminate the employment relationship at any time. *You* can quit whenever you want (which is good for you), but your *employer* can fire you whenever it wants (which is obviously bad for you).

Fortunately for you, over the past several decades, the courts have undercut employers’ rights under the employment-at-will doctrine.[67] By and large, management can no longer fire employees at will: usually, employers must show just cause for termination, and in some cases, they must furnish written documentation to substantiate the reasons for terminating an employee. If it’s a case of poor performance, the employee is generally warned in advance that his or her current level of performance could result in termination. As a rule, managers give employees who have been warned a reasonable opportunity to improve performance. When termination is unavoidable, it should be handled in a private conversation, with the manager explaining precisely why the action is being taken.

Key Takeaways

- Managers conduct **performance appraisals** to evaluate work performance, usually following a three-step process:
  1. Setting goals and performance expectations and specifying the criteria for measuring performance
  2. Completing written evaluations to rate performance according to predetermined criteria
  3. Meeting with employees to discuss evaluations and ways to improve performance
- **Turnover**—the permanent separation of an employee from a company—has a negative effect on an organization.
- In addition to offering competitive compensation, companies may take a variety of steps to retain qualified employees:
  1. Providing appropriate training and development
  2. Helping employees achieve a satisfying work/nonwork balance in their lives
  3. Creating a positive work environment

4. Recognizing employee efforts
5. Involving employees in decision making

- On the other hand, employers may have to terminate the employment of (that is, fire) some workers.
  1. They may lay off workers because revenues are down and they have to **downsize**—to cut costs by eliminating jobs.
  2. Sometimes a job is phased out, and sometimes an employee simply fails to meet performance requirements.
- If there's no written employment contract, the employment relationship falls under the principle of **employment-at-will**, by which an employer can end it at any time. Usually, however, the employer must show just cause.

Exercises

1. What steps does a manager take in evaluating an employee's performance? Explain the benefits of performance appraisals, and identify some of the potential problems entailed by the performance-evaluation process.
2. As an HR manager, what steps would you take to retain valuable employees? Under what circumstances would you fire an employee? Can you fire someone without giving that person a warning?

Labor Unions

Learning Objective

1. Explain why workers unionize and how unions are structured, and describe the collective-bargaining process.

As we saw earlier, Maslow believed that individuals are motivated to satisfy five levels of unmet needs (physiological, safety, social, esteem, and self-actualization). From this perspective, employees should expect that full-time work will satisfy at least the two lowest-level needs: they should be paid wages that are sufficient for them to feed, house, and clothe themselves and their families, and they should have safe working conditions and some degree of job security. Organizations also have needs: they need to earn profits that will satisfy their owners. Sometimes, the needs of employees and employers are consistent: the organization can pay decent wages and provide workers with safe working conditions and job security while still making a satisfactory profit. At other times, there is a conflict—real, perceived, or a little bit of both—between the needs of employees and those of employers. In such cases, workers may be motivated to join a labor union—an organized group of workers that bargains with employers to improve its members' pay, job security, and working conditions.

Figure 14.10 "Labor Union Density, 1930–2010" charts labor-union density—union membership as a percentage of payrolls—in the United States from 1930 to 2010. As you can see, there's been a steady decline since the mid-1950s, and, today, only about 12 percent of U.S. workers belong to unions (U.S. Department of Labor, 2011). Only membership among public workers (those employed by federal, state, and local governments, such as teachers, police, and firefighters) has grown. In the 1940s, 10 percent of public workers and 34 percent of those in the private sector belonged to unions. Today, this has reversed: 36 percent of public workers and 7 percent of those in the private sector are union members.[68]

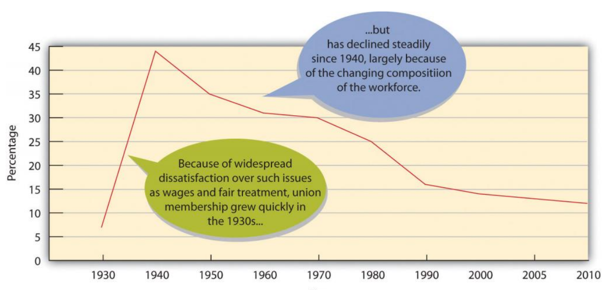

Figure 14.10 Labor Union Density, 1930–2010

Why the decline in private sector unionization? Many factors come into play. The poor economy has reduced the number of workers who can become union members. In addition, we've shifted from a manufacturing-based economy characterized by large, historically unionized companies to a service-based economy made up of many small firms that are hard to unionize. Finally, there are more women in the workforce, and they're more likely to work part-time or intermittently.[69][70]

Union Structure

Unions have a pyramidal structure much like that of large corporations. At the bottom are *locals* that serve workers in a particular geographical area. Certain members are designated as *shop stewards* to serve as go-betweens in disputes between workers and supervisors. Locals are usually organized into *national unions* that assist with local contract negotiations, organize new locals, negotiate contracts for entire industries, and lobby government bodies on issues of importance to organized labor. In turn, national unions may be linked by a *labor federation*, such as the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), which provides assistance to member unions and serves as the principal political organ for organized labor.

Collective Bargaining

In a nonunion environment, the employer makes largely unilateral decisions on issues affecting its labor force, such as salary and benefits. Management, for example, may simply set an average salary increase of 3 percent and require employees to pay an additional $50 a month for medical insurance. Typically, employees are in no position to bargain for better deals. (At the same time, however, for reasons that we've discussed earlier in this chapter, employers have a vested interest in treating workers fairly. A reputation for treating employees well, for example, is a key factor in attracting talented people.)

The process is a lot different in a union environment. Basically, union representatives determine with members what they want in terms of salary increases, benefits, working conditions, and job security. Union officials then tell the employer what its workers want and ask what they're willing to offer. When there's a discrepancy between what workers want and what management is willing to give—as there usually is—union officials serve as *negotiators* to bring the two sides together. The process of settling differences and establishing mutually agreeable conditions under which employees will work is called collective bargaining.

The Negotiation Process

Negotiations start when each side states its position and presents its demands. As in most negotiations, these opening demands simply stake out starting positions. Both parties expect some give-and-take and realize that the final agreement will fall somewhere between the two positions. If everything goes smoothly, a tentative agreement is reached and then voted on by union members. If they accept the agreement, the process is complete and a contract is put into place to govern labor-management relations for a stated period. If workers reject the agreement, negotiators go back to the bargaining table.

Mediation and Arbitration

If negotiations stall, the sides may call in outsiders. One option is mediation, under which an impartial third party assesses the situation and makes recommendations for reaching an agreement. A mediator's advice can be accepted or rejected. If the two sides are willing to accept the decision of a third party, they may opt instead for arbitration, under which the third party studies the situation and arrives at a binding agreement.

Grievance Procedures

Another difference between union and nonunion environments is the handling of grievances—worker complaints on contract-related matters. When nonunion workers feel that they've been treated unfairly, they can take up the matter with supervisors, who may or may not satisfy their complaints. When unionized workers have complaints (such as being asked to work more hours than stipulated under their contract), they can call on union representatives to resolve the problem, in conjunction with supervisory personnel. If the outcome isn't satisfactory, the union can take the problem to higher-level management. If there's still no resolution, the union may submit the grievance to an arbitrator.

When Negotiations Break Down

At times, labor and management can't resolve their differences through collective bargaining or formal grievance procedures. When this happens, each side may resort to a variety of tactics to win support for its positions and force the opposition to agree to its demands.

Union Tactics

The tactics available to the union include *striking*, *picketing*, and *boycotting*. When they go on strike, workers walk away from their jobs and refuse to return until the issue at hand has been resolved. As undergraduates at Yale discovered when they arrived on campus in fall 2003, the effects of a strike can engulf parties other than employers and strikers: with four thousand dining room workers on strike, students had to scramble to find food at local minimarkets. The strike—the ninth at the school since 1968—lasted twenty-three days, and in the end, the workers got what they wanted: better pension plans.

Though a strike sends a strong message to management, it also has consequences for workers, who don't get paid when they're on strike. Unions often ease the financial pressure on strikers by providing cash payments. (Some unionized workers, by the way, don't have the right to strike. Strikes by federal employees, such as air-traffic controllers, are illegal because they jeopardize the public interest).

Figure 14.11 Strike. The adverse affects of a strike can impact management and workers alike. Source: Wikimedia Commons – GNU Free.

The adverse affects of a **strike** can impact management and workers alike. [71]

When you see workers parading with signs outside a factory or an office building (or even a school), they're probably picketing. The purpose of picketing is informative—to tell people that a workforce is on strike or to publicize some management practice that's unacceptable to the union. In addition, because other union workers typically won't cross picket lines, marchers can interrupt the daily activities of the targeted organization. How would you like to show up for classes to find faculty picketing outside the classroom building? In April 2001, faculty at the University of Hawaii, unhappy about salaries, went on strike for thirteen days. Initially, many students cheerfully headed for the beach to work on their tans, but before long, many more—particularly graduating seniors—began to worry about finishing the semester with the credits they needed to keep their lives on schedule.[72]

The final tactic available to unions is boycotting, in which union workers refuse to buy a company's products and try to get other people to follow suit. The tactic is often used by the AFL-CIO, which maintains a national "Don't Buy or Patronize" boycott list. In 2003, for example, at the request of two affiliates, the Actor's Equity Association and the American Federation of Musicians, the AFL-CIO added the road show of the Broadway musical *Miss Saigon* to the list. Why? The unions objected to the use of nonunion performers who worked for particularly low wages and to the use of a "virtual orchestra," an electronic apparatus that can replace a live orchestra with software-generated orchestral accompaniment.[73]

Management Tactics

Management doesn't sit by passively, especially if the company has a position to defend or a message to get out. One available tactic is the lockout—closing the workplace to workers—though it's rarely used because it's legal only when unionized workers pose a credible threat to the employer's financial viability. Another tactic is replacing striking workers with strikebreakers—nonunion workers who are willing to cross picket lines to replace strikers. Though the law prohibits companies from permanently replacing striking workers, it's often possible for a company to get a court injunction that allows it to bring in replacement workers.

Lockout tactics were used in the 2011 labor dispute between the National Football League (NFL) and the National Football League Players Association when club owners and players failed to reach an agreement on a new contract. Prior to the 2011 season, the owners imposed a lockout, which prevented the players from practicing in team training facilities. Both sides had their demands: The players wanted a greater percentage of the revenues, which the owners were against. The owners wanted the players to play two additional season games, which the players were against. With the season drawing closer, an agreement was finally reached in July 2011 bringing the 130-day lockout to an end and ensuring that the 2011 football season would begin on time.[74]

The Future of Unions

As we noted earlier, union membership in the United States is declining. So, what's the future of organized labor? Will membership continue to decline and unions lose even more power? The AFL-CIO is optimistic about union membership, pointing out recent gains in membership among women and immigrants, as well as health care workers, graduate students, and professionals.[75][76]

But convincing workers to unionize is still more difficult than it used to be and could become even harder in the future. For one thing, employers have developed strategies for dissuading workers from unionizing—in particular, tactics for withholding job security. If unionization threatens higher costs for wages and benefits, they can resort to part-time or contract workers. They can also outsource work, eliminating jobs entirely, and more employers are now investing in technology designed to reduce the amount of human labor needed to produce goods or offer services.

Key Takeaways

- Some workers belong to **labor unions**—organized groups of workers that bargain with employers to improve members' pay, job security, and working conditions.
- Unions have a pyramidal structure. At the bottom are *locals*, who serve workers in a particular geographical area.
  1. Locals are usually organized into *national unions* that assist with local contract negotiations and negotiate industry-wide contracts.
  2. Nationals may be linked by a *labor federation*, such as the AFL-CIO, which provides assistance to member unions and serves as the principal political organ for organized labor.
- When there's a discrepancy between what workers want in terms of salary increases, benefits, working conditions, and job security and what management is willing to give, the two sides engage in a process called **collective bargaining**.
  1. If everything goes smoothly, a contract is soon put into place.
  2. If negotiations break down, the sides may resort to **mediation** (in which an impartial third party makes recommendations for reaching an agreement) or **arbitration** (in which the third party imposes a binding agreement).
- When unionized workers feel that they've been treated unfairly, they can file **grievances**—complaints over contract-related matters that are resolved by union representatives and employee supervisors.
- If labor differences can't be resolved through collective bargaining or formal grievance procedures, each side may resort to a variety of tactics. The union can do the following:
  1. Call a **strike** (in which workers leave their jobs until the issue is settled)
  2. Organize **picketing** (in which workers congregate outside the workplace to publicize their position)
  3. Arrange for **boycotting** (in which workers and other consumers are urged to refrain from buying an employer's products)
- Management may resort to a **lockout**—closing the workplace to workers—or call in **strikebreakers** (nonunion workers who are willing to cross picket lines to replace strikers).

Exercises

1. You've just gotten a job as an autoworker. Would you prefer to work in a unionized or nonunionized plant? Why? If you were hired as a high-level manager in the company, would you want your workers to be unionized? Why, or why not? What's your opinion on the future of organized labor? Will union membership grow or decline in the next decade? Why, or why not?
2. What happens in a unionized company when negotiations between labor and management break down? Identify and describe the tactics that unions can use against management and those that management can use against unions.

Cases and Problems

Learning on the Web (AACSB)

What's Your (Emotional) IQ?

If you were an HR manager, on what criteria would you base a hiring decision—intelligence (IQ), education, technical skills, experience, references, or performance on the interview? All these can be important determinants of a person's success, but some experts believe that there's an even better predictor of success. It's called *emotional intelligence* (or EI), and it gained some currency in the mid-1990s thanks to Daniel Goleman's book *Emotional Intelligence: Why It Can Matter More Than IQ*. EI is the ability to understand both our own emotions and those of others, as well as the ability to use that understanding in managing our behavior, motivating ourselves, and encouraging others to achieve goals.

An attractive aspect of EI is that, unlike IQ, it's not fixed at an early age. Rather, its vital components—self-awareness, self-management, social awareness, and relationship management—can be strengthened over time. To assess your level of EI, go to the Web site maintained by the Hay Group, a management-consulting firm, and take the ten-item test that's posted there (http://psychology.about.com/library/quiz/bl_eq_quiz.htm?questnum=6&cor=2399). After completing the test, you'll get your EI score, some instructions for interpreting it, and an answer key.

When you've finished with the test, rank the following items according to the importance that you'd give them in making a hiring decision: intelligence, education, technical skills, experience, references, interview skills, and emotional intelligence. Explain your ranking.

Career Opportunities

Are You a People Person?

You might not like the idea of sitting across the desk from a corporate college recruiter and asking for a job, but what if you were on the other side of the desk? As a recruiter, you'd get to return to campus each year to encourage students to join your company. Or, maybe you'd like to help your company develop a new compensation and benefits program, implement a performance-evaluation system, or create a new training program. All these activities fall under the umbrella of HR.

To learn more about the field of HR, go to the WetFeet Web site (http://wetfeet.com/Careers-and-Industries/Industries/Human-Resources.aspx#jobdescriptions) and read the page "Human Resources Overview." Then answer these questions:

1. What is the human resources field like?
2. What do HR professionals like about their jobs? What do they dislike?
3. Are job prospects in the HR field positive or negative? Which HR areas will experience the fastest growth?
4. Based on the job descriptions posted, which specific HR job would you want?

Finally, write a paragraph responding to this question: Do you find the HR field interesting? Why, or why not?

Ethics Angle (AACSB)

Misstating the Facts

Life couldn't get much better for George O'Leary when he was named the head football coach at Notre Dame. Unfortunately, he barely had time to celebrate his new job before he was ruled ineligible: after just a week on the job, he was forced to resign, embarrassing himself, his family, his friends, and Notre Dame itself. Why? Because of a few lies that he'd put on his résumé twenty years earlier. To get the facts behind this story, go to the *Sports Illustrated* Web site (http://sportsillustrated.cnn.com/football/college/news/2001/12/14/oleary_notredame/) and read the article "Short Tenure: O'Leary Out at Notre Dame After One Week." Then, answer the following questions:

1. Was O'Leary's punishment appropriate? If you were the athletic director at Notre Dame, would you have meted out the same punishment? Why, or why not?
2. False information on his résumé came back to haunt O'Leary after twenty years. Once he'd falsified his résumé, was there any corrective action that he could have taken? If so, what?
3. If O'Leary had told Notre Dame about the falsifications before they came to light, would they have hired him?
4. Would his previous employer take him back?
5. O'Leary was later hired as a head coach by the University of Central Florida. Will the episode involving his résumé undermine his ability to encourage players to act with integrity? Will it affect his ability to recruit players?
6. What's the lesson to be learned from O'Leary's experience? In what ways might a few (theoretical) misstatements on your résumé come back to haunt you?

Team-Building Skills (AACSB)

Dorm Room Rescue

Any night of the week (at least as of this writing), you can relax in front of the TV and watch a steady stream of shows about how to improve your living space—such as *New Spaces*. You like the concept of these programs well enough, but you're tired of watching them in a tiny, cluttered dorm room that's decorated in early barracks style. Out of these cramped conditions, however, you and a team of friends come up with an idea. On graduation, you'll start a business called Dorm Room Rescue to provide decorating services to the dorm dwellers who come after you. You'll help college students pick colors and themes for their rooms and select space-saving furniture, storage materials, area rugs, and wall decorations. Your goal will be to create attractive dorm rooms that provide comfort, functionality, and privacy, as well as pleasant spaces in which students can relax and even entertain.

The team decides to develop a plan for the HR needs of your future company. You'll need to address the following issues:

1. Number of employees
2. Job descriptions: duties and responsibilities for each type of employee
3. Job specifications: needed skills, knowledge, and abilities

The Global View (AACSB)

Sending Ed to China

You're the HR manager for a large environmental consulting firm that just started doing business in China. You've asked your top engineer, Ed Deardon, to relocate to Shanghai for a year. Though China will be new to Deardon, working overseas won't be; he's already completed assignments in the Philippines and Thailand; as before, his wife and three children will be going with him.

You've promised Deardon some advice on adapting to living and working conditions in Shanghai, and you intend to focus on the kinds of cultural differences that tend to create problems in international business dealings. Unfortunately, you personally know absolutely nothing about living in China and so must do some online research. Here are some promising sites:

- Executive Planet (http://www.executiveplanet.com/index.php?title=China)
- China Window (http://china-window.com)
- Los Angeles Chinese Learning Center (http://chinese-school.netfirms.com)

Instructions

Prepare a written report to Deardon in which you identify and explain five or six cultural differences between business behavior in the United States and China, and offer some advice on how to deal with them.

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CHAPTER OVERVIEW

5: E-Business

5.1: Chapter 15- Managing Information and Technology

Learning Objectives

1. Distinguish between data and information.
2. Define information system (IS) and identify the tasks of the information systems manager.

By the time the company took the plunge and committed $100 million to marketing-related information technology (IT), Caesars had been collecting and storing data about customers for almost a decade. “While the company thought it important to collect customer information,” recalls a senior marketing executive, “the problem was we had millions of customers to collect information on, but we had no systematic way of turning it into a marketing decision. We didn’t know what to do with it.” In other words, Caesars was collecting a lot of *data* but not necessarily any *information*. So what’s the difference?

As an example, suppose that you want to know how you’re doing in a particular course. So far, you’ve taken two 20-question multiple-choice tests. On the first, you got questions 8, 11, and 14 wrong; on the second, you did worse, missing items 7, 15, 16, and 19. The items that you got wrong are merely **data**—unprocessed facts. What’s important is your total score. You scored 85 on the first exam and 80 on the second. These two numbers constitute **information**—data that have been processed, or turned into some useful form. Knowing the questions that you missed simply supplied you with some data for calculating your scores.

Now let’s fast-forward to the end of the semester. At this point, in addition to taking the two tests, you’ve written two papers and taken a final. You got a 90 and 95 on the papers and a 90 on the final. You now have more processed data, but you still want to organize them into more useful information. What you want to know is your average grade for the semester. To get the information you want, you need yet more data—namely, the weight assigned to each graded item. Fortunately, you’ve known from day one that each test counts 20 percent, each paper 10 percent, and the final exam 40 percent. A little math reveals an average grade of 87.

Though this is the information you’re interested in, it may be mere data to your instructor, who may want different information: an instructor who intends to scale grades, for example, will want to know the average grade for the entire class. You’re hoping that the class average is low enough to push your average of 87 up from a B+ to an A– (or maybe even an A—it doesn’t hurt to hope for the best). The moral of the story is that what constitutes *information* at one stage can easily become *data* at another: or, one person’s information can be another person’s data.

As a rule, you want information; data are good only for generating the information. So, how do you convert data into information that’s useful in helping you make decisions and solve problems? That’s the question we’ll explore in the next section.

Information Systems

To gather and process data into information and distribute it to people who need it, organizations develop an information system (IS)—the combination of technologies, procedures, and people who collect and distribute the information needed to make decisions and coordinate and control company-wide activities. In most large organizations, the IS is operated by a senior management team that includes a chief information officer (CIO) who oversees information and telecommunications systems. There may also be a chief technology officer who reports to the CIO and oversees IT planning and implementation. As for information managers, their tasks include the following:

- Determining the information needs of members of the organization
- Collecting the appropriate data
- Applying technology to convert data into information
- Directing the flow of information to the right people

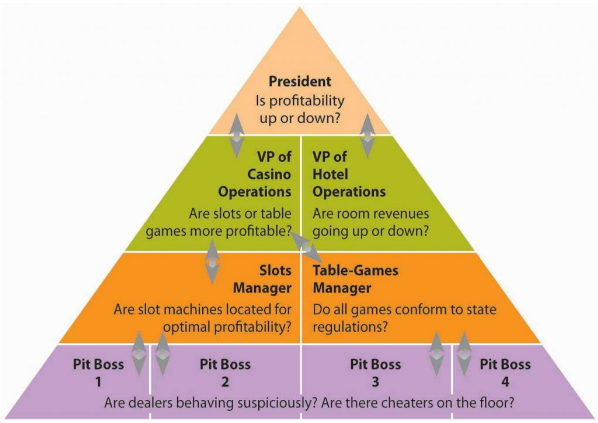
Differences in Information Needs

The job is complicated by the fact that information needs vary according to different levels, operational units, and functional areas. Consider, for instance, the information needs of managers at several levels:

- *Top managers* need information for planning, setting objectives, and making major strategic decisions.
- *Middle managers* need information that helps them allocate resources and oversee the activities under their control.
- *First-line managers* require information that helps them supervise employees, oversee daily operations, and coordinate activities.

Figure 15.1 "Information Needs and Flows" illustrates a hypothetical hierarchy of information needs at Caesars. The president, for example, needs information to determine whether profitability is up or down or if the organization is facing any new competitive threats. At the vice-presidential level, executives need information that will help them in controlling and planning for specific areas of operations. The VP of casino operations, for example, might need to know which operations are most profitable—slots, table games, or other gaming activities. The VP of hotel operations might want to know whether room revenues are going up or down.

Figure 15.1 Information Needs and Flows



The information needs of middle-level and lower-level managers are different still. The slot-machine manager might want to know whether the placement of machines on the casino floor affects profitability. The poker manager might want to know whether all table games comply with state regulations. At a lower level, the pit manager (who's in charge of table games in a particular area) needs to know whether there's a card-counter at his blackjack table or whether a dealer's activities are suspicious.

Even at a given level, information needs can vary. A manager on the hotel side of the business, for instance, doesn't care much about profitability at the poker tables, while a pit manager doesn't have much use for hotel housekeeping reports. The reports that an accountant needs would hardly be the same as those needed by a human resources manager.

The Need to Share Information

Having stressed the differences in information needs, we should pause to remind ourselves that the managerial levels, operations, and functions of every organization are intertwined, to a greater or lesser degree. If you'll glance again at Figure 15.1 "Information Needs and Flows", you'll be reminded that organizations need to share information, that information must flow, and that it must flow in both directions, bottom-up and top-down. At Caesars, for instance, both casino and hotel managers are concerned about security, which is also of interest to managers in different functional areas. Information supplied by the security group is obviously vital to managers in the gaming areas, but HR managers also need it to screen potential employees. Marketing information is clearly important to both casino and hotel operations: to maximize overall profits, the company uses marketing data to fill hotel rooms with customers who spend big in the casinos.[1]

Caesars's information needs entail more than allowing individuals in a given casino to share information; information has to be shared among all of Caesars's thirty-nine casinos. Thus, Caesars relies on an *integrated IT system* that allows real-time communication among all its properties. Installing the system (in the mid-1990s) was complicated, and not everyone in the organization liked the idea. Some managers felt that information sharing threatened their independence. Others, including some in the IT group, doubted that a large number of separate IT systems could be adequately integrated. To get everyone on board, John Bushy, then senior VP of information technology, pledged that he wouldn't cut his hair until the system was up and running. By the time it was operational in 1997, Bushy had hair down to his shoulders, but it was worth it: Caesars's ability to share real-time information across all its properties has been a major factor in the company's success. Caesars's new system cut costs by $20 million a year, increased brand recognition, and increased the number of customers playing at more than one Caesars property by 72 percent.[2][3]

Enterprise Systems

Many large and mid-size companies rely on a highly integrated system called an **enterprise resource planning (ERP) system** to channel information to multiple users. To understand what an ERP system does, forget about the P for *planning* (it really doesn't have much to do with planning) and the R for *resource* (it's an imprecise term).[4] Focus on the E for *enterprise*. An ERP system integrates the computer needs of all activities *across the enterprise* into a single system that serves all users. Such broad integration isn't a simple task, and you wouldn't be the first person to wonder whether it wouldn't be easier to give each department its own computer system. Salespeople, for example, need a system that tracks sales and generates sales reports. Meanwhile, manufacturing personnel don't need to track sales but do need to track inventory. What's the problem with stand-alone computer systems? Quite simply, users in various departments can't share information or communicate with each other.

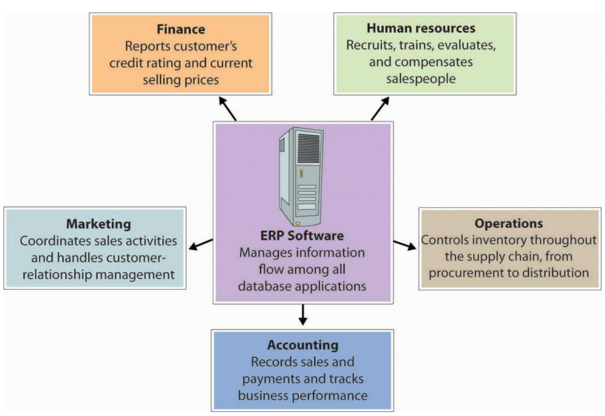
What If You Don't Have ERP?

Imagine that you're a sales manager for a fairly large manufacturing company that produces and sells treadmills. Like every other department in the organization, you have your own computer system. A local sporting-goods store orders one hundred treadmills through a regional sales representative. It's your job to process the order. It wouldn't be much of a problem for you to go into your computer and place the order. But how would you know if the treadmills were actually in stock and when they could be delivered? How would you know if the customer's credit was any good? You could call the warehouse and ask if the treadmills are in stock. If they are, you'd tell the warehouse manager that you're placing an order and hope that the treadmills are still in stock by the time your order gets there two days later. While you're at it, you'd better ask for an expected delivery date. As a final precaution, you should probably call the finance department and ask about your customer's credit rating. So now you've done your job, and it can hardly be your fault that because the cost of manufacturing treadmills has gone up, accounting has recommended an immediate price increase that hasn't shown up in your computer system yet.

What If You Do Have ERP?

Wouldn't it be easier if you had an ERP system like the one illustrated in Figure 15.2 "ERP System"—one that lets you access the same information as every other department? Then you could find out if there were one hundred treadmills in stock, the expected delivery date, your customer's credit rating, and the current selling price—without spending most of the day exchanging phone calls, e-mails, text messages, and faxes. You'd be in a better position to decide whether you can give your customer credit, and you could promise delivery (at a correct price) on a specified date. *Then*, you'd enter the order into the system. The information that you entered would be immediately available to everyone else. The warehouse would know what needs to be shipped, to whom, and when. The accounting department would know that a sale had been made, the dollar amount, and where to send the bill. In short, everyone would have up-to-date information, and no one would have to reinput any data.

Figure 15.2 ERP System



Key Takeaways

- **Data** are unprocessed facts. **Information** is data that have been processed or turned into some useful form.
- To gather and process data into information and distribute it to people who need it, an organization develops an **information system (IS)**—the combination of technologies, procedures, and people who collect and distribute the information needed to make decisions and to coordinate and control company-wide activities.
- In most large organizations, the information system is operated by a senior management team that includes a **chief information officer (CIO)** who oversees information and telecommunications systems.
- There may also be a **chief technology officer** who reports to the CIO and oversees IT planning and implementation.

- The tasks of **information managers** include:
  1. Determining the information needs of people in the organization
  2. Collecting the appropriate data
  3. Applying technology to convert data into information
  4. Directing the flow of information to the right people
- The job is complicated by the fact that information needs vary according to different levels, operational units, and functional areas.
- In addition, information must be shared. To channel information to multiple users, large and mid-size companies often rely on a highly integrated system called an **enterprise resource planning (ERP) system**.
- An ERP system integrates the computer needs of all business activities *across the enterprise* into a single computer system that serves all users.

Exercises

1. Using the college-application process as an example, explain the difference between *data* and *information*. Identify the categories of data that you supplied on your college application and the information generated from them by the admissions department.
2. **(AACSB) Analysis**
3. **(AACSB) Analysis**

Managing Data

Learning Objective

1. Explain how IS managers capture, store, and analyze data.

Did you ever think about how much data you yourself generate? Just remember what you went through to start college. First, you had to fill out application forms asking you about test scores, high school grades, extracurricular activities, and finances, plus demographic data about you and your family. Once you'd picked a college, you had to supply data on your housing preferences, the curriculum you wanted to follow, and the party who'd be responsible for paying your tuition. When you registered for classes, you gave more data to the registrar's office. When you arrived on campus, you gave out still more data to have your ID picture taken, to get your computer and phone hooked up, to open a bookstore account, and to buy an on-campus food-charge card. Once you started classes, data generation continued on a daily basis: your food card and bookstore account, for example, tracked your various purchases, and your ID tracked your coming and going all over campus. And you generated grades.

And all these data apply to just one aspect of your life. You also generated data every time you used your credit card and your cell phone. Who uses all these data? How are they collected, stored, analyzed, and distributed in organizations that have various reasons for keeping track of you?

Data and Databases

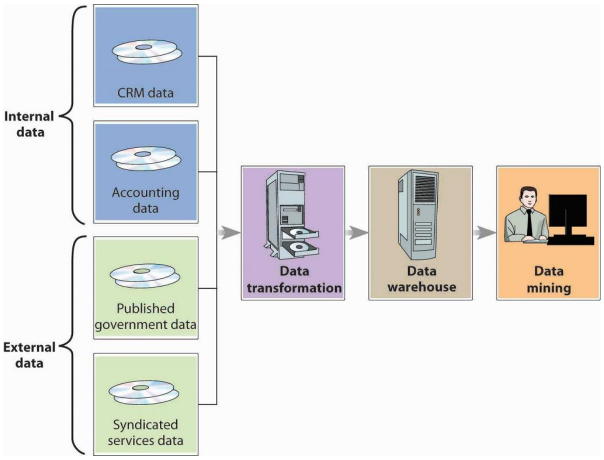
To answer such questions, let's go back to our Caesars example. As we've seen, Caesars collects a vast amount of data. Its hotel system generates data when customers make reservations, check in, buy food and beverages, purchase stuff at shops, attend entertainment events, and even relax at the spa. In the casino, customers apply for rewards programs, convert cash to chips (and occasionally chips back to cash), try their luck at the tables and slots, and get complimentary drinks. Then, there are the data generated by the activities of the company itself: employees, for instance, generate payroll and benefits data, and retail operations generate data every time they buy or sell something. Moreover, if we added up all these data, we'd have only a fraction of the amount generated by the company's gaming operations.

How does Caesars handle all these data? First of all, it captures and stores them in several **databases**— electronic collections of related data that can be accessed by various members of the organization. Think of databases as filing cabinets that can hold massive amounts of organized information, such as revenues and costs from hotel activities, casino activities, and events reservations at each of Caesars facilities.

Warehousing and Mining Data

What if Caesars wants to target customers who generate a lot of revenue, by using a program designed to entice return visits? How would it identify and contact these people? Theoretically, it could search through the relevant databases—those that hold customer-contact information (such as name and address) and information about customer activity in the company's hotels, casinos, and entertainment venues. It would be a start, perhaps, but it wouldn't be very efficient. First of all, it would be time-consuming. Plus, what if the same data weren't stored in a similar fashion in each database? In that case, it would be quite hard to combine the data in a meaningful way. To address this problem, Caesars managers will rely on a system like the one illustrated in Figure 15.3 "The Data Mining Process", which calls for moving all the relevant data into a **data warehouse**—a centralized database in which data from several databases are consolidated and organized so that they can be easily analyzed.

Figure 15.3 The Data Mining Process



Data transformation -> Data warehouse -> Data mining">

Data Mining

With the data in one central location, management can find out everything it needs to about a particular group of customers. It can also use the data to address some pretty interesting questions. Why do people come to our casinos? How can we keep customers coming back? How can we increase the number of visits per customer? How can we increase the amount they spend on each visit? What incentives (such as free dinners, hotel rooms, or show tickets) do our customers like most? To come up with answers to these questions, they'll perform a technique called **data mining**—the process of searching and analyzing large amounts of data to reveal patterns and trends that can be used to predict future behavior.

Data Mining and Customer Behavior

By data-mining its customer-based data warehouse, Caesars's management can discover previously unknown relationships between the general behavior of its customers and that of a certain group of customers (namely, the most profitable ones). Then, it can design incentives to appeal specifically to those people who will generate the most profit for the company.

To get a better idea of how data mining works, let's simplify a description of the process at Caesars. First, we need to know how the casino gathered the data to conduct its preliminary analysis. Most customers who play the slots use a Caesars player's card that offers incentives based on the amount of money that they wager on slot machines, video poker, and table games.[5] To get the card, a customer must supply some personal information, such as name, address, and phone number. From Caesars's standpoint, the card is extremely valuable because it can reveal a lot about the user's betting behavior: actual wins and losses, length of time played, preferred machines and coin denominations, average amount per bet, and—most important—the speed with which coins are deposited and buttons pushed.[6] As you can see from Figure 15.3 "The Data Mining Process", Caesars's primary data source was *internal*—generated by the company itself rather than provided by an outside source—and drew on a marketing database developed for *customer relationship management* (CRM).

Figure 15.4 Caesars Resort

Caesars collects data on its customers by using players' cards to gather information and to track betting behavior. [7]

What does the casino do with the data that it's mined? Caesars was most interested in "first trippers"—first-time casino customers. In particular, it wanted to know which of these customers should be enticed to return. By analyzing the data collected from player's-card applications and from customer's actual play at the casino (even if for no more than an hour), Caesars could develop a profile of a profitable customer. Now, when a first-timer comes into any of its casinos and plays for a while, Caesars can instantly tell whether he or she fits the profitable-customer profile. To lure these people back for return visits, it makes generous offers of free or reduced-rate rooms, meals, entertainment, or free chips (the incentive of choice for Caesars's preferred customers). These customers make up 26 percent of all Caesars's customers and generate 82 percent of its revenues. Surprisingly, they're not the wealthy high rollers to whom Caesars had been catering for years. Most of them are regular working people or retirees with available time and income and a fondness for slots. They generally stop at the casino on the way home from work or on a weekend night and don't stay overnight. They enjoy the thrill of gambling, and you can recognize them because they're the ones who can't push the button or pump tokens in fast enough.[8]

Key Takeaways

- Organizations capture and store data in **databases**—electronic collections of related data that can be accessed by various people in the organization.
- To facilitate data analysis, IS managers may move data from various databases into a **data warehouse**—a centralized database in which data are consolidated and organized for efficient analysis.
- To come up with answers to a huge range of questions, managers perform a technique called **data mining**—the process of searching and analyzing large amounts of data to reveal patterns and trends that can be used to predict future behavior.

Exercise

(AACSB) Analysis

Caesars uses data mining to identify its most profitable customers and predict their future behavior. It then designs incentives to appeal specifically to these customers. Do you see any ethical problems with this process? Is it ethical to encourage people to gamble? Explain your answer.

Types of Information Systems

Learning Objective

1. Discuss ways in which an IS can be designed to meet the needs of individuals at various organizational levels.

As we saw earlier, different managers, operational units, and functional areas have different information needs. That's why organizations often tailor information systems to meet particular needs. Caesars's IT group, for example, developed the Player Contact System [9][10] to help its casino salespeople connect to top customers on a more personal basis. Working from a prioritized list of customer names displayed on a computer screen, the salesperson clicks on a name to view relevant information about the customer, such as background and preferred casino activities. There's even a printed script that can be used to guide the conversation. Such a system isn't very helpful, however, to middle or top-level managers, who need systems to help them carry out their oversight and planning responsibilities. To design marketing programs, for instance, marketing managers rely on summary information gleaned from a dedicated customer-relationship management system. Let's look at some of the widely available information systems designed to support people at the operational and upper-management levels.

Operations Support Systems

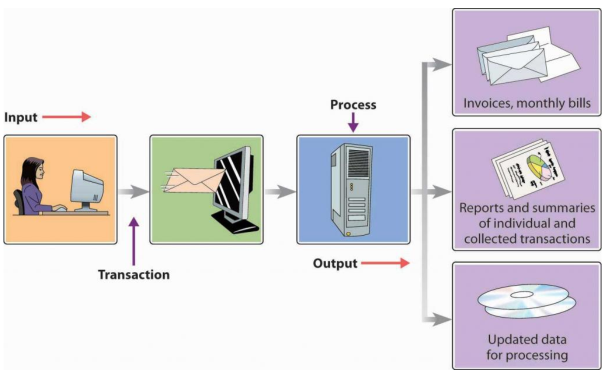
Operations support systems are generally used by managers at lower levels of the organization—those who run day-to-day business operations and make fairly routine decisions. They may be *transaction processing systems*, *process control systems*, or *design and production systems*.

Transaction Processing Systems

Most of an organization's daily activities are recorded and processed by its transaction processing system, which receives input data and converts them into output—information—intended for various users. Input data are called transactions—events that affect a business. A *financial transaction* is an economic event: it affects the firm's assets, is reflected in its accounting statements, and is measured in monetary terms. Sales of goods to customers, purchases of inventory from suppliers, and salaries paid to employees are all financial transactions. Everything else is a *nonfinancial transaction*. The marketing department, for example, might add some demographic data to its customer database. The information would be processed by the firm's transaction processing system, but it wouldn't be a financial transaction.

Figure 15.5 "Transaction Processing System" illustrates a transaction processing system in which the transaction is a customer's electronic payment of a bill. As you can see, transaction processing system output can consist not only of documents sent to outside parties (in this case, notification of payment received), but also of information circulated internally (in the form of reports), as well as of information entered into the database for updating.

Figure 15.5 Transaction Processing System



Process Control Systems

Process control refers to the application of technology to monitor and control physical processes. It's useful, for example, in testing the temperature of food as it's being prepared or gauging the moisture content of paper as it's being manufactured. Typically, it depends on sensors to collect data periodically. The data are then analyzed by a computer programmed either to make adjustments or to signal an operator.

Caesars uses process-control technology to keep customers happy. At any given point, some slot machines are down, whether because a machine broke or ran out of money or somebody hit the jackpot. All these contingencies require immediate attention by a service attendant. In the past, service personnel strolled around looking for machines in need of fixing. Now, however, a downed slot machine sends out an "I need attention" signal, which is instantly picked up by a monitoring and paging system called MessengerPlus and sent to a service attendant.

Design and Production Systems

Modern companies rely heavily on technology to design and make products. Computer-aided design (CAD) software, for instance, enables designers to test computer models digitally before moving new products into the prototype stage. Many companies link CAD systems to the manufacturing process through computer-aided manufacturing (CAM) systems that not only determine the steps needed to produce components but also instruct machines to do the necessary work. A CAD/CAM system can be expanded by means of computer-integrated manufacturing (CIM), which integrates various operations (from design through manufacturing) with functional activities ranging from order taking to final shipment. The CIM system may also control **industrial robots**—computer-run machines that can perform repetitive or dangerous tasks. A CIM system is a common element in a flexible manufacturing system, which makes it possible to change equipment setups by reprogramming computer-controlled machines that can be adapted to produce a variety of goods. Such flexibility is particularly valuable to makers of customized products.

Management Support Systems

Mid- and upper-level managers rely on a variety of information systems to support decision-making activities, including *management information systems, decision support systems, executive support systems*, and *expert systems*.

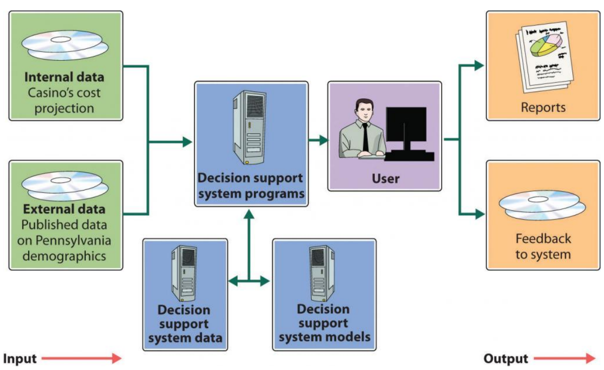
Management Information Systems

A management information system extracts data from a database to compile reports, such as sales analyses, inventory-level reports, and financial statements, to help managers make routine decisions. The type and form of the report depend on the information needs of a particular manager. At Caesars, for example, several reports are available each day to a games manager (who's responsible for table-game operations and personnel): a customer-analysis report, a profitability report, and a labor-analysis report.[11]

Decision Support Systems

A decision support system is an interactive system that collects, displays, and integrates data from multiple sources to help managers make nonroutine decisions. For example, suppose that a gaming company is considering a new casino in Pennsylvania (which has recently legalized slot machines). To decide whether it would be a wise business move, management could use a decision support system like the one illustrated in Figure 15.6 "Decision Support System". The first step is to extract data from internal sources to decide whether the company has the financial strength to expand its operations. From external sources (such as industry data and Pennsylvania demographics), managers might find the data needed to determine whether there's sufficient demand for a casino in the state. The decision support system will apply both types of data as variables in a quantitative *model* that managers can analyze and interpret. People must make the final decision, but in making sense of the relevant data, the decision support system makes the decision-making process easier—and more reliable.[12]

Figure 15.6 Decision Support System



Executive Information Systems

Senior managers spend a good deal of their time planning and making major decisions. They set performance targets, determine whether they're being met, and routinely scan the external environment for opportunities and threats. To accomplish these tasks, they need relevant, timely, easily understood information. Often, they can get it through an executive information system, which provides ready access to strategic information that's customized to their needs and presented in a convenient format. Using an executive information system, for example, a gaming-company executive might simply touch a screen to view key summary information that highlights in graphical form a critical area of corporate performance, such as revenue trends. After scanning this summary, our executive can "drill down" to retrieve more detailed information—for example, revenue trends by resort or revenue trends from various types of activities, such as gaming, hotel, retail, restaurant, or entertainment operations.

Artificial Intelligence

Artificial intelligence is the science of developing computer systems that can mimic human behavior. Ever since the term was coined in 1956, artificial intelligence has always seemed on the verge of being "the next big thing." Unfortunately, optimistic predictions eventually collided with underwhelming results, and many experts began to doubt that it would ever have profitable applications.[13] In the last decade, however, some significant advances have been made in artificial intelligence—albeit in the area of game playing, where activities are generally governed by small sets of well-defined rules. But even the game-playing environment is sometimes complex enough to promote interesting developments. In 1997, for example, IBM's Deep Blue—a specialized computer with an advanced chess-playing program—defeated the world's highest-ranked player.[14]

More recently, several artificial intelligence applications have been successfully put to commercial use. Let's take a brief look at two of these: *expert systems* and *face-recognition technology*.

Expert Systems

Expert systems are programs that mimic the judgment of experts by following sets of rules that experts would follow. They're useful in such diverse areas as medical diagnosis, portfolio management, and credit assessment. For example, you've called the customer-service department of your credit-card company because you want to increase your credit line. Don't expect to talk to some financial expert who's authorized to say yes or no. You'll be talking to a service representative with no financial expertise whatsoever. He or she will, however, have access to an expert system, which will give you an answer in a few seconds. How does it work? The expert system will prompt the representative to ask you certain questions about your salary and living expenses. It will also check internal corporate data to analyze your purchases and payment behavior, and, based on the results, it will determine whether you get an increase and, if so, how much.

At Caesars, an expert system called the Revenue Management System helps to optimize the overall profitability of both hotel and casino operations. When a customer requests a room, the program accesses his or her profile in the database and consults certain "rules" for assessing the application.[15] One rule, for example, might be, "If the customer has wagered more than $100,000 in the past year, add 10 points." Eventually, the system decides whether your application will be accepted (and at what rate) by adding up points determined by the rules. While a tightwad may not get a room even when there are vacancies, a high roller may get a good rate on a luxury suite even if the hotel is nearly full.

Face-Recognition Technology

Caesars uses another particularly interesting, and sophisticated, application of artificial intelligence. In the hotel-casino business, it's crucial to identify and turn away undesirable visitors. One tool for this task is a digital camera-surveillance system that uses *face-recognition technology*. Using this technology, a program classifies a person's face according to the presence/absence or extent of certain unique features, such as dimpled chins, receding jaws, overbites, and long or short noses. If there's a match on, for example, fifteen features between a person being scanned and someone in the company database, a staff member decides whether the two people are the same. If a security manager then concludes that the face belongs to a skilled card-counter, the customer will be discouraged from playing blackjack; if it belongs to a known cheater, the individual will be escorted out of the casino. The system, however, does more than spot undesirables. It can also identify high rollers and send information about customers to managers on the floor. That's why a Caesars manager can greet a preferred customer at the door with his favorite drink and a personalized greeting, such as "Hi, Bill! How's Karen? Did you ever get that vintage Corvette? Here, have a gin rickey on the house".[16][17]

Key Takeaways

- Information needs vary according to managerial level (top, middle, or first-line).
- An IS, or information system, can be divided into two categories:
  1. Those that meet the needs of low-level managers
  2. Those that meet the needs of middle- and upper-level managers
- Low-level managers—those who run day-to-day operations and make routine decisions—use **operations support systems**, which usually fall into three categories: transaction processing systems, process control systems, and computer-aided design software.
  1. Most daily activities are recorded and processed by a **transaction processing system**, which receives input data and converts them into output—information—intended for various users.
  2. **Process control** refers to the application of technology to monitor and control physical processes, such as food preparation. The system depends on sensors to collect data for analysis by a computer programmed either to make adjustments or to signal an operator.
  3. Technology can be used to design and make products. **Computer-aided design (CAD)** software, for instance, enables designers to test computer models digitally before moving new products into the prototype stage.

- Mid- and upper-level managers may use one of four types of **management support system** to assist in decision-making activities: management information systems, decision support systems, executive information systems, and expert systems.
  1. A **management information system** extracts data from a database to compile reports, such as sales analyses, needed for making routine decisions.
  2. A **decision support system** is an interactive system that collects and integrates data from multiple sources to assist in making nonroutine decisions.
  3. To develop plans and make major decisions, managers may gather relevant, timely, easily understood information through an **executive information system**; an EIS provides ready access to strategic information that's customized to their needs and presented in a convenient format.
  4. An **expert system** mimics expert judgment by following sets of rules that experts would follow; it relies on **artificial intelligence**—the science of developing computer systems that can mimic human behavior.

Exercise

(AACSB) Analysis

For each of the following situations, select the appropriate management support system to aid the user: decision support system, executive support system, or expert system. In each case, describe the management support system that you recommend.

- You're trying to identify a rash on your arm.
- You own two golf courses in the Northeast, and you're thinking about building one in Florida. You need to gather and analyze information about your current operations in the Northeast, as well as external information about the golf industry in Florida.
- You own three McDonald's franchises. Every morning, you want to know the revenues and costs at each store. You're also interested in a breakdown of revenues by product and costs by category of expense (salaries, food and ingredients, maintenance, and so on).

Computer Networks and Cloud Computing

Learning Objectives

1. Describe the main systems for sharing information through networked computers.
2. Define cloud computing and identify its advantages and disadvantages.

Once it's grown beyond just a handful of employees, an organization needs a way of sharing information. Imagine a flower shop with twenty employees. The person who takes phone orders needs access to the store's customer list, as do the delivery person and the bookkeeper. Now, the store may have one computer and everyone could share it. It's more likely, however, that there are a number of computers (several for salespeople, one for delivery, and one for bookkeeping). In this case, everyone needs to be sure that customer records have been updated on all computers every time that a change is required.

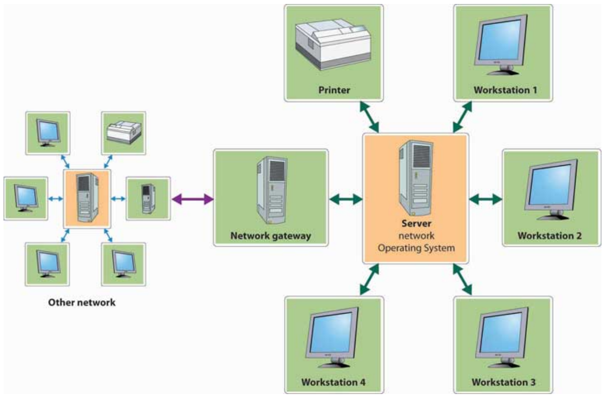
Networks

Likewise, many companies want their personal computers to run their own software and process data independently. But they also want people to share databases, files, and printers, and they want them to share applications software that performs particular tasks, including word processing, creating and managing spreadsheets, designing graphical presentations, and producing high-quality printed documents (*desktop publishing*).

The solution in both cases is ***networking***—linking computers to one another. The two major types of networks are distinguished according to geographical coverage:

- A local area network (LAN) links computers that are in close proximity—in the same building or office complex. They can be connected by cables or by wireless technology. Your university might have a LAN system that gives you access to resources, such as registration information, software packages, and printers. Figure 15.7 "Local Area Network (LAN)" illustrates a LAN that's connected to another network by means of a *gateway*—a processor that allows dissimilar networks to communicate with one another.

Figure 15.7 Local Area Network (LAN)



- Because a wide area network (WAN) covers a relatively large geographical area, its computers are connected by telephone lines, wireless technology, or even satellite.

Like the one in Figure 15.7 "Local Area Network (LAN)", some networks are client-server systems, which include a number of client machines (the ones used by employees for data input and retrieval) and a server (which stores the database and the programs used to process the data). Such a setup saves time and money and circulates more-accurate information.

Cloud Computing

A cloud is a "visible mass of condensed water vapor floating in the atmosphere, typically high above the ground".[18] The term "cloud computing" means performing computer tasks using services provided over the Internet.[19] So how do you connect the two definitions? When IT professionals diagrammed computer systems, they used a cloud symbol to represent the Internet. So when you hear or read that an individual or company is using the "cloud" or technology firms, such as IBM, Hewlett-Packard, and Salesforce.com, are offering cloud services, just substitute the word "Internet" for "cloud" and things will make sense.

You might be surprised to learn that you're already using the cloud—that is if you use Facebook (which is very likely—in fact, just mentioning Facebook here might prompt you to stop studying and check out your friends' pages). How do you know that Facebook is a cloud application? Remember the trick: just substitute the word "Internet" for "cloud." The Facebook computer application lets you store information about yourself and share it with others using the Internet.

Business Applications

Think about the functional areas of business you've explored in this text: accounting, finance, human resources, management, marketing, operations, and product design. Now imagine you're Katrina Lane, senior vice president and chief technology officer for Caesars Entertainment, who is responsible for the information technology needed to handle multiple tasks in all these functional areas. You're sitting at your desk when Gary Loveman, chief executive officer of Caesars, walks in and gives you the news. Caesars just purchased the Planet Hollywood Casino and Resort in Las Vegas and will open up two new casinos in Ohio in 2012. This is good news for the company, but it means a lot of work for you and your staff.

You wonder whether this might be the time to outsource some of your computing tasks to a technology firm specializing in cloud computing. You remember an example that really makes sense:[20] Right now, whenever Microsoft comes out with a new version of Word, Caesars has to pay $350 per PC for the latest version. Wouldn't it make more sense to rent the use of the Microsoft Word program from a cloud vendor for say $5 a month (or $60 a year)? Given that the average time between new releases of Word is two years, your total cost per PC would be $120 (2 × $60)—a savings of about $230 per PC ($350 − $120). Your employees wouldn't mind; instead of working offline, they would just login to the Internet and work with their online version using the files that were saved for them. And the members of your IT staff would be pleased that they wouldn't need to install the new version of Word on all your PCs.

The As-A-Service Group

Companies can contract for various cloud computing services. The Microsoft Word example discussed previously is classified as software as a service (SaaS). This type of service gives companies access to a large assortment of software packages without having to invest in hardware or install and maintain software on its own computers. The available software, which includes e-mail and collaboration systems and customer relationship management programs, can be customized and used by an individual client or shared among several clients. A second type of service is called infrastructure as a service (IaaS). Instead of providing users with software, a technology firm offering infrastructure as a service provides hardware, including servers, central processing units, network equipment, and disk space.[21] The most successful IaaS provider is Amazon Web Services.[22] The company rents computer power and storage to users who access their data via the Internet. The last as-a-service model is called platform as a service (PaaS). Those offering platform as a service provide services that enable users to develop customized web applications. Because they don't have to start from scratch but rather build on existing platforms made available by the service provider, the web applications can be developed quickly.

Video Clip 15.1 Cloud Computing

"Traditional business applications and platforms are too complicated and expensive. They need a data center, a complex software stack, and a team of experts to run them."

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=173

Advantages and Disadvantages of Cloud Computing

In making your final decision (as the pretend chief technology officer for Caesars) you should consider these advantages and disadvantages of cloud computing:

Advantages

Shifting some of Caesars's IT functions to the cloud would produce a number of advantages:

1. *Cost Savings*—By "renting" software rather than buying it, Caesars can reduce its costs. The monthly fee to "use" the software is generally less than the combined cost of buying, installing, and maintaining the software internally. On the hardware site, housing Caesars's data in a service provider's facilities, rather than in-house, reduces the large outlay of cash needed to build and maintain data centers.
2. *Speed of Delivery*—Purchasing and installing software and data processing equipment can be time consuming. A cloud computing service provider could get Caesars's applications up and running in only a few weeks.
3. *Scalable*—Caesars is constantly expanding both in the number of casinos it owns and geographically. In this ever-changing environment, it's difficult to gauge the level of our technology needs. If we overestimate our requirements, we end up paying for technology we don't need. If we underestimate, efficiency goes down, and the experience for our customers diminishes. By using cloud computing we are able to have exactly what we need at our disposal at any point in time.
4. *Employees Can Be Mobile*—The use of cloud computing will free workers from their desks and allow them to work wherever they are. As applications move to the cloud, all that is needed for our employees to connect to their "offices" is the Internet. This mobility benefit also makes it easier for employees to collaborate on projects and connect with others in the company.
5. *Information Technology Staff*—Although our current staff is extremely qualified and dedicated, finding experienced and knowledgeable staff is a continuing problem particularly in the casino industry which suffers from historically high turnover. By using cloud computing, we reduce our human resource needs by shifting some of our work to outside vendors who are able to hire and keep well qualified individuals (in part because IT professionals enjoy working for technology companies).

Disadvantages

Although the advantages of moving to a cloud environment outnumber the disadvantages, the following disadvantages are cause for concern:

1. *Disruption in Internet Service*—If Caesars moves some of its applications to the cloud, its employees can work on these applications on any device and in any location as long as they have an Internet connection. But what if the Internet is unavailable because of a disruption? Depending on the length of the disruption, this could create serious problems for Caesars.
2. *Security*—Many companies are reluctant to trust cloud service providers with their data because they're afraid it might become available to unauthorized individuals or criminals. This is a particular problem for Caesars, which collects and stores sensitive client information and has to constantly be on the lookout for fraudulent activity of staff and customers.[23]
3. *Service Provider System Crash*—Organizations considering moving to the cloud are justifiably concerned about the possibility of a computer service crash at their service providers' facilities. It looks like this concern was warranted. In April of 2011, Amazon Web Service (a leading cloud services provider) experienced an outage in one of its large web-connected data centers. The outage crashed its system and brought down the Web sites of a number of companies, including the location-based social network, Foursquare.[24] It took more than thirty-six hours to get all seventy or so of the crashed sites up and running.

Go or No Go?

So, pretend chief technology officer for Caesars, what's your decision: will you get on the cloud or stay on the ground? If you are curious about what the real chief technology officer did, she took the high road and transferred a number of applications to Salesforce.com's Web-based Force.com's cloud applications service.[25]

Key Takeaways

- Once an organization has grown to more than a few employees, it needs to network individual computers to allow them to share information and technologies.
- A **client-server system** links a number of client machines (for data input and retrieval) with a server (for storing the database and the programs that process data).
- Many companies want personal computers to run their own software and process data independently.
- But they also want individuals to share databases, files, printers, and **applications software** that perform particular types of work (word processing, creating and managing spreadsheets, and so forth).
- There are two systems that can satisfy both needs.
  1. A **local area network (LAN)** links computers in close proximity, connecting them by cables or by wireless technology.
  2. A **wide area network (WAN)** covers a relatively large geographical area and connects computers by telephone lines, wireless technology, or satellite.
- The term "**cloud computing**" means performing computer tasks using services provided over the Internet.
- The **software as a service (SaaS)** category of cloud computing gives companies access to a large assortment of software packages without having to invest in hardware or install and maintain software on its own computers.
- A technology firm offering **infrastructure as a service** provides users with hardware, including servers, central processing units, network equipment, and disk space.
- Those offering the **platform as a service** category of cloud computing provide services that enable users to develop customized web applications.
- Shifting IT functions to the cloud produces a number of advantages, including cost savings, speedy delivery of software, scalability (you pay for only what you need), employee mobility, and a reduction in information technology staff.
- The following disadvantages of cloud computing are cause for concern: disruption in internet service, security issues, and unreliability of service provider systems.

Exercises

1. What's the difference between a LAN and a WAN? Give an example of the use to which each type of system can be put. Does your college maintain either type of computer network?
2. In what ways could your college benefit from cloud computing? In responding, consider the three types of services offered by cloud service providers: software as a service, infrastructure as a service, and platform as a service. What type of security issues might your college administrators be concerned with?

Data Communications Networks

Learning Objective

1. Explain how four networking technologies—the Internet, the World Wide Web, intranets, and extranets—make data communication possible.

In addition to using networks for information sharing within the organization, companies use networks to communicate and share information with those outside the organization. All this is made possible by data communication networks, which transmit digital data (numeric data, text, graphics, photos, video, and voice) from one computer to another using a variety of wired and wireless communication channels. Let's take a closer look at the networking technologies that make possible all this electronic communication—in particular, the *Internet* (including the *World Wide Web*), *intranets*, and *extranets*.

The Internet and the World Wide Web

Though we often use the terms *Internet* and *World Wide Web* interchangeably, they're not the same thing.[26] The Internet is an immense global network comprising smaller interconnected networks linking millions of computers around the world. Originally developed for the U.S. military and later adapted for use in academic and government research, the Internet experienced rapid growth in the 1990s, when companies called Internet service providers were allowed to link into the Internet infrastructure in order to connect paying subscribers. Today, Internet service providers, such as CompuServe, America Online (AOL), MSN, and Comcast, enable us to use the Internet to communicate with others through e-mail, texting, instant messaging, online conferencing, and so on. These services also connect us with third-party providers of information, including news stories, stock quotes, and magazine articles.

The World Wide Web (or simply "the Web") is just a portion of the Internet—albeit a large portion. The Web is a subsystem of computers that can be accessed on the Internet using a special protocol, or language, known as *hypertext transfer protocol* (HTTP). What's the difference between the Internet and the Web? According to Tim Berners-Lee (one of the small team of scientists who developed the concept for the Web in 1989), the Internet is a network of networks composed of cables and computers. You can use it to send "packets" of information from one computer to another, much like sending a postcard. If the address on the packet is accurate, it will arrive at the correct destination in much less than a second. Thus, the Internet is a packet-delivery *service* that delivers such items as e-mail messages all over the globe. The Web, by contrast, is composed of *information*—documents, pictures, sounds, streaming videos, and so on. It's connected not through cables, but rather through *hypertext links* that allow users to navigate between resources on the Internet.[27]

Because it's driven by programs that communicate between computers connected to the Internet, the Web couldn't exist without the Internet. The Internet, on the other hand, could exist without the Web, but it wouldn't be nearly as useful. The Internet itself is enormous, but it's difficult to navigate, and it has no pictures, sounds, or streamed videos. They exist on computers connected to the Web, which also makes it much easier to retrieve information. The creation of Web browsers—software, such as Microsoft's Internet Explorer and Netscape Navigator, that locates and displays Web pages—opened up the Internet to a vast range of users. Almost 80 percent of individuals in the United States use the Internet regularly.[28][29] So, who's in charge of the Web? No one owns it, but an organization called the World Wide Web Consortium (W3C) oversees the development and maintenance of standards governing the way information is stored, displayed, and retrieved on it.[30]

The Technology of the Web

Figure 15.8 Google

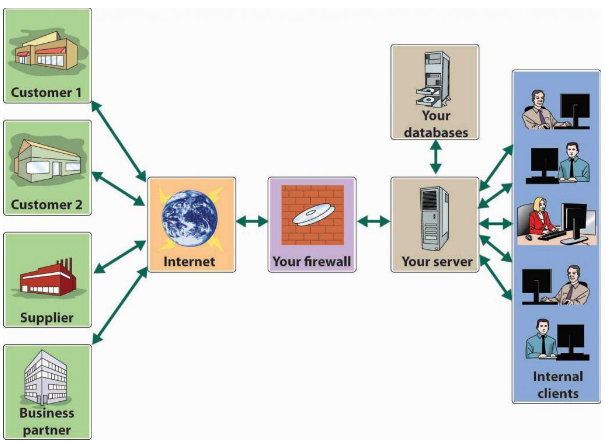
Let's look a little more closely at some of the technologies that enable us to transmit and receive data over the Web. Documents on the Web are called *Web pages*, and they're stored on *Web sites*. Each site is maintained by a *Webmaster* and opens with a *home page*. Each Web page is accessed through a unique address called a *uniform resource locator (URL)*. For example, if you want to find statistics on basketball star LeBron James, you could type in the URL address http://www.nba.com/home/playerfile/lebron_james. The prefix *http://* is the protocol name, *http://www.nba.com* the domain name, *playerfile* the subdirectory name, and *lebron_james* the document name (or Web page). A computer that retrieves Web pages is called a Web server. A search engine is a software program that scans Web pages containing specified keywords and provides a list of documents containing them. The most popular search engine is Google; others include Bing, Yahoo!, Ask, and AOL.

Intranets and Extranets

What's the difference among the Internet, an intranet, and an extranet? It depends on who can and can't access the information on the network. The Internet is a public network that anyone can use. A company's intranet, on the other hand, is a private network using Internet technologies that's available only to employees; access is controlled by a software program called a firewall. The information available on an intranet varies by company but may include internal job postings, written company policies, and proprietary information, such as price lists meant for internal use only.

An extranet is an intranet that's partially available to certain parties outside the organization. Say, for example, you've posted the following information on your intranet: company policies, payroll and benefit information, training programs, parts specifications and inventories, and production schedules. To allow suppliers to bid on contracts, you might give them access to sections of the site disclosing parts specifications, inventories, and production schedules. All other sections would be off limits. You'd control access to employee-only and supplier-accessible sections by means of usernames and passwords. As you can see from Figure 15.9 "How an Extranet Works", which illustrates some of the connections made possible by an extranet, access can be made available to customers and business partners, as well.

Figure 15.9 How an Extranet Works



E-Commerce

The level of e-commerce—conducting business over the Internet—varies by company. Some companies, such as Amazon.com, rely on the Internet for their existence. Others, especially smaller firms, have yet to incorporate the Internet into their business models, but these companies belong to a dwindling group: about half of small companies and 90 percent of large companies have Web sites, and a third of the companies that maintain Web sites sell products through them.[31][32] Larger companies now find that they must do business over the Internet, including selling and buying goods.

Why Business Uses the Internet

Businesses use the Internet for four purposes: *presenting information*, *selling products*, *distributing digital products*, and *acquiring goods and services*.

Presenting Information

By posting a Web site, a company can tell people about itself, its products, and its activities. Customers can also check the status of orders or account balances. Information should always be current, complete, and accurate. Customers should be able to find and navigate the site, which should be able to accommodate them during high-use periods.

Selling Products

Selling over the Internet—whether to individuals or to other businesses—enables a business to enlarge its customer base by reaching buyers outside its geographical area. A company selling over the Internet must attract customers to its site, make the buying process simple, assure customers that the site is secure, and provide helpful information.

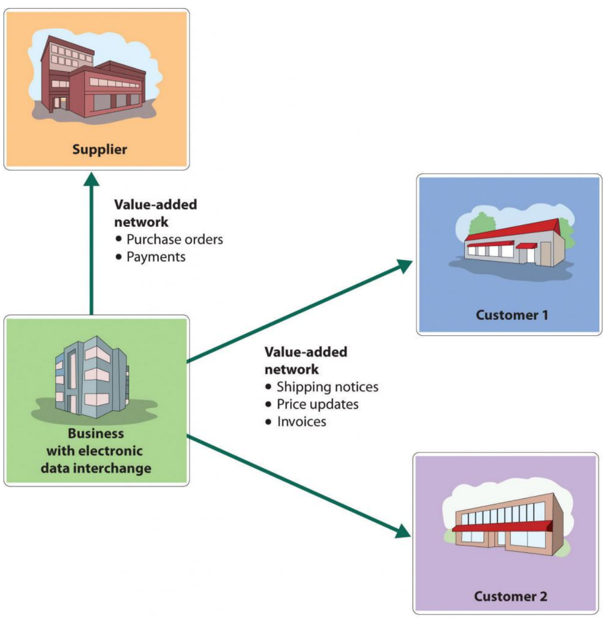
Distributing Digital Products

Some companies use the Internet to sell and deliver such digital products as subscriptions to online news services, software products and upgrades, and music and video products. In these businesses, the timely delivery of products is crucial. Sales of digital products over the Internet are expected to increase substantially in the future, particularly sales of digital music.[33][34]

Acquiring Goods and Services

E-purchasing (which was introduced in Chapter 11 "Operations Management in Manufacturing and Service Industries") saves time, speeds up delivery, reduces administrative costs, and fosters better communications between a firm and its suppliers. Most importantly, it cuts the costs of purchased products because it's now feasible for buyers to request competitive bids and do comparative shopping. Many companies now use a technology called electronic data interchange to process transactions and transmit purchasing documents directly from one IS to another. Figure 15.10 "Electronic Data Interchange System and Value-Added Networks" shows an electronic data interchange system at a company that subscribes to a *value-added network*—a private system supplied by a third-party firm—over which it conducts a variety of transactions.

Figure 15.10 Electronic Data Interchange System and Value-Added Networks



The Virtual Company

Imagine a company that retails products for schoolteachers over the Internet—for example, books, software, and teaching supplies purchased from various manufacturers and distributors. It would need facilities to store inventories and personnel to handle inventories and fill customer orders. But what if this company decided to get out of the traditional retail business? What if it decided instead to team up with three trading partners—a book publisher, a software developer, and a manufacturer of office supplies? Our original company could re-create itself as a Web site for marketing the books, software, and supplies provided by its partners, without taking physical possession of them. It would become a virtual company. Its partners would warehouse their own products and furnish product descriptions, prices, and delivery times. Meanwhile, the virtual company, besides promoting all three lines of products, would verify customer orders and forward them to its partners, who would ship their own products directly to customers. All four partners would be better off, because they'd be competing in a business in which none of them could compete by itself. This business approach has allowed Spun.com, a CD, DVD, and game Internet retailer, to avoid carrying the $8 million inventory that it would have needed to support its sales. Rather than hold its own inventory, Spun.com merely passes the orders on to Alliance Entertainment (a home entertainment products wholesale distributor), which ships them directly to customers.[35]

Key Takeaways

- **Data communication networks** transmit digital data from one computer to another computer using a variety of wired and wireless communication channels.
- One such network, the **Internet**, is an immense global network of smaller interconnected networks linking millions of computers.
- By connecting paying subscribers into the Internet infrastructure, a company called an **Internet service provider** provides services, such as e-mail, online conferencing, and instant messaging.
- A large portion of the Internet, the **World Wide Web** ("the Web"), is a subsystem of computers that can be accessed by means of a special protocol known as *hypertext transfer protocol (HTTP)*.
- Computers on the Web are connected with **hypertext links** that permit users to navigate among Internet resources.
- A Web **browser** is software that locates and displays Web pages.
- Though the Web couldn't exist without the Internet, it's the Web that provides such multimedia material as pictures, sounds, and streaming videos.
- Businesses use the Internet for four purposes: presenting information, selling products, acquiring goods and services, and distributing digital products.
- While the Internet is a public network that anyone can use, a company's **intranet** is a private network that's available only to its employees; access is controlled by a software program called a *firewall*.
- An **extranet** is an intranet that's partially available to certain outside parties, such as suppliers.

Exercises

1. If asked by your instructor, how would you explain the difference between the Internet and the World Wide Web?
2. **(AACSB) Analysis**

Security Issues in Electronic Communication

Learning Objective

1. Identify and discuss challenges faced by companies engaged in e-commerce.

E-commerce has presented businesses with opportunities undreamt of only a couple of decades ago. But it also has introduced some unprecedented challenges. For one thing, companies must now earmark more than 5 percent of their annual IT budgets for protecting themselves against disrupted operations and theft due to computer crime and sabotage.[36] The costs resulting from cyber crimes—criminal activity done using computers or the Internet—are substantial and increasing at an alarming rate. A 2010 study of forty-five large U.S. companies revealed that the median cost of cybercrime for the companies in the study was $3.8 million a year.[37] And some cybercrimes involve viruses that can spread rapidly from computer to computer creating enormous damage. It's estimated, for example, that damage to 50,000 personal computers and corporate networks from the so-called Blaster worm in August 2003 totaled $2 billion, including $1.2 billion paid by Microsoft to correct the problem.[38] The battle against technology crime is near the top of the FBI's list of priorities, behind only the war against terrorism and espionage.[39] In addition to protecting their own operations from computer crime, companies engaged in e-commerce must clear another hurdle: they must convince consumers that it's safe to buy things over the Internet—that credit-card numbers, passwords, and other personal information are protected from theft or misuse. In this section, we'll explore some of these challenges and describe a number of the efforts being made to meet them.

Data Security

In some ways, life was simpler for business-people before computers. Records were produced by hand and stored on paper. As long as you were careful to limit access to your records (and remembered to keep especially valuable documents in a safe), you faced little risk of someone altering or destroying your records. In some ways, storing and transmitting data electronically is a little riskier. Let's look at two data-security risks associated with electronic communication: *malicious programs* and *spoofing*.

Malicious Programs

Some people get a kick out of wreaking havoc with computer systems by spreading a variety of destructive programs. Once they're discovered, they can be combated with antivirus programs that are installed on most computers and that can be updated daily. In the meantime, unfortunately, they can do a lot of damage, bringing down computers or entire networks by corrupting operating systems or databases.

Viruses, Worms, and Trojan Horses

The cyber vandal's repertory includes "viruses," "worms," and "Trojan horses." Viruses and worms are particularly dangerous because they can copy themselves over and over again, eventually using up all available memory and closing down the system. Trojan horses are viruses that enter your computer by posing as some type of application. Some sneak in by pretending to be virus-scanning programs designed to rid your computer of viruses. Once inside, they do just the opposite.

Spoofing

It's also possible for unauthorized parties to gain access to restricted company Web sites—usually for the purpose of doing something illegal. Using a technique called "spoofing," culprits disguise their identities by modifying the address of the computer from which the scheme has been launched. Typically, the point is to make it look as if an incoming message has originated from an authorized source. Then, once the site's been accessed, the perpetrator can commit fraud, spy, or destroy data. You could, for example, spoof a manufacturing firm with a false sales order that seems to have come from a legitimate customer. If the spoof goes undetected, the manufacturer will incur the costs of producing and delivering products that were never ordered (and will certainly never be paid for).

Every day, technically savvy thieves (and dishonest employees) steal large sums of money from companies by means of spoofing or some other computer scheme. It's difficult to estimate the dollar amount because many companies don't even know how much they've lost.

Revenue Theft

In addition to the problems of data security faced by every company that stores and transmits information electronically, companies that sell goods or provide services online are also vulnerable to activities that threaten their revenue sources. Two of the most important forms of computer crime are *denial of service* and *piracy*.

Denial of Service

A denial-of-service attack does exactly what the term suggests: it prevents a Web server from servicing authorized users. Consider the following scenario. Dozens of computers are whirring away at an online bookmaker in the offshore gambling haven of Costa Rica. Suddenly a mass of blank incoming messages floods the company's computers, slowing operations to a trickle. No legitimate customers can get through to place their bets. A few hours later, the owner gets an e-mail that reads, "If you want your computers to stay up and running through the football season, wire $40,000 to each of 10 numbered bank accounts in Eastern Europe."

You're probably thinking that our choice of online gambling as an example of this scheme is a little odd, but we chose it because it's real: many companies in the online-gambling industry suffer hundreds of such attacks each year.[40] Because most gambling operations opt to pay the ransom and get back to business as usual, denial of service to businesses in the industry has become a very lucrative enterprise.

Online gambling operations are good targets because they're illegal in the United States, where they can't get any help from law-enforcement authorities. But extortionists have been known to hit other targets, including Microsoft and the Recording Industry Association of America. The problem could become much more serious if they start going after e-commerce companies and others that depend on incoming orders to stay afloat.

Piracy

Technology makes it easier to create and sell intellectual property, but it also makes it easier to steal it. Because digital products can be downloaded and copied almost instantly over the Internet, it's a simple task to make perfect replicas of your favorite copyright-protected songs, movies, TV shows, and computer software, whether for personal use or further distribution. When you steal such materials, you're cheating the countless musicians, technicians, actors, programmers, and others involved in creating and selling them. Theft cuts into sales and shrinks corporate profits, often by staggering amounts. Entertainment-industry analysts estimate that

$30 billion worth of songs were illegally downloaded in the five year period ending in 2009.[41] The software industry estimates that the global market for pirated software reached $59 billion in 2010.[42]

So, what's being done to protect the victimized companies? Actually, quite a lot, even though it's a daunting task, both in the United States and abroad.[43] In 1998, Congress passed the Digital Millennium Copyright Act, which outlaws the copying of copyright-protected music (unless you're copying legally acquired music for your own use). The penalties are fairly stiff: up to three years in prison and $250,000 in fines.[44][45] To show that it means business, the music industry is also hauling offenders into court, but legal action is costly and prosecuting teenage music lovers doesn't accomplish much. Some observers believe that the best solution is for the industry to accelerate its own efforts to offer its products online.[46] Initial attempts seem to be working: people who are willing to obey copyright laws have downloaded more than ten billion songs from the iTunes site alone.[47]

Firewalls

Builders install firewalls (or fireproof walls) in structures to keep a fire that starts in one part of a building from entering another part. Companies do something similar to protect their computer systems from outside intruders: they install virtual firewalls—software and hardware systems that prevent unauthorized users from accessing their computer networks.

You can think of the firewall as a gatekeeper that stands at the entry point of the company's network and monitors incoming and outgoing traffic. The firewall system inspects and screens all incoming messages to prevent unwanted intruders from entering the system and causing damage. It also regulates outgoing traffic to prevent employees from inappropriately sending out confidential data that shouldn't leave the organization.

Risks to Customers

Many people still regard the Internet as an unsafe place to do business. They worry about the security of credit-card information and passwords and the confidentiality of personal data. Are any of these concerns valid? Are you really running risks when you shop electronically? If so, what's being done to make the Internet a safer place to conduct transactions? Let's look a little more closely at the sort of things that tend to bother some Internet users (or, as the case may be, nonusers), as well as some of the steps that companies are taking to convince people that e-commerce is safe.

Credit-Card Theft

One of the more serious barriers to the growth of e-commerce is the perception of many people that credit-card numbers can be stolen when they're given out over the Internet. Though virtually every company takes considerable precautions, they're not entirely wrong. Cyber criminals, unfortunately, seem to be tirelessly creative. One popular scheme involves setting up a fraudulent Internet business operation to collect credit-card information. The bogus company will take orders to deliver goods—say, Mother's Day flowers—but when the day arrives, it will have disappeared from cyberspace. No flowers will get delivered, but even worse, the perpetrator can sell or use all the collected credit-card information.

Password Theft

Many people also fear that Internet passwords—which can be valuable information to cyber criminals—are vulnerable to theft. Again, they're not altogether wrong. There are schemes dedicated entirely to stealing passwords. In one, the cyber thief sets up a Web site that you can access only if you register, provide an e-mail address, and select a password. The cyber criminal is betting that the site will attract a certain percentage of people who use the same password for just about everything—ATM accounts, e-mail, employer networks. Having finagled a password, the thief can try accessing other accounts belonging to the victim. So, one day you have a nice cushion in your checking account, and the next you're dead broke.

Invasion of Privacy

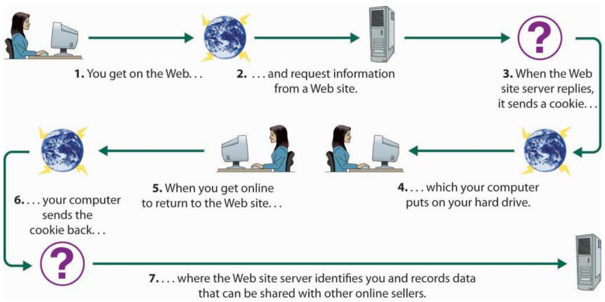
If you apply for a life-insurance policy online, you may be asked to supply information about your health. If you apply for a mortgage online, you may be asked questions about your personal finances. Some people shy away from Internet transactions because they're afraid that such personal information can be stolen or shared with unauthorized parties. Once again, they're right: it does happen.

How Do "Cookies" Work?

In addition to data that you supply willingly, information about you can be gathered online without your knowledge or consent.[48] Your online activities, for example, can be captured by something called a *cookie*. The process is illustrated in Figure 15.11 "How

Cookies Work”. When you access a certain Web site, it sends back a unique piece of information to your browser, which proceeds to save it on your hard drive. When you go back to the same site, your browser returns the information, telling the site who you are and confirming that you’ve been there before. The problem is not that the cookie can identify you in the same way as a name or an address. It is, however, linked to other information about you—such as the goods you’ve bought or the services you’ve ordered online. Before long, someone will have compiled a profile of your buying habits. The result? You’ll soon be bombarded with advertisements targeted to your interests. For example, let’s suppose you check out the Web site for an online diet program. You furnish some information but decide that the program is not for you. The next time you log on, you may be greeted by a pop-up pushing the latest miracle diet.

Figure 15.11 How Cookies Work



Cookies aren’t the only form of online espionage. Your own computer, for example, monitors your Internet activities and keeps track of the URLs that you access.

Shoring Up Security and Building Trust

So, what can companies do to ease concerns about the safety of Internet transactions? First, businesses must implement internal controls for ensuring adequate security and privacy. Then, they must reassure customers that they’re competent to safeguard credit-card numbers, passwords, and other personal information. Among the most common controls and assurance techniques, let’s look at *encryption* and *seals of assurance*.

Encryption

The most effective method of ensuring that sensitive computer-stored information can’t be accessed or altered by unauthorized parties is encryption—the process of encoding data so that only individuals (or computers) armed with a secret code (or key) can decode it. Here’s a simplified example: You want to send a note to a friend on the other side of the classroom, but you don’t want anyone else to know what it says. You and your friend could devise a code in which you substitute each letter in the message with the letter that’s two places before it in the alphabet. So you write A as C and B as D and so on. Your friend can decode the message, but it’ll look like nonsense to anyone else. This is an oversimplification of the process. In the real world, it’s much more complicated: data are scrambled using a complex code, the key for unlocking it is an algorithm, and you need certain computer hardware to perform the encryption/decryption process.

Certificate Authorities

The most commonly used encryption system for transmitting data over the Internet is called *secure sockets layer* (SSL). You can tell whether a Web site uses SSL if its URL begins with *https* instead of *http*. SSL also provides another important security measure: when you connect to a site that uses SSL (for example, your bank’s site), your browser will ask the site to authenticate itself—prove that it is who it says it is. You can be confident that the response is correct if it’s verified by a certificate authority—a third-party (such as VeriSign) that verifies the identify of the responding computer and sends you a digital certificate of authenticity stating that it trusts the site.

Key Takeaways

- Though a source of vast opportunities, **e-commerce**—conducting business over the Internet—also presents some unprecedented challenges, particularly in the area of security.
  1. *Malicious programs*, such as viruses and worms, can wreak havoc with computer systems.
  2. Unauthorized parties may gain access to restricted company Web sites in order to steal funds or goods.

3. **Firewalls**—software and hardware systems that prevent unauthorized users from accessing computer networks—help to reduce the risks of doing business online.

- Companies that do business online are also vulnerable to illegal activities.
  1. A *denial-of-service attack*, for example, prevents a Web server from servicing authorized users; the culprit demands a ransom to stop the attack.
  2. Companies that use the Internet to create and sell intellectual property (such as songs, movies, and software) face the problem of *piracy*.
  3. The theft of digital products, which can be downloaded and copied almost instantly over the Internet, not only cheats the individuals and organizations that create them, but also reduces sales and shrinks corporate profits.
- Finally, online businesses must convince consumers that it's safe to buy things over the Internet—that credit-card numbers, passwords, and other personal information are protected from theft.
- One effective method for protecting computer-stored information is **encryption**—the process of encoding data so that only individuals (or computers) armed with a secret code (or key) can decode it.
  1. A commonly used encryption scheme is a *secure sockets layer* (SSL), which directs the user's browser to ask a site to authenticate itself.
  2. Often, the user receives a digital certificate of authenticity, verifying that a third-party security provider called a **certificate authority** has identified a computer.

Exercise

(AACSB) Reflective Skills

Are you, or is someone you know, hesitant to buy things over the Internet? What risks concern you? What are companies doing to ease consumers' concerns about the safety of Internet transactions?

Careers in Information Management

Learning Objective

1. Identify career opportunities in information management.

The number and variety of opportunities in the IS field have grown substantially as organizations have expanded their use of IT. In most large organizations, the senior management team includes a *chief information officer (CIO)* who oversees information and telecommunications systems. A large organization might also have a *chief technology officer* who reports to the CIO and oversees IT planning and implementation.

Most entry-level IS jobs require a business degree with a major in information systems. Many people supplement their IS majors with minors in computer science or some other business area, such as accounting, finance, marketing, or operations management.

If you're starting out with an IS degree, you may choose to follow either a management path or a technical path. At Kraft Foods, for example, IS professionals can focus on one of two areas: applications development (a management focus) and information technology (a technology focus). "Applications development," according to the company itself, "calls for an ability to analyze [Kraft's] clients' needs and translate them into systems applications. Information technology calls for the ability to convert business systems specifications into technical specifications and to provide guidance and technical counsel to other Kraft professionals".[49] Despite the differences in focus, Kraft encourages IS specialists to develop expertise in both areas. After all, it's the ability to apply technical knowledge to business situations that makes IS professionals particularly valuable to organizations. (By the way, if you want a career in casinos, you can major in casino management at a number of business schools.)

Key Takeaways

- The number and variety of opportunities in the information systems (IS) field have grown substantially as companies have expanded their use of information technology.
- The senior management team in large organizations includes a chief information officer who oversees information and a chief technology officer who oversees IT planning and implementation.
- Most entry-level IS jobs require a business degree with a major in information systems.
- Many supplement their IS majors with computer science or some other business area, such as accounting, finance, marketing, or operations management.
- Those entering organizations with IS degrees may choose to follow either a management or a technology path.

Exercise

(AACSB) Reflective Skills

Why is studying IT important to you as a student? How will competency in this area help you get and keep a job in the future?

Cases and Problems

Learning on the Web

Taking Care of Your Cyber Health

It seems that some people have nothing better to do than wreak havoc by spreading computer viruses, and as a computer user, you should know how to protect yourself from malicious tampering. One place to start is by reading the article "How Computer Viruses Work," by Marshall Brain, which you can access by going to the How Stuff Works Web site (http://computer.howstuffworks.com/virus.htm). After reading the article, answer the following questions:

1. Why do people create viruses?
2. What can you do to protect yourself against viruses?

Career Opportunities

Could You Manage a Job in IT or IS?

Do you have an aptitude for dealing with IT? Would you enjoy analyzing the information needs of an organization? Are you interested in directing a company's Internet operations or overseeing network security? If you answered yes to any of these questions, then a career in IT and IS might be for you. Go to the U.S. Department of Labor Web site (http://www.bls.gov/oco/ocos258.htm) and learn more about the nature of the work, qualifications, and job outlook in IT and IS management. Bearing in mind that many people who enter the IT field attain middle-management positions, look for answers to the following questions:

1. What kinds of jobs do IT managers perform?
2. What educational background, work experience, and skills are needed for positions in IT management?
3. What's the current job outlook for IS and IT managers? What factors drive employment opportunities?
4. What's the median annual income of a mid-level IT manager?

Ethics Angle (AACSB)

Campus Commando or Common Criminal?

Do you want to be popular (or at least more prominent) on campus? You could set up a Web site that lets fellow students share music files over the campus network. All you have to do is seed the site with some of your own downloaded music and let the swapping begin. That's exactly what Daniel Peng did when he was a sophomore at Princeton. It was a good idea, except for one small hitch: it was illegal, and he got caught. Unimpressed with Peng's technological ingenuity, the Recording Industry Association of America (RIAA) sued him, and he was forced to settle for $15,000. Instead of delivering music, Peng's Web site now asks visitors to send money to help defray the $15,000 and another $8,000 in legal costs.

To learn more about the case, read these articles from the Daily Princetonian: "Peng, RIAA Settle Infringement Case" (http://www.dailyprincetonian.com/2003/05/02/8154/), and "Peng '05 Sued by Recording Industry for 'Wake' Site" (http://www.dailyprincetonian.com/2003/04/04/7791).

After researching the topic, answer the following questions:

1. The practice of sharing commercial music files is illegal. Do you think that it's also unethical? Why, or why not?
2. What steps to curb the practice are being taken by the music industry? By college administrators? By the government? Do you approve of these steps? Have they been effective?
3. What, ultimately, do you see as the solution to the problem?

Source: Josh Brodie, "Peng, RIAA Settle Infringement Case," *The Daily Princetonian*, http://www.dailyprincetonian.com/2003/05/02/8154/ (accessed November 14, 2011); Zachary Goldfarb and Josh Brodie, "Peng '05 Sued by Recording Industry for 'Wake' Site," *The Daily Princetonian*http://www.dailyprincetonian.com/2003/04/04/7791/ (accessed November 14, 2011).

Team-Building Skills (AACSB)

CampusCupid.com

It’s no secret that college can be fun. For one thing, you get to hang around with a bunch of people your own age. Occasionally, you want to spend time with just one special someone, but finding that special person on a busy campus can take some of the fun out of matriculating. Fortunately, you’re in the same love boat with a lot of other people, so one possible solution—one that meshes nicely with your desire to go into business—is to start an online dating service that caters to your school. Inasmuch as online dating is nothing new, you can do some preliminary research. For example, go to the Internetnews Web site (http://www.internetnews.com/ec-news/article.php/2228891/Online+Personals+Big+Profits+Intense+Competition.htm) and read the article “Online Personals: Big Profits, Intense Competition.”

Next, you and several of your classmates should work as a team to create a business model for an online dating service at your school. After working out the details, submit a group report that covers the following issues:

1. *Services*. How will you earn revenues? What services will you offer? How will you price these services? What forms of payment will you accept? Will you sell ads? If so, what kinds?
2. *Appearance*. What will your site look like? Will it have graphics? Sound? Video? What will your domain name be? What information will you collect from customers? What information will you provide to visitors?

3. *Operations*. What criteria will you use to match customers? How will your customers interface with the Web site? How will they connect with each other? Will you design your own software or buy or lease it from vendors? Before you answer, go to these vendors’ Web sites and check out their dating software:

- WebDate (http://www.webscribble.com/products/webdate/index.shtml)
- PG Dating (http://www.datingpro.com/dating)

4. *Attracting Customers*. How will you attract customers to the site? How will you monitor and analyze site activity?
5. *Security*. How will you guarantee confidentiality? How will you ensure that your site is secure? How will you limit access to students at your school?
6. *Opportunities and Challenges*. What opportunities do e-businesses offer? What challenges do they create? How would your business model change if you decided to run it as a traditional business rather than as an e-business?

The Global View (AACSB)

“Hong Kong—Traditional Chinese”

Hewlett-Packard (HP) provides technology solutions to individuals, businesses, and institutions around the world. It generates annual revenues of $80 billion from the sale of IT products, including computers, printers, copiers, digital photography, and software. Anyone in the United States who wants to buy an HP product, get technical support, download software, learn about the company, or apply for a job can simply go to the HP Web site. But what if you live in Hong Kong? How would you get answers to your questions? You’d do the same thing as people in this country do—go to HP’s Web site.

Try to imagine, however, the complex process of developing and maintaining a Web site that serves the needs of customers in more than seventy countries. To get a better idea, go to the HP Web site (http://www.hp.com). Start by looking at HP’s line of notebooks and checking its prices. Then, review the company information (click on “About HP” in the bottom right) that’s posted on the site, and, finally, look for a job—it’s good practice (click on “Jobs” in the bottom right).

Now pretend that you live in Hong Kong and repeat the process. Start by going to the same HP Web site (http://www.hp.com). Click on the United States (next to U.S. flag in the bottom left) and then Asia and Oceania. If you can read Chinese, click on “Hong Kong—Traditional Chinese.” Otherwise, click on “Hong Kong—English.” Then, answer the following questions:

1. How easy was it to navigate the site and to switch back and forth between the U.S. and Hong Kong sections of the site?
2. Identify at least five differences between the two sections.
3. Does HP’s Web site meet the needs of customers in both the United States and Hong Kong? Why, or why not? How could it be improved?

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5.2: Chapter 16- E-Business and E-Commerce- The Difference

Learning Objectives

1. Define e-business and e-commerce and explain the difference between them.
2. Understand that there are several different types of e-commerce and that a business can be engaged in more than one type at the same time.
3. Explain what a business model is and why the model that is selected is so important.

E-business and e-commerce are terms that are often used interchangeably. But ***e-business*** and ***e-commerce*** are not the same. This section will elaborate on the differences between the two and some of the foundational knowledge that is critical to understanding and using e-commerce in particular.

E-Business

It is important that small businesses understand the nature of e-business and how it can facilitate operations as well as growth—if growth is desired. It has been said on other occasions, and it will continue to be said, that not all small businesses look for growth, choosing instead to happily remain small. For the small businesses that do want to grow, however, e-business can help them do it through the internet and online technologies to create operational efficiencies, thereby increasing customer value.[1]

E-Business Components

E-business involves several major components: business intelligence (BI), customer relationship management (CRM), supply chain management (SCM), enterprise resource planning (ERP), e-commerce, conducting electronic transactions within the firm, collaboration, and online activities among businesses.[2]

Figure 16.1 Components of E-Business

Business intelligence is about the activities that a small business may undertake to collect, store, access, and analyze information about its market or competition to help with decision making. When conducted online, BI is efficient and quick, helping companies to identify noteworthy trends and make better decisions faster. BI has been described as "the crystal ball of the 21st century."[3]

Customer relationship management (CRM) refers to "…a customer service approach that focuses on building long-term and sustainable customer relationships that add value for the customer and the company."[4] It is a company-wide strategy that brings together information from all data sources within an organization (and sometimes from external data sources) to give one holistic view of each customer in real time. The goal is to reduce costs and increase profitability while providing customer satisfaction.[5]

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

SCM is about efficiently and effectively improving the way that a company finds those raw components and then delivers the product or the service to the customer.[6] SCM applications are now available for small businesses. More details about SCM are presented in Chapter 12 “People and Organization”.

Enterprise resource planning (ERP), is about integrating all departments and functions across a company (sales, marketing, human resources, finance, accounting, production, engineering, etc.) into a single computer system that can serve the particular needs of each department. The objective is to provide information quickly and efficiently to those who need it. Small businesses have many vendor choices for ERP systems. There are more than thirty vendors in the field, and they are looking to small and midsize businesses as their primary growth market.[7]

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

Conducting electronic transactions within a firm can occur through an ***intranet***, a private network within a business that is used for information sharing, processing, and communication., e-mail, and instant messaging. An intranet is a private network within a business that is used for information sharing, processing, and communication. The goal is to “streamline the workplace and allow easy information exchange within an organization.”[8]

Collaboration can occur internally or externally, and it often involves business partners. The goal is to help teams or business partners communicate with each other more effectively and efficiently, manage projects and shared materials, save companies the costs of travel, and reduce travel-related productivity losses. E-mail, instant messaging, newsgroups, bulletin boards, discussion boards, virtual team rooms, online meetings, and ***wikis***, a web page that can be viewed and modified by anybody with a web browser and access to the Internet unless it is password protected, are common means of collaboration.[9] The most well-known wiki is *Wikipedia*.

Online activities between businesses focus on information sharing and communication via e-mail, online meetings, instant messaging, and extranets. An ***extranet,*** is the part of an intranet that is made available to business partners, vendors, or others outside a company. It allows a business “to share documents, calendars, and project information with distributed employees, partners, and customers” and “it enables 24/7 private, secure access to collaborative tools with just an Internet connection.”[10]They make communication easier, eliminate redundant processes, reduce paperwork, increase productivity, provide immediate updates and information, and provide quick response times to problems and questions.”[11] The result is money and time saved for employees, the company, vendors, and your customers. Commercial transactions typically do not take place on extranets.

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

E-Commerce

The moment that an exchange of value occurs, e-business becomes e-commerce.[12] E-commerce is the revenue generator for businesses that choose to use the Internet to sell their goods and services. Some small businesses rely on the Internet to grow and survive. Many small businesses also look to e-commerce for their own business needs, such as computers and office technology, capital equipment and supplies, office furnishings, inventory for online sale, or other business-related goods.[13] This is not surprising considering the pervasiveness of the Internet for business transactions of all shapes and sizes.

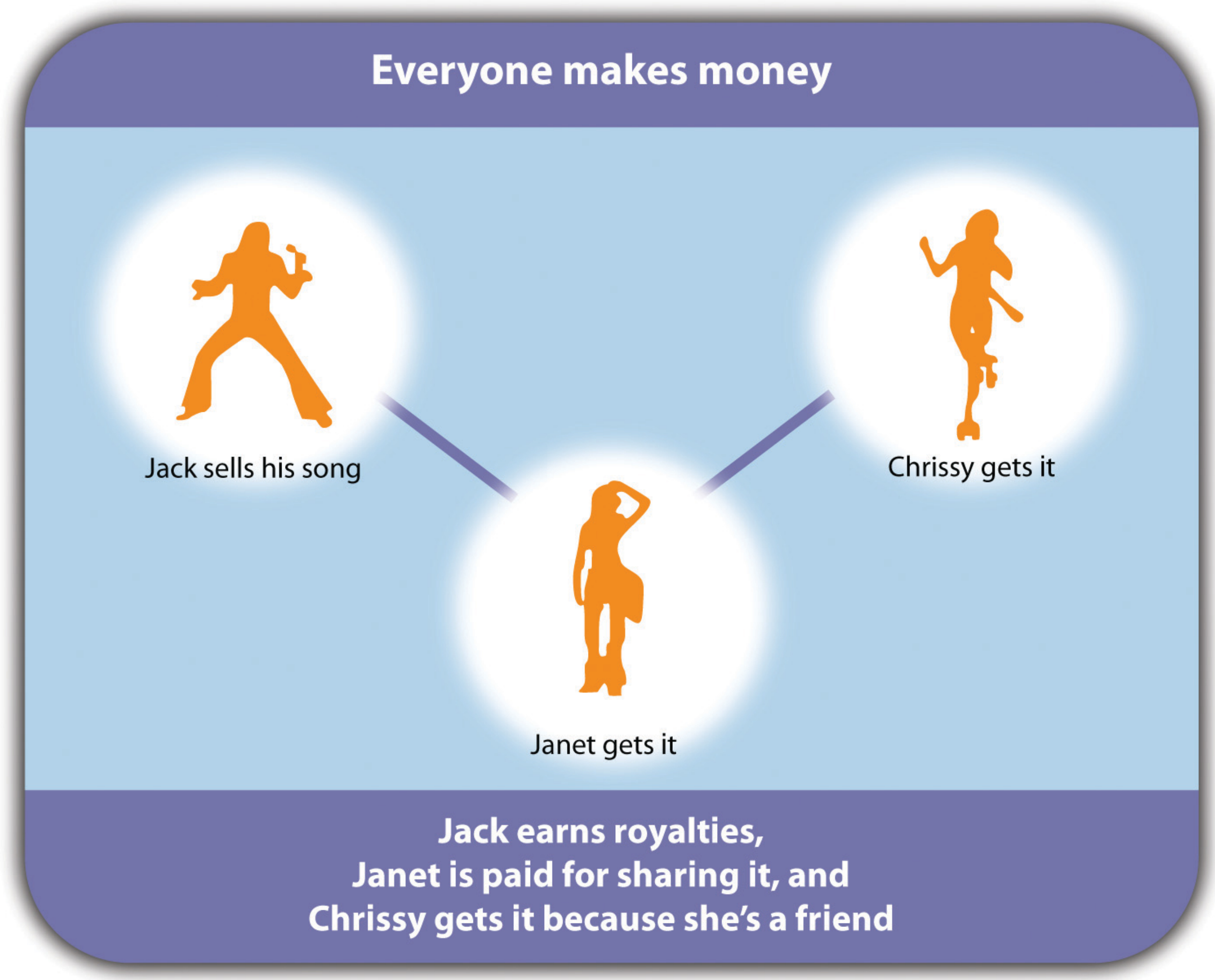
Types of E-Commerce

Every Internet business is either ***pure-play***, or ***brick-and-click***. A pure-play business, such as Amazon and Zappos, has an online presence only and uses the capabilities of the Internet to create a new business. Brick-and-click businesses, such as Barnes and Noble and Vermont Country Store, combine a physical presence with an online presence. These businesses use the Internet to supplement their existing businesses. [14]

There are several different types of e-commerce. A common classification system is with respect to the nature of transactions or the relationships among participants.[15] There are seven major types of e-commerce:

1. ***Business-to-business (B2B)*** e-commerce, where businesses focus on selling to other businesses or organizations, is the largest form of e-commerce.[16][17] Cisco, Staples, and Spiceworks (information technology [IT] and IT networks for the small- and medium-sized business) are all B2B companies.
2. ***Business-to-consumer (B2C)*** is the earliest form of e-commerce, but it is second in size to B2B. It refers to retail sales between businesses and individual consumers. Consumers gather information; purchase physical goods, such as books and clothing; purchase information goods, such as electronic material or digitized content, such as software; and, for information goods, receive products over an electronic network. [18]
3. ***Consumer-to-consumer (C2C)***e-commerce is where consumers sell products and personal services to each other with the help of an online market maker to provide catalog, search engine, and transaction-clearing capabilities so that products can be easily displayed, discovered, and paid for. The most well-known C2C business is eBay, but there are many other online market makers as well. Craigslist is an extremely popular small e-commerce business for placing classified ads.
4. ***Business-to-government (B2G)*** e-commerce can generally be defined as transactions with the government. The Internet is used for procurement, filing taxes, licensing procedures, business registrations, and other government-related operations. This is an insignificant segment of e-commerce in terms of volume, but it is growing.
5. ***Consumer-to-business (C2B)*** e-commerce is between private individuals who use the Internet to sell products or services to organizations and individuals who seek sellers to bid on products or services. [19]Elance is an example of C2B where a consumer posts a project with a set budget deadline and within hours companies and/or individuals review the consumer's requirements and bid on the project. The consumer reviews the bids and selects the company or individual that will complete the project. Elance empowers consumers around the world by providing the meeting ground and platform for such transactions."Ecommerce Definition and Types of Ecommerce," *DigitSmith*, accessed October 10, 2011, www.digitsmith.com/ecommerce-definition.html. Priceline.com is a well-known example of C2B e-commerce.
6. ***Mobile commerce (m-commerce)*** refers to the purchase of goods and services through wireless technology, such as cell phones, and handheld devices, such as Blackberries and iPhones. Japan has the lead in m-commerce, but it is expected to grow rapidly in the United States over the next several years. eMarketer predicts mobile content revenues will grow to more than $3.53 billion in 2014, a compound annual growth rate of nearly 20 percent for the period 2009–2014, with the fastest growth coming from mobile music.[20]
7. ***Peer-to-peer (P2P)*** technology makes it possible for Internet users to share files and computer resources directly without having to go through a central web server. P2P began with Napster offering free music downloads via a file-sharing system.[21] Tamago launched the world's first P2P commerce system in 2005, which allowed people to sell every type of digital media directly from their computers to customers all over the world. People who publish videos, photos, music, e-books, and so forth can earn royalties, while buyers earn commissions for distributing media to others.[22]

Figure 16.2 How P2P E-Commerce Works at Tamago.com



Source: [23]

Although these types of e-commerce have been discussed individually, there are many instances in which one company engages in multiple types. Office Depot and Staples are brick-and-click businesses that engage in B2B, B2C, and perhaps B2G e-commerce. Carbonite and Gourmet Gift Baskets are both pure-play small businesses that engage in B2C and B2B e-commerce.

E-Commerce Business Models

The decision to engage in e-commerce is an important one. The advantages are clear: lower business costs; 24/7 accessibility anywhere; the potential for stronger customer service; the ability to introduce a niche product; the ability to reach global markets on a more equalized basis with larger firms, making mass customization possible; and greater customer loyalty. But the risks are there as well. Internet problems, website problems, security and privacy breaches, intellectual property theft, legal liability, product and/or service failure, customer deceit, and customer dissatisfaction are but a few of the risks. Therefore, the choice of an e-commerce business model must be made carefully. Each model will have different implications in terms of business planning and strategy.

An ***e-commerce business model*** is the method that a business uses to generate revenue online. "The business model spells out how a company makes money by specifying where it is positioned in the value chain. Some models are quite simple. A company produces a good or service and sells it to customers. If all goes well, the revenues from sales exceed the cost of operation and the company realizes a profit. Other models can be more intricately woven."[24] Another way to look at a business model is that it "reflects management's hypothesis about what customers want, how they want it, and how the enterprise can organize to best meet those needs, get paid for doing so, and make a profit."[25] There are many models to choose from, and new models will continue to emerge as technology evolves and businesses look for new and creative ways to generate revenue. Some of the many e-commerce business models are as follows:[26]

- The ***virtual merchant model*** is used by online retailers that operate over the Internet only. FreshDirect is a small business that offers fresh food and brand-name groceries for home delivery in New York. Amazon is another example of a virtual merchant.
- The ***brokerage model*** brings buyers and sellers together and facilitates transactions. Supply Chain Connect is a small business that helps "companies optimize their purchasing and sales purchasing and sales processes through the use of e-commerce across a broad range of products including chemicals, plastics, wire and cable, and manufactured goods."[27]
- The ***incentive marketing model*** is a "customer loyalty program that provides incentives to customers such as redeemable points or coupons for making purchases from associated retailers."[28]Cool Savings, a small business that uses this model, wants to be its customers' free resource for valuable coupons, discounts, and special offers from their favorite brands and stores.

Because the business model will be at the center of the business plan, the model must be designed carefully. Although value proposition and the revenue model may be the most important and easily identifiable aspects of a company's business model, the other six elements are equally important.[29][30]

Table 16.1 Key Elements of a Business Model

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

Source: [31]

E-Commerce Trends

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

- E-commerce will continue to grab more market share.[32]
- It is expected that, in some way, the web will influence 53 percent of all purchases made in 2014.[33].
- The lines between online and offline commerce will become less defined. If somebody buys from a mobile device in your store, is that a web sale or a store sale? Retailers need to think of some new ways that they can take the web's influence into account.[34]
- B2B e-commerce will continue to significantly outpace B2C e-commerce, representing more than 85 percent of all e-commerce.
- M-commerce is the fastest growing segment of visitors to e-commerce websites. If a business does not allow customers to both browse its catalog and conduct transactions on a mobile device, customers will seek out other brands that offer such experience.[35]

- Many businesses have increased their social marketing initiatives through a combination of Facebook pages, Twitter tweets, YouTube fan videos, and blogs. Any business that sells its products or services online without having a social strategy will suffer.[36]

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

- The Internet will continue to create opportunities for small businesses. It is now possible to buy a wide range of specialized products and services that are not available elsewhere. The Internet has provided a lifeline for many small producers and has allowed entrepreneurs to enter retailing without having to invest heavily in physical outlets.[37] Small businesses can easily enter the e-commerce arena as pure-play businesses. Take Socrata, an online service that makes it easy to share data—anything from crime statistics to football schedules. This small start-up business discovered that federal agencies were the site's biggest users. "It became clear that a really good place for our technology was helping government organizations share data in the interest of transparency."[38]
- Broadband and wireless networks will be everywhere. Small businesses will need to factor in the effect of the broadband revolution on their businesses.[39] Consider the case of the small, ten-person shop in Seattle that engraves plaques and trophies. Today, 60 percent of its business is conducted online, with customers who live outside the Seattle area.[40]
- The Internet will continue to be a platform that provides small businesses with a wide range of new tools, services, and capabilities. Small businesses will find new ways to use the Internet, contributing to the blurred distinctions between the physical and the virtual worlds.[41]
- Small business relationships will become increasingly virtual as online social networks expand.[42] Many small businesses are promoting their presence on Facebook and Twitter. Westbrook Lobster and Arisco Farms are both small businesses in Connecticut that have an online social presence. Naked Pizza in New Orleans has a presence on Twitter that has proven to be a boon to its business. [43]

Video Clip 16.1

Naked Pizza on Twitter

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Naked Pizza can now be followed on Twitter.

Is E-Commerce for All Small Businesses?

Despite the popularity and pervasiveness of e-commerce, not all small businesses may be interested in pursuing e-commerce as a part of their businesses. Many small businesses survive without an online presence. However, business analysts have agreed for a long time "that for any company larger than a local mom and pop store, e-commerce is now a business requirement."[44]

Key Takeaways

- E-business and e-commerce are not synonymous terms. E-commerce generates revenue. E-business does not.
- E-business and/or e-commerce may not be of interest to all small businesses. However, using technology well is proving to be one of the most prominent drivers of business success.

- E-business consists of several major components, one of which is e-commerce.
- Every Internet business is either pure-play (an Internet presence only) or brick-and-click (having both a physical and an online presence).
- The seven major types of e-commerce are B2B, B2C, C2C, B2G, C2B, m-commerce, and P2P.
- An e-commerce business model is the method that a business uses to generate revenue online. Some models are very simple; others are more complicated. New business models are being introduced all the time.
- E-commerce will continue to grab more market share, and the line between online and offline commerce will become less defined.

Exercises

1. In The Mill's restaurant case, the son, Robert, wants to bring his expertise to improving the operations of the business. What other elements of digital technology, e-business, and e-commerce could be used to improve operations?
2. Joan Watson is the owner of Joan's Gourmet Baskets, a small brick-and-mortar business that specializes in gourmet gift and picnic baskets. Joan has been keeping up with the fancy food and gourmet food trends (being a great fan of the Fancy Food Show that is held several times a year), and she thinks she should tap into this sector by creating an online business that will complement her physical business. This would make her baskets available to a wider market. She is proud of the quality of her products and the customer loyalty that she has earned through her hard work and hopes she will be able to be just as successful in the e-commerce environment.

   Joan knows that she needs more information before proceeding further. She has asked you to prepare a report that answers the following questions: How will her physical business compare to her online business; that is, where will things be the same, and where will they be different? What business model should she use? What are the special challenges and obstacles she will face as she moves from traditional commerce to e-commerce? What is Web 2.0 all about and does she need to be concerned about it? She expects that you will do additional gourmet foods research to support your ideas.

E-Commerce Operations

Learning Objectives

1. Explain the issues associated with whether a small business should buy or build its website.
2. Explain some of the legal issues that are relevant to e-commerce.
3. Discuss the need for an ethical website, particularly in terms of security, privacy, and trust.
4. Explain why order fulfillment is such an important part of successful e-commerce.

There are multiple parts to the creation of an e-commerce website: the infrastructure (the nuts and bolts building of the site), the e-marketing side (the design and creation of a web presence, and the operational side. The operational side is the focus of this section.

The Website: Buy or Build?

Unless a small business owner is technologically savvy or employs someone who is, building the company's website in-house from the ground up is not a particularly good idea. An effective website presence requires a good looking, professionally designed website. There are several approaches to having someone else build that website. Two are described here.

- ***Full-service web developers*** provide design, programming, support, hosting, search engine optimization, and more. Any combination of the services can be selected. Having the developer perform all the services would be the most expensive alternative. ***Hosting*** is the housing, serving, and maintaining of the files for one or more websites.[45] ***Search engine optimization*** refers to the strategies intended to position a website at the top of search engines such as Google, Yahoo!, and Bing. [46]
- A much lower-priced option is to select one of the many companies online that can help you to design your website. Typically these sites provide a choice of website design templates that can be easily edited; design services that are available if none of the templates meet your needs; hosting; ***domain name*** selection (your business address or name on the Internet, e.g., gone.2012books.lardbucket.org) and ***domain name registration*** (registering your domain name with a domain name registrar and paying a fee that must be renewed annually); and ***search engine placement*** (submitting your website to specific search

engines of your choice). [47] Intuit.comand Webs.comare two companies that offer these and other services. The lowest level of services are often free.

Video Clip 16.2

Domain Name Dollar Store

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A humorous look at getting a URL for your website at a rock bottom price.

The ultimate cost for a website will be a function of its size, complexity, and the level of design. No two projects will cost the same. Part of the process of building a website, however, should be conducting some research and talking with website designers. The Internet offers a variety of sources on how to determine how much a website should cost. WebpageFX.com offers a historical perspective on website costs, a cost calculator to find out how much a web project would cost, and examples of specific web design and website development projects with cost figures.[48]

Consider the following two scenarios:

- "A small business needs a website for their business so they have a presence on the Internet. The site is simple—about 5 pages with information about the business, the services they provide, and a form that can be submitted and the information received via email. The budget isn't available for creating a graphic 'look,' and existing images will be used. A smaller, less experienced designer may take on a project like this for a few hundred dollars. A medium sized firm might quote $3000 to $4000 depending on variables. A larger firm would probably not take a project this small."[49]
- "A mail order company wants to get into online sales. They currently have no website. They have a narrow mix of about 200 products with a broad target market; it's also time to update their image. Depending on a wide range of variables, a project like this could start at about $7000 and go into six figures."[50]

There is no easy answer to the question of how much a website will cost. "A simple answer is that it will cost whatever a business is willing to spend—anywhere from free to millions of dollars." A better way to address cost is to answer the following questions: [51]

- What are your needs, goals, and expectations?
- What are the needs and expectations of your visitors, customers, and clients?
- Is your business already established with its unique brand or identity?
- What is required in terms of the skills, experiences, and level of design?
- Do you want to hire a high-profile design shop, a medium-sized design studio, a small company, or a student?
- What can you afford to budget for your project?

Legal

There is nothing easy about the law. It is complex under the best of circumstances, but it is necessary to protect the rights and privileges of people and businesses. Companies that choose to engage in e-commerce must be aware of the legal environment because “a lack of awareness…can lead to missteps as well as missed opportunities….”[52] A summary of important legal issues for e-commerce is in Table 16.2 “Important Legal Issues for E-Commerce”. However, the focus here is on three areas: electronic transactions, intellectual property, and jurisdiction.

Table 16.2 Important Legal Issues for E-Commerce

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

Source: [53]

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

Intellectual property is “a creation of the mind, such as inventions, literary and artistic works, and symbols, names, images, and designs, used in commerce.” [54] Music, photos, videos, digital news, and artwork are forms of intellectual property that can be transmitted over the Internet. All small business owners need to be concerned about the theft of intellectual property. They are afforded multiple protections, which are summarized in Table 16.3 “Intellectual Property Protections”.

Table 16.3 Intellectual Property Protections

Law	Protection Provided by the Law
Intellectual property law	Protects creations of the human mind
Patent law	Protects inventions and discoveries

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

Source: [55]

It is important to protect intellectual property because businesses will not realize the full benefits of their inventions and would be inclined to focus less on research and development. Additionally, without intellectual property protections, "exporters face unfair competition abroad, non-exporters face counterfeit imports at home, and all businesses face legal, health and safety risks from the threat of counterfeit goods entering their supply chains."[56] Unfortunately, US small businesses are at a disadvantage because:[57]

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

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

Jurisdiction refers to the right and power that a court has to interpret and apply the law in a particular geographic location. [58] "A court must have jurisdiction over the litigants and the claims before it entertains a lawsuit. In the context of Internet commerce, this issue erupts when a dispute arises between businesses from different states [or countries]."[59] Many small businesses will be selling products online in other states and in other countries, so it is important to understand the jurisdictions that might be applicable to any online transaction. "In many cases, laws from the customer's state are the ones that will apply in the event a problem arises. This is equally true regarding the laws of other countries." [60] From the perspective of any business, but particularly a small business, it would be much easier from both a time and a money perspective to have an issue litigated in the home state of a business. Although there are no guarantees, these steps can be taken to increase the chances of a dispute being settled in the home state of a business: [61]

1. If using a contract with another party, make sure the contract says that any dispute must be filed in your home state and that both parties to the contract agree to jurisdiction in that state.
2. When a customer is purchasing an item on the website of a business, one of the terms and conditions of the transaction should be that the customer agree to jurisdiction in the home state of that business. This can be done with a check box next to the statement. Make the customer check it off before completing the purchase.
3. A less effective way is to include a disclaimer on the website that any transaction will convey jurisdiction to the home state of a business, and any dispute must be heard by a court of competent jurisdiction in the home state of the business.

All these steps should also be considered when selling to other countries. However, the laws in other countries will undoubtedly introduce complications into protecting the US-based business. Take the example of Yahoo! and the sale of Nazi memorabilia on one of its auction websites. A French court ruled that such sales breached French law against the display of Nazi items. Yahoo! took steps to remove and ban all such hate paraphernalia from its auction sites, but it continued to fight jurisdiction of the French ruling in American courts.[62] It would be very easy for a small business to inadvertently find itself in a similar situation. That is why a business needs to be careful when selling outside its home country. Be familiar with foreign laws. This is not an easy task because the minute a business website goes live, the business goes global. The laws of the world suddenly become relevant.

Ethical Issues

It is known that "ethical factors do play a significant role in e-consumers' purchasing decisions."[63] Therefore, ethical factors should be of major concern in e-commerce and, accordingly, in the information and protections offered by an e-commerce website.

It has been observed that the "Internet represents a new environment for unethical behavior," and "ethical transgressions are more likely to happen in e-transactions as compared to face-to-face transactions."[64] To a large extent, this is due to the absence of physical and interpersonal cues that are present in traditional retailing or business settings. The implication is that e-commerce operations should focus more specifically and explicitly on the ethics messages that are being conveyed by the website. Thus the focus of this ethics discussion is on three major components of e-commerce ethics: security, privacy, and trust.

Security and Privacy

Website security (the protection of a company, its suppliers, its customers, and its employees from criminal activity) is a critical consideration for any small business engaged in e-commerce. The Internet is a global playground for criminals. It is less risky to steal online because "the potential for anonymity on the Internet cloaks many criminals in legitimate-looking identities, allowing them to place fraudulent orders with online merchants, steal information by intercepting e-mail,…shut down e-commerce sites by using software viruses,"[65] and steal financial information and money. This new type of crime is referred to as cybercrime, and it is a serious threat to e-commerce.

Cybercrime refers to any criminal activity that is done using computers and the Internet,[66] and it includes a wide range of offences. Downloading illegal music, stealing from online bank accounts, stealing credit card numbers and personal information, stealing identities, posting confidential business information on the Internet, and creating and distributing viruses on other computers are only some of the thousands of crimes that are considered cybercrimes.[67] Cybercrimes can take place anytime and anyplace. It has cost American companies a median loss of $3.8 million a year, and data protection and information technology (IT) practitioners from 45 US organizations from various sectors reported that, across their companies, 50 successful attacks were experienced over a four-week period.[68]

Video Clip 16.3 The Challenges of Cybercrime

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Cybercrime today.

Video Clip 16.4 Cybercrime

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Cybercrime is on the rise.

Video Clip 16.5 Cybercrime in Canada

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New cybercrime threats.

Cybercrime is more profitable than the illegal drug trade (more than $100 billion globally per year). Every three seconds an identity is stolen, and without security, an unprotected PC can become infected within four minutes of connecting to the Internet. [69][70] A Microsoft security intelligence report maintains that cybercrime is fast maturing as a profession, with cybercriminals becoming more sophisticated and packaging online threats that can be sold to others.[71]

Examples of Cybercrimes "Computer Crime & Intellectual Property Section," US Department of Justice, accessed October 10, 2011, www.cybercrime.gov.

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

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

Cybercrime hurts the bottom line of any business, but small and medium-sized businesses are the new cybercrime target. "Hackers and computer criminals…are taking a new aim—directly at small and midsize businesses…Smaller businesses offer a much more attractive target than larger enterprises that have steeled themselves with years of security spending and compliance efforts.”[72] Small businesses are potentially very lucrative targets for several reasons:

- Nearly one fifth of small businesses do not use antivirus software.
- Two thirds of small businesses do not have a security plan in place.
- Sixty percent of small businesses do not use encryption on their wireless links.
- Only about 60 percent of mom-and-pop shops have met the credit card industry’s data security standards for protecting credit card data. Compliance at the smallest businesses is even worse.
- Two thirds of small and medium-sized businesses believe that large companies are the main target for cybercrime,…yet 85 percent of the fraud seen in business occurs in small and medium-sized businesses.[73]

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

Video Clip 16.6 How SSL Security Works on E-Commerce Websites

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How Amazon.com grew so fast by incorporating SSL security.

Given the state of cybercrime, assuring the ***security*** and the ***privacy*** of e-consumers (the protection of the personal information of customers on the Internet) are necessary to build and maintain confidence in the e-market, particularly because the risk of privacy invasion and security flaws is significant.[74] Further, such assurances have been found to have a significant impact on the willingness to purchase. [75]

E-customers voice their privacy concerns in different ways. Here are some examples:[76]

- “I don’t like websites that ask you for personal information that is not necessary for the purchase to be made.”
- “All privacy notices contain the same information, and besides, how do I know that the website actually follows the privacy policy.”
- “I’m not comfortable at all with the idea of the online retailer having my personal information and selling it to other companies for marketing purposes.”

The scope of failure in protecting customers’ personal information can be potentially devastating because of the global reach of the Internet; the effect can easily reach millions of people. [77] Heartland is a payment processor responsible for handling about 100 million credit card transactions every month. They disclosed in June 2009 that thieves had used malicious software in its network in 2008 to steal an unknown number of credit card numbers. [78]

Fortunately, the theft of credit card and other personal information originating from websites accounted for only about 11 percent of the identity theft or fraud that affected 11 million Americans in 2009.[79] This is why the act of providing credit card information on a website for a purchase is still considered by some people to be so risky that they refuse to conduct any Internet transactions. This has obvious implications for any small company that hopes to do business online.

Fortunately, there is a very straightforward way to provide the security and privacy that online customers seek: the use of Secure Sockets Layer (SSL), a security protocol that is used by web browsers and web servers to help users protect their data during transfer.[80]

Companies like VeriSign offer SSL protection certificates, and the placement of its icon on a website can offer security and privacy assurances to online customers. The inclusion of SSL protection should be discussed with your website designer.

Trust

Trust is about believing—believing that someone will do what they say and that they will not intentionally do something to hurt you. Trust is an important part of all business relationships. Without trust, all e-commerce would come to a halt. “Trust is central to establishing successful e-commerce ventures and to ensure the continued success of this business paradigm into the future.”[81] Trust will improve competitiveness, reduce the costs of doing business, build loyalty, and increase the effectiveness of websites. In short, trust can be an important source of competitive advantage. Trust is essential.

In the physical world, trust is much easier to develop. Physical cues from spaces and buildings, face-to-face voice and body language, and salesperson effectiveness can translate easily into trust relationships. In the online world, however, trust develops as a result of the complex interaction of multiple factors that have design implications for the website. Here are some examples of trust: [82] [83] [84] [85] [86]

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

Another element of trust is ***order fulfillment***. Order fulfillment is all about meeting expectations, and some argue that this is the most important element of trust. [87] Delays in the delivery of a product, the delivery of the wrong product, and the hassles of returning merchandise are stresses that can contribute to a less-than-satisfactory Internet buying experience. Such experiences contribute to a lack of trust. In contrast, satisfied consumers express themselves this way: [88]

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

Buying some products online, such as clothing, furniture, and toys, does not offer buyers the opportunity to touch and feel the product before buying. As a result, order fulfillment becomes even more important to customer satisfaction.

Linked closely to order fulfillment is ***product reliability***. Product reliability refers to “the accurate display and description of a product so that what customers receive is what they thought they ordered.”[89] Online retailers should provide a complete and realistic description of the product and its benefits—with high-quality pictures and perhaps even demonstration videos if possible, appropriate, and affordable—along with product availability and likely ship dates. Customers should be notified by e-mail of order acceptance, and the anticipated delivery date with phone and e-mail contacts for any needed assistance.

Video Link 16.1 Inflatable Fruitcake

Inflatable fruitcake with demonstration.

www.inflatablefruitcake.com/

What all this says is that website owners must proceed carefully to create their online presence in a way that will inspire trust. “If consumers trust online merchants and have confidence in the reliability and integrity of merchants, they will likely feel more at ease making purchases and disclosing sensitive information online. Therefore, the success of online merchants and the future of e-commerce may depend heavily on online trust.”[90]

Payment Options

Nowhere are security, privacy, and trust more necessary than at the point of payment. Without this transaction, there is no e-commerce, so it is imperative that small businesses selling online take the necessary steps to reduce customer concerns about shopping online. A recent survey found that retailers operating online may have lost more than $44 billion dollars over a one-year period as a result of transaction problems on their websites; in addition, 27 percent of online shoppers would turn to an offline or online competitor if they encountered an online transaction issue. [91] More specifically, online shoppers who encountered a transaction problem would react as follows: [92]

- Sixty-six percent would contact customer service, including
  - Fifty-three percent calling customer service; and
  - Thirty-six percent e-mailing or logging a web complaint with customer service.
- Thirty-two percent would abandon the transaction entirely, including
  - Twenty-seven percent turning to an online or offline competitor.

To make matters even worse, the potential for lost revenue when customers have a negative online shopping experience is amplified by the rising use of social media like Facebook and Twitter; the voicing of displeasure on social networks can significantly damage a company's reputation.[93] The message is clear. Online transactions must run smoothly.

But there is another important issue: the number of payment options that are offered to the customer. Research shows that the more payment options customers have, the more likely they will complete their purchase.[94] [95] [96] [97] [98]

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

Customers shopping online expect convenience and a variety of payment options. Credit cards are by far the most popular means for making an online payment, with one survey indicating that 70 percent of online consumers used this payment method.[99] Any small business that does not have its website set up to accept credit cards will lose 60–80 percent of its potential orders. Further, offering a credit card option will increase the number of orders, and those orders will be substantially larger because credit cards enable impulse buying, reassure customers of your legitimacy, and simplify your billing.[100]

Consistent with credit cards being the online payment method of choice, it has been reported that 99 percent of online businesses offer a general purpose credit card, which include Visa, MasterCard, American Express, and Discover."[101] However, debit cards are growing in popularity ahead of other payment alternatives.

The 15 Most Popular Online Payment Solutions

https://www.entrepreneur.com/article/286006

- Due
- Stripe
- Dwolla
- Apple Pay
- Payoneer
- 2Checkout
- Amazon Payments
- Square
- Payza
- Skrill
- Venmo
- Google Wallet
- WePay
- Intuit GoPayment
- Authorize.net

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

Key Takeaways

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

Exercises

1. Find three small business websites. Analyze each website in terms of its trustworthiness. Discuss why you would or would not trust each site. Be specific.
2. Discuss whether you think an unintelligible privacy policy is ethical. Be specific in your arguments.

E-Commerce Technology

Learning Objectives

1. Explain what an e-commerce platform is.
2. Discuss the importance of a CRM solution to a small business.
3. Explain m-commerce and why small businesses should consider incorporating it into their e-commerce strategy.
4. Explain the significance of Web 2.0 to a small business.

Digital technology has put small business on a more equal footing with its larger competitors. Although it is certainly true that a commitment to technology is not for every small business, it is also true that technology is transforming small business in important ways: (1) businesses are easier to find online than ever before; (2) communicating with customers is shifting to e-mail marketing and social media; (3) e-mail and mobile phones are improving productivity; (4) collaboration among employees who are working in multiple venues is easier; (5) outsourcing is easier; and (6) more companies are shifting their attention to how they can sell products and services online. Using technology well is proving to be one of the most prominent drivers of business success.[102]

Technology specifically related to e-commerce is a large umbrella. E-commerce platforms, customer relationship management (CRM), going mobile, and Web 2.0 will be discussed in this section.

E-Commerce Platforms

An ***e-commerce platform*** is the software that makes it possible for a business to sell online. In general, the core e-commerce platform should support basic requirements such as custom styling, search engine optimization, credit card processing, promotions, catalog management, analytics, product browsing, checkout, and order management. Additionally, e-commerce platforms should provide self-service content management systems (CMS), support multiple languages, and support multiple stores.[103] These requirements may vary slightly depending on which type of e-commerce is being conducted. ***Analytics*** refer to the tools that can track the different ways people use your website and then make sense of the data.[104]

The ***all-in-one e-commerce platform solution*** has become more popular with online merchants. This solution provides everything: the core e-commerce platform plus hosting, accounting, analytics, and marketing tools such as e-mail management. Because all the tools are integrated, they work together.[105] It has also been reported that e-commerce platforms are now enabling online retailers to better reach consumers through mobile devices and social media sites.[106] This is great news for the small business that wants to tap into these growing markets.

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

Customer Relationship Management

Customer relationship management refers to “a customer service approach that focuses on building long-term and sustainable customer relationships that add value for the customer and the company.” [107]Some small businesses may wonder whether they really need the added complexity of a small business CRM solution. The answer will depend to a large extent on the size of the business and its growth objectives. However, it has been observed that there is no small business out there that, "sometimes in spite of themselves, didn't benefit from implementing a… CRM or its watered down equivalent—a simpler Contact Management software solution."[108] Recent studies have revealed that CRM applications account for the following: [109]

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

It has also been noted that companies can boost their profits by almost 100 percent by retaining just 5 percent of their customers. [110] What does this mean for the small business that chooses to go with a CRM solution? As long as the solution is well implemented and actually used, there should be an immediate payoff and productivity improvement throughout the company. Additionally, choosing to engage in e-commerce makes the selection of a CRM solution even more important because the quality of customer relationships is so important to online success.

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

Going Mobile

As defined earlier in this chapter, mobile e-commerce (m-commerce) refers to the purchase of goods and services through wireless technology, such as cell phones and handheld devices. It consists of two primary components: "…the ability to use a wireless phone or other mobile device to conduct financial transactions and exchange payments over the Internet…and the ability to deliver information that can facilitate a transaction—from making it easy for your business to be 'found' via a mobile Web browser to creating mobile marketing campaigns such as text promotions and loyalty programs."[111] It is predicted that in 2015 m-commerce revenues will make up 8.5 percent of all US e-commerce revenue and 20 percent of global e-commerce revenue. In the United States, that will represent only one half of 1 percent of all retail revenues.[112] However, even though m-commerce is lagging behind other mobile uses, wireless devices and m-commerce are expected to create another revolution in e-commerce. The most important thing that online retailers can do is to "…take action soon because the mobile environment is adapting much more quickly than the web."[113]

Small businesses need to sort out the hype from what's real and the trends.[114] [115] [116] [117] [118] [119] [120]

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

Video Clip 16.7 Mobile E-Commerce Capabilities

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Gene Alvarez, Gartner Group, discusses m-commerce.

Major retailers have been able to easily offer remote access to customers who want to make purchases using mobile devices (e.g., Target and Nordstrom). Software is now available for small businesses to offer some of the same bells and whistles, giving their online customers the ability to shop via smartphones.[121]

Mobile e-commerce may not be for all small businesses, but a small business owner who is already in e-commerce or has plans to do so should give it consideration. Multichannel shoppers tend to purchase more, so small companies need to think of ways to "effectively engage customers by delivering consistent, rich experiences across all channels, including mobile, to maintain and fuel double-digit ecommerce industry growth rates."[122] Online customers are ready and increasingly interested in using mobile devices to make purchases.

Web 2.0

There is no agreement about an exact definition of **Web 2.0** but, in general, it refers to websites that are more interactive, engaging, and interesting than before. A Web 2.0 site is one where visitors can engage with you, your business, and your site by doing things like the following:[123]

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

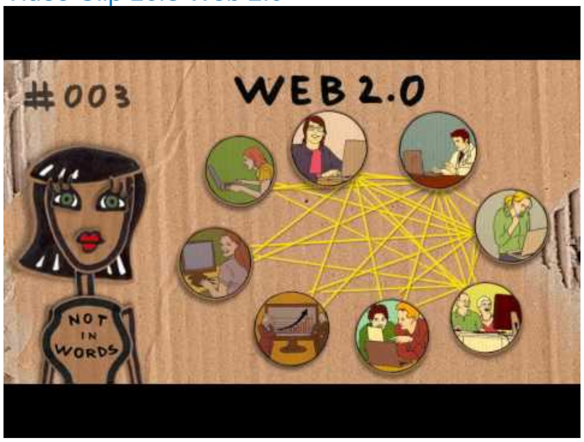
Web 2.0 is about having a conversation with your customers. This is very different from **Web 1.0**, where websites were static and all you could do was read. Web 2.0 sites are collaborative and interactive. The small business that creates a site that engages and interacts with people, that makes people want to stick around, will be giving people more of a chance to create a connection with the business.[124] These closer ties will increase customer awareness and consideration of the company's products and services, improve customer satisfaction, increase the chances of loyalty, increase the chances for sales, and add to the bottom line. There will also be significant benefits realized between the small business and its suppliers and partners: lowering the costs of communication and doing business.

A much smaller percentage of small businesses have adopted elements of Web 2.0 as compared to large enterprises and midsize companies.[125] However, many small businesses are using Web 2.0 in a variety of positive ways.[126]

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

As Web 2.0 keeps evolving, the value and opportunities it will bring to small businesses will continue to grow. “The increased flow of two-way information between business and customer, the increase in information distribution through blogs and wikis, and the increased participation of customers in product improvement and even design will continue. By adopting Web 2.0 technologies and tools, small businesses can improve market share, profit, and reputation, now and in the future.”[127]

Video Clip 16.8 Web 2.0



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Evolution of website technology to Web 2.0.

Key Takeaways

- E-commerce platforms make it possible for businesses to sell online. The all-in-one platform solution has become more popular with online merchants. There are many platforms that are tailored specifically for small and medium-sized businesses.
- Small businesses should think about CRM. CRM solutions are now available for even the smallest of businesses.
- Even though m-commerce is lagging behind other mobile uses, wireless devices and m-commerce are expected to create another revolution in e-commerce.
- Web 2.0 is important. It is about having a conversation with your customers. Small businesses need to learn about it and strongly consider incorporating it into their e-commerce strategies.
- Web 2.0 keeps evolving, so the value and opportunities it will bring to small businesses will continue to grow.

Exercises

1. Select three small business websites. Identify the features that are examples of Web 2.0.
2. Find three CRM solutions (software products) online that are geared to small businesses. Compare the features. If you owned a small business, which one would you choose? Why?

The Three Threads

Learning Objectives

1. Explain how e-business and e-commerce contribute to customer value.
2. Explain how e-business and e-commerce can benefit a company’s cash flow.
3. Explain why e-business and e-commerce are becoming increasingly necessary for small business survival.

Customer Value Implications

E-business in general and e-commerce in particular can both contribute to increased customer value. In the case of e-business, moving operations to digital technology can improve productivity, reduce or eliminate duplicative processes, streamline supply chain management and enterprise resource planning, improve customer and vendor relationships, improve business intelligence, increase and improve internal collaboration while doing the same with external business partners. In all instances, the customer, the vendor, and the business partner should realize increased value from doing business with the company in terms of greater efficiency, speed of information flows and transactions, and overall satisfaction.

In the case of e-commerce, customer value is provided via convenience, a greater selection of products, the ability to easily compare prices and services, 24/7 availability, privacy protection, multiple payment options, and reliable order fulfillment processes. Web 2.0, in particular, presents "consumers with a whole array of options in searching for value products and services and finding exactly what they need and want with minimum efforts, in line with the current customer desire for personalization, individual approach and empowerment." [128]

Cash-Flow Implications

The cash flow of a small business should benefit from all the sources of value just mentioned because they should result in lower operating costs, improved customer relationships, and higher sales. In particular, cash flow should increase as a result of the following:

- Prepaid purchases by business-to-business (B2B) customers. This may apply to other e-commerce customers as well.
- Multiple payment options. The greater the number of options, the higher the number of sales and the higher the average order size.
- Lower costs of sales as a result of the reduced need for telephone, travel expenses, and live salespeople.
- Eliminating many steps in business processes and cutting out the middlemen. [129]
- Saving money on employees and salaries because of **customer outsourcing** (i.e., anything that the customer does individually, things like searching for product or service information, entering his or her billing information, and signing up for an e-mail confirmation. These are things that customer service representatives do not have to do.[130]
- Increased sales as a result of selling niche products. "It turns out that most small businesses (and start-ups) have relatively niche-y products…The Internet disproportionately favors small businesses since it enables them to position their niche goods to people *shopping for* that particular niche good."[131]

This is not an exhaustive list. However, it is illustrative of the many ways in which e-business and e-commerce can impact the cash flow of a small business in a favorable way.

Digital Technology and E-Environment Implications

Although not all small businesses may choose to go the route of digital technology and the e-environment (e-business and e-commerce), it has been advised on many fronts that small businesses seriously consider creative ways in which to incorporate them all into their operations. Digital technology is difficult to avoid, whether it be computers, smartphones, or iPads. Even on a small scale, digital technology can help improve business processes and keep costs down.

The importance of e-business and e-commerce to small business has been the focus of this chapter. Realistically, neither can be avoided by small businesses that want to grow. E-commerce in particular has opened up the world to small business. Websites have "created a flattening effect in the sense that small businesses and large businesses [are] suddenly on a level playing field…The web [allows] small companies to have the same reach as a large firm. A small company's web site [can] be viewed a million times just as easily as a large firm's web site, and that information [is] available worldwide, 24 hours a day. Small businesses [can] now have some of the same abilities as large companies to reach customers with rich content of information about their products nationally or internationally."[132] The small business that wants to grow will ignore e-business and e-commerce at its peril.

Key Takeaways

- E-business and e-commerce both contribute to increased customer value.
- The cash flow of a small business should benefit from the customer value offered by e-business and e-commerce.
- Even though some small businesses may choose not to go the route of digital technology, e-business, or e-commerce, it has been suggested that small businesses seriously consider creative ways in which to incorporate them into all operations.

Exercises

1. Select three small businesses that engage in e-commerce. Interview the owners and ask them to describe (1) how e-commerce has added customer value and (2) the positive and negative impacts on cash flow.

2. Locate at least one small business that is a nonemployer (i.e., consists of only the owner). Interview the owner about the role that digital technology plays in the business and what his or her plans are, if any, to increase its incorporation. Find out if the business has a website. If it does, are there plans to engage in e-commerce? If the business does not have a website, find out why not and whether there are any plans to create one.

Disaster Watch – I've Been Hacked

I've Been Hacked!

Not discouraged by the bad economy, Marnie McCormick opened "The Country Store" in the local shopping center. McCormick had done her homework. She originally leased the store front for a temporary stint, selling a line of unique handcrafted products and locally made foods while asking people what sort of products they wished were available in the area. In this way, she was able to build the kind of store that was needed, using the existing demand to decide what kinds of products she would offer.

McCormick had a myriad of concerns at start-up—inventory, suppliers, marketing, outfitting the store, and administrative systems. What she did not know was that someone had hacked into her computer system. From somewhere unknown, the hard drive of her computer in the store had been hacked. The hackers had downloaded a key-logging program (a virus that makes it possible for the hacker to record all your keystrokes, gaining access to passwords and other sensitive information). The hackers were able to see everything that she typed into the computer: e-mails, communications with vendors and customers, passwords—everything. The hackers only had to wait until she logged into her online bank account before they had all the information they needed for the payoff. She soon discovered that someone had been in her bank account, transferring money at will. The hackers had changed the password. The system crashed immediately.

As soon as she had opened the doors to her new store, McCormick had to close them. What should she do to get her store up and running again? How can she prevent this from happening in the future?[133]

Vermont Teddy Bear Company

Source: Used with permission from Vermont Teddy Bear.

In 1980, John Sortino got the idea for making teddy bears. He was playing with his young son, Graham, and noticed that none of Graham's 38 stuffed animals was made in the United States. This inspired John to make a teddy bear for Graham—named Bearcho. John then went on to make others, falling in love with the idea of making them by hand. Bearcho was soon followed by Buffy, Bearazar, and Fuzzy Wuzzy, all made in his wife's sewing room. By 1983, John was selling his bears from a gift cart at an open-air market in Burlington, Vermont. The sale of his first bear took 4 days, and it took 1 year to sell 200 bears.[134]; [135] Today, the Vermont Teddy Bear Company produces about 300,000 bears a year.

The Vermont Teddy Bear Company has tapped into America's long-standing love affair with teddy bears by creating a wide variety of customized teddy bears and shipping them to customers via the well-recognized Bear-Gram, "…a customized bear placed in a colorful box with an air hole and game printed on the inside, and enclosed with a personalized greeting and candy treat."[136] The company has experienced many changes, including John's departure in 1995 to pursue other interests and the addition of Pajamagram and Calyx Flowers as additional unique brands, but the Vermont Teddy Bear Company remains a household name and a Vermont icon.

Jay Bruns, vice president of branding, talks about the importance of knowing how to present the product so the company can grow further. Right now, a Vermont Teddy Bear is a unique gift item that promises quality for life, but the dynamics of gifting have changed. Same day or overnight delivery is not special anymore, so a Vermont Teddy Bear must offer something more than convenience. It needs to be a "go-to" gift of choice rather than an emergency or "last-minute" gift. This requires presenting the product as fresh and special.Telephone interview with Jay Bruns, vice president of branding, Vermont Teddy

Bear Company, March 9, 2012. E-commerce is an integral part of Vermont Teddy Bear's marketing strategy, with online sales accounting for more than one-half of its total sales. The company saw the growth in online buying and launched its website in October 1996 in an effort to reach the online consumer base. Elisabeth Robert, the CEO at the time, saw the potential synergy between radio and the Internet and used the power of the company's radio advertising "…to direct customers to the company's website where they could actually see the bears they were ordering."[137]

Victor Castro, director of e-commerce, describes the company's e-commerce strategy as direct marketing with a focus on easy ordering and the customer being able to interact with the brand. Convenience has become even more convenient, and the Vermont Teddy Bear Company makes things simple. As the consumer becomes more proficient online, it will be necessary to communicate properly what the Vermont Teddy Bear gift is all about (i.e., the experience of owning the bear). Castro says that the company has been very successful at that. However, the company's e-commerce strategy must evolve with changes in the online customer.[138]

To learn more about the Bear-Gram, go to www.vermontteddybear.com/Static/Bear-Grams.aspx. To take the online factory tour, go to www.vermontteddybear.com/Static/tour-welcomestation.aspx.

Video Clip 16.9 PBS Curiosity Quest—Vermont Teddy Bear

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A tour of the Vermont Teddy Bear factory.

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CHAPTER OVERVIEW

6: Marketing

6.1: Chapter 17- Marketing Strategy

Learning Objectives

1. Understand how marketing for small businesses differs from marketing for big businesses.
2. Understand the most significant risk factor facing small businesses.
3. Explain marketing strategy and why it is so important for small businesses.

Small-business marketing and big business marketing are not the same. The basic marketing principles that guide both are the same, but there are important differences with respect to scope, budget, risk factors, and areas of opportunity.[1][2] Small businesses cannot compete with the marketing budgets of big companies. As a result, small businesses do not have the luxury of large staffs and the staying power that comes with high profits. There is little room for error. Failed strategies can lead to ruin.

The scope of small business marketing does not extend across the same level of multiple products and services that characterize most big businesses. Combined with having few if any products in the pipeline, this significantly reduces the insulation that small businesses have against ups and downs in the marketplace or strategic failures. “Small business marketing strategies have to be more targeted, cost-effective and more elaborately planned [s]o as to minimize the losses in case the strategy fails.”[3]

Competition is the most significant risk factor facing small businesses. Trying to eliminate an established brand takes a lot of work, but it is an overnight job to wipe out a small business. Competition is a huge threat for small businesses.[4] This means that small businesses should be very knowledgeable about their competition to deal effectively with them.

Opportunity areas for small businesses are also very different from those of big businesses. The small business can take advantage of niche markets and local needs and wants. They are much better able to emphasize personal, one-to-one interactions and can market real time in ways that cannot be matched by big businesses. Smaller can actually end up being more powerful.[5]

Given the special marketing vulnerabilities of small businesses, the importance of understanding the components of a **marketing strategy** —all within the context of marketing objectives, should be clear. A marketing strategy involves selecting one or more target markets, deciding how to differentiate and position the product or the service, and creating and maintaining a marketing mix that will hopefully prove successful with the selected target market(s)—all within the context of **marketing objectives**. Marketing objectives are what a company wants to accomplish with its marketing strategy: “Strategy is not a wish list, set of goals, mission statement, or litany of objectives…A marketing strategy is a clear explanation of how you’re going to get there, not where or what there is. An effective marketing strategy is a concise explanation of your stated plan of execution to reach your objectives…Marketing without strategy is the noise before failure.”[6]

Key Takeaways

- Small-business marketing and big business marketing are not the same.
- The most significant risk factor facing small businesses is competition.
- It is important for a small business to have a marketing strategy so that it is better positioned to choose among options.
- An effective marketing strategy is a concise explanation of a business’s stated plan of execution to reach its objectives.
- Marketing without strategy is the noise before the failure.

Exercises

1. You just started a new job with a twenty-five-employee small business. By accident, you found out that the company does not have a clear marketing strategy. So far, the company has been lucky with its product sales, but you have a feeling that things will not continue at the same pace for much longer because a competitor has entered the marketplace. Assuming that you had the opportunity, how would you go about convincing the owner that the smart thing to do right now is to create a marketing strategy? Make the case to the owner.

The Marketing Strategy Process

Learning Objectives

1. Describe the marketing strategy process.
2. Explain why segmentation, target market, differentiation, positioning, and website decisions are so important for the small business.
3. Describe the marketing strategy decision areas for each element of the marketing mix.

The focus of this text is on the management of the small business that is up and running as opposed to a start-up operation. As a result, the considerations of marketing strategy are twofold:

1. to modify or tweak marketing efforts already in place and
2. to add products or services as the business evolves. In some instances, it may be appropriate and desirable for a small business to backfit its marketing activities into a complete marketing strategy framework.

The marketing strategy process consists of several components (Figure 17.1 “Marketing Strategy Process”). Each component should be considered and designed carefully: company vision, company mission, marketing objectives, and the marketing strategy itself.

Figure 17.1 Marketing Strategy Process

Source: [7][8]

Vision and Mission

It is awfully important to know what is and what is not your business.[9]

-Gertrude Stein

The **vision statement** tries to articulate the long-term purpose and idealized notion of what a business hopes to become. (Where do we see the business going?) It should coincide with the founder's goals for the business, stating what the founder ultimately envisions the business to be.[10] The **mission statement** looks to articulate the more fundamental nature of a business (i.e. why the business exists?). It should be developed from the customer's perspective, be consistent with the vision, and answer three questions: What do we do? How do we do it? And for whom do we do it?

Both the vision statement and the mission statement must be developed carefully because they "provide direction for a new or small firm, without which it is difficult to develop a cohesive plan. In turn, this allows the firm to pursue activities that lead the organization forward and avoid devoting resources to activities that do not."[11] Although input may be sought from others, the ultimate responsibility for the company vision and mission statements rests with the small business owner. The following are examples of both statements:

- **Vision statement.** "Within the next five years, Metromanage.com will become a leading provider of management software to North American small businesses by providing customizable, user-friendly software scaled to small business needs."[12]
- **Mission statement.** "Studio67 is a great place to eat, combining an intriguing atmosphere with excellent, interesting food that is also very good for the people who eat there. We want fair profit for the owners and a rewarding place to work for the employees." [13]

Marketing Objectives

Marketing objectives are what a company wants to accomplish with its marketing. They lay the groundwork for formulating the marketing strategy. Although formulated in a variety of ways, their achievement should lead to sales. The creation of marketing objectives is one of the most critical steps a business will take. The company needs to know, as precisely as possible, what it wants to achieve before allocating any resources to the marketing effort.

Marketing objectives should be SMART: specific, measurable, achievable, realistic, and time-based (i.e., have a stated time frame for achievement). It has been recommended that small businesses limit the number of objectives to a maximum of three or four. If you have fewer than two objectives, you aren't growing your business like you should be in order to keep up with the market. Having more than four objectives will divide your attention, and this may result in a lackluster showing on each objective and no big successes. [14] If a small business has multiple marketing objectives, they will have to be evaluated to ensure that they do not conflict with each other. The company should also determine if it has the resources necessary to accomplish all its objectives.[15]

For small businesses that already have, or are looking to have, a web presence and sell their products or services online, e-marketing objectives must be included with all other marketing objectives. E-marketing is defined as "the result of information technology applied to traditional marketing."[16] The issues of concern and focus will be the same as for traditional marketing objectives. The difference is in the venue (i.e., online versus onground). Examples of e-marketing objectives are as follows: to establish a direct source of revenue from orders or advertising space; improve sales by building an image for the company's product, brand, and/or company; lower operating costs; [17] provide a strong positive customer experience; and contribute to brand loyalty. The ultimate objective, however, will be "the comprehensive integration of e-marketing and traditional marketing to create seamless strategies and tactics."[18]

The Marketing Strategy

With its focus being on achieving the marketing objectives, marketing strategy involves segmenting the market and selecting a target or targets, making differentiation and positioning decisions, and designing the marketing mix. The design of the product (one of the four Ps) will include design of the company website. Differentiation refers to a company's efforts to set its product or service apart from the competition, and positioning is placing the brand (whether store, product, or service) in the consumer's mind in relation to other competing products based on product traits and benefits that are relevant to the consumer.[19] It has been said that "in some cases strategy just happens because a market and a product find each other and grow organically. However, small businesses that understand the power of an overarching marketing strategy, filtered and infused in every tactical process, will usually enjoy greater success."[20]

Key Takeaways

- The marketing strategy process consists of company vision, company mission, marketing objectives, and the marketing strategy itself.
- The company vision: Where do we see the business going?
- The company mission: Why does our business exist?

- Marketing objectives: What do we want to accomplish with our marketing strategy?
- Marketing strategy: How will we accomplish our marketing objectives?
- Marketing objectives should be SMART: specific, measurable, achievable, realistic, and time-based (i.e., have a specific time frame for accomplishment).
- Small businesses should limit the number of objectives to three or four to increase the chances that they will be achieved.
- E-marketing objectives must be included with traditional marketing objectives.
- E-marketing and traditional marketing should be integrated to create seamless marketing strategies and tactics.
- Marketing strategy involves segmenting the market, selecting a target or targets, making differentiation and positioning decisions, and designing the marketing mix. The design of the product will include design of the company website.

Exercises

1. Develop the marketing objectives for The Mill restaurant in New Glasgow, PEI.
2. Explain the differences between an onground marketing strategy and an online marketing strategy.

Segmentation and the Target Market

Learning Objectives

1. Explain segmentation and the target market.
2. Explain why segmentation, the target market, differentiation, positioning, and website decisions are so important for a small business.
3. Describe the marketing strategy decision areas for each element of the marketing mix.

Whether market segments and target markets are selected on the basis of intuition, marketing research, or a combination of the two, they are the basis for creating an effective marketing mix for any small business. Segmentation and target market decisions must be made for both onground and online customers.

Segmentation

Market segmentation dividing a market into relatively homogeneous subgroups that behave much the same way in the marketplace, is the necessary precursor to selecting a target market or target markets. The challenge is knowing which group(s) to select. Many small business owners have a good intuitive sense of the segments that make sense for the business, and they choose to go with that intuition in devising their marketing strategy. However, that intuition may not be precise or current enough to be of the most help in planning a marketing strategy. Marketing research can be of help here, even to the smallest of businesses.

Table 17.1 Market Segmentation

Consumer Segmentation Examples	Business Segmentation Examples
Geographic Segmentation • Region (e.g., Northeast or Southwest) • City or metro size (small, medium, or large) • Density (urban, suburban, or rural) • Climate (northern or southern)	**Demographic Segmentation** • The industry or industries to be served • The company sizes to be served (revenue, number of employees, and number of locations)
Demographic Segmentation • Age • Family size • Family life cycle (e.g., single or married without kids) • Gender • Income • Occupation • Education • Religion • Race/ethnicity • Generation • Nationality • Social class	**Operating Variables** • The customer technologies to be focused on • The users that should be served (heavy, light, medium, or nonusers) • Whether customers needing many or few services should be served
Psychographic Segmentation • Personality • Lifestyle • Behavioral occasions (regular or special occasion) • Values	**Purchasing Approaches: Which to Choose?** • Highly centralized versus decentralized purchasing • Engineering dominated, financially dominated, and so forth • Companies with whom a strong relationship exists or the most desirable companies • Companies that prefer leasing, service contracts, systems purchases, or sealed bidding • Companies seeking quality, service, and price
Behavioral Segmentation • Benefits of the product (e.g., toothpaste with tartar control) • User status (nonuser, regular user, or first-time user) • Usage rate (light user, medium user, or heavy user) • Loyalty status (none, medium, or absolute) • Attitude toward the product (e.g., enthusiastic or hostile)	**Situational Factors: Which to Choose?** • Companies that need quick and sudden delivery or service • Certain application of the product instead of all applications • Large or small orders or something in-between
Personal Characteristics: Which to Choose? • Companies with similar people and values • Risk-taking or risk-aversive customers • Companies that show high loyalty to their suppliers	**Other Characteristics** • Status in industry (technology or revenue leader) • Need for customization (specialized computer systems)

Marketing research can help the small business identify and refine the segments that offer the greatest opportunities. Part of that process will be to identify segments that meet the requirements of **measurability**; ***substantiality***, ***stability***, ***accessibility***, ***actionability***, and ***differential response***.[21] Meeting these requirements will increase the chances for successful segmentation.

- **Measurability.** Is it easy to identify and estimate the size of a segment? A small business that moves forward without a clear definition of its market segments is working blind. Intuition can only go so far. Are there people who are interested in freshly baked cookies for dogs (it would seem so), and how many of these people are there? (Check out Happy Hearts Dog Cookies.)
- **Substantiality.** Is the segment large and profitable enough to justify an investment? A small business may not require a huge number of customers to be profitable, but there should be enough people interested in the product or the service being offered to make operating the business worthwhile. Fancy designer clothes for dogs, for example, is a business that can survive—but not everywhere (see www.ralphlauren.com/search/index.jsp?kw=pup&f=Home).
- **Stability.** Stability has to do with consumer preferences. Are they stable over time? Although segments will change over time, a small business needs to be aware of preferences that are continuously changing. Small businesses can be more nimble at adapting their businesses to change, but too much volatility can be damaging to a business's operations.
- **Accessibility.** Can a business communicate with and reach the segment? A small business interested in women who work outside the home will present greater communication challenges than will stay-at-home wives and mothers.
- **Actionability.** Is a small business capable of designing an effective marketing program that can serve the chosen market segment? There was a small manufacturer of low-priced cigarettes in Virginia that found it difficult to compete with the big brands and other established lower-priced brands such as Bailey's. The manufacturer's solution was to sell to Russia where "Made in Virginia, USA" worked very well with customers and retailers.[22]
- **Differential response.** The extent to which market segments are easily distinguishable from each other and respond differently to company marketing strategies.[23] For the small business that chooses only one segment, this is not an issue. However, the small manufacturer of ramen noodles in New York City needs to know whether there are different segments for the product and whether the marketing strategy will appeal to those segments in the same positive way.

Once multiple segments have been identified, it is necessary to select a target market or target markets. If only a single segment has been identified, it becomes the target market.

Target Market

The selection of a **target market** or target markets will be based on the segments that have been identified as having the greatest potential for the business. A *target market* refers to one or more segments that have been chosen as the focus for business operations. Only some of the people in the marketplace will be interested in buying and/or using a company's product or service, and no company has the resources to be all things to all people. Resources are always finite, but this will especially be the case for the small business, so all marketing efforts should be directed as precisely as possible.

Selecting the target market should be guided by several considerations:[24]

- **Financial condition of the firm.** Limited resources may dictate the selection of only one target market.
- **Whether the competition is ignoring smaller segments.** If yes, this may be a ready-made target market.
- **Is the market new to the firm?** If yes, concentrating on one target market may make the most sense.
- **Specific need or want.** Does the proposed target market have a specific need or want for the product or the service?
- **Ability to buy.** Does the proposed target market have the resources to buy the product or the service?
- **Willingness to buy.** Is the proposed target market willing to buy the product or the service?
- **Will this target market be profitable?** There needs to be enough demand to make money.

Choosing the right target market is a critical part of the marketing strategy of a small business. The target market should be the best match for a company's products and services, thus helping to maximize the efficiency and effectiveness of its marketing efforts.

If a small business wants to go with a niche market, the same considerations apply. A niche market is a small, more narrowly defined market that is not being served well or at all by mainstream product or service marketers. The great advantage of pursuing a niche market is that you are likely to be alone there: "other small businesses may not be aware of your particular niche market, and large businesses won't want to bother with it."[25] Ideally, a small business marketing to a niche market will be the only one doing so. Niches are very important to small businesses that want to sell pricey chocolates (see, for example, www.cocoadolce.com/about.php). They focus on niches such as weddings, seasonal offerings, and specialty items. They also sell online in order to reach a broader market.

Key Takeaways

- Market segments and target markets are the basis for creating an effective marketing mix.
- Segmentation and target market decisions must be made for both onground and online customers.
- Market segmentation precedes the selection of a target market.
- There are many ways to segment a market.
- Segments must be measurable, substantial, stable, accessible, actionable, and easily distinguishable from other segments.
- The target market should be the segment or segments that show the greatest profit potential for a small business.
- A niche market is a small, more narrowly defined target market that is not being served well or at all by other businesses.

Exercises

1. How should the market for The Mill's restaurant be segmented for his new restaurant in Summerside, PEI? How should Frank decide on a target market or target market(s)? Be specific. Do not assume that the Summerside market is the same as the New Glasgow market.
2. Assume that you work for a small manufacturer of children's hair-care products. What criteria would you use for effective segmentation? How would you then decide on a target market or target markets?

Differentiation and Positioning

Learning Objectives

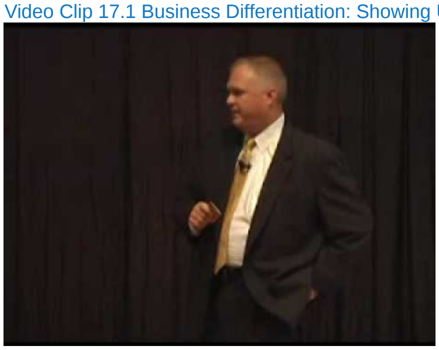
1. Explain differentiation and positioning.
2. Explain why differentiation and positioning are so important for an online marketing strategy and an onground marketing strategy.
3. Understand that a successful differentiation strategy cannot be copied by competitors.
4. Understand that there are many ways to differentiate a product or a service.
5. Understand that successful positioning of a small business or its brand is built on a well-defined target market combined with solid points of differentiation.

Differentiation and positioning considerations are relevant to each element of the marketing mix as well as to onground and online marketplaces. The small business should be working toward a **competitive advantage**— "The ability to perform in one or more ways that competitors cannot or will not match."[26]

Differentiation

Differentiation, setting yourself apart from the competition, is one of the most important and effective marketing tools available to small business owners.[27] Effective differentiation can put a business (or a brand) in the top position among the competition, but an ineffective differentiation strategy can leave a business buried in the middle or at the bottom of the pack.[28] A successful differentiation strategy cannot be imitated by competitors—but it can bring you great success with consumers.[29]

Video Clip 17.1 Business Differentiation: Showing Up Differently



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

Small businesses, whether business-to-consumer (B2C) or business-to-business (B2B), can differentiate their companies or brands in many different ways: quality, service, price, distribution, perceived customer value, durability, convenience, warranty, financing, range of products/services offered, accessibility, production method(s), reliability, familiarity, product ingredients, and company image are all differentiation possibilities.[30] There are others as well, limited only by the imagination. One way to uncover differentiation possibilities is to examine customer experience with a product or a service by asking the following questions:[31]

- How do people become aware of their needs for a product or a service?
- How do customers find a company's offering?
- How do customers make their final selection?
- How do consumers order and purchase the product or the service?
- What happens when the product or the service is delivered?
- How is the product installed?
- How is the product or the service paid for?
- How is the product stored?
- How is the product moved around?
- What is the consumer really using the product for?
- What do consumers need help with when they use the product?
- What about returns or exchanges?
- How is the product repaired or serviced?
- What happens when the product is disposed of or no longer used?

No matter what the bases are for differentiating a company or a product, the decision should be made carefully with the expectation that the difference cannot be imitated. When customers are asked whether they can tell the difference between a particular small business and its closest competitors, the answer will hopefully be yes.

Video Clip 17.2 The "Murals Your Way" Advantage

https://www.youtube.com/watch?v=mQgSi9KPLSY

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

Video Link 17.1 Bedbug Dog Sniffs Up Profits. An unusual means of differentiation.

http://money.cnn.com/video/smallbusiness/2010/08/13/sbiz_bedbug_canine.cnnmoney

https://www.orkincanada.ca/blog/k9-bed-bug-detection/

Positioning

Positioning is about the mind of the consumer: placing a company or a brand (sometimes they are the same, e.g., Carbonite, CakeLove, and Sugar Bakery & Sweet Shop) in the consumer's mind in relation to the competition.[32]

The positioning decision is often the critical strategic decision for a company or a brand because the position can be central to customers' perception and choice decisions. Further, because all elements of the marketing program can potentially affect the position, it is usually necessary to use a positioning strategy as a focus for developing the marketing program. A clear positioning strategy can ensure that the elements of the marketing program are consistent and supportive.[33]

Both big and small businesses practice positioning, but small businesses may not know it as positioning. The small business owner thinks about positioning intuitively, does not use the terminology, and does not always know how to promote the position. Additionally, in many if not most small businesses, "the positioning of products is based on the opinions of the business owner, his or her family, and selected friends and family."[34] This notwithstanding, an understanding of positioning should be in every small business owner's tool kit.

Video Clip 17.3 Small-Business Market Position

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

Video Clip 17.4 What Is Market Positioning?

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A discussion of positioning.

Successful positioning of a small business or its brand is built on a well-defined target market combined with solid points of differentiation. There are six approaches to positioning that the small business owner should consider:[35]

1. **Positioning by attribute.** The most frequent positioning strategy. The focus is on a particular attribute, a product feature, or customer benefit. CakeLove in Maryland positions itself as "cakes from scratch" with natural ingredients (not the least of which is butter, lots of it).

Video Link 17.2 Welcome to CakeLove

An introduction to CakeLove bakery.

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2. **Positioning by price/quality.** A very pervasive approach to positioning. Some small companies and brands offer more in terms of service, features, or performance, and a higher price serves to signal this higher quality to the customer. As an example, Derry Church Artisan Chocolates are very expensive, but they position themselves as having the very high quality that justifies a high price.[36]
3. **Positioning by use or application.** Focuses on how a product is used or different applications of the product. A solitary custom tailoring shop located in a downtown professional office area could position itself as the only tailor where you can conveniently go "for lunch."
4. **Positioning by product user.** The focus shifts from the product to the user. KIND Snacks are cereal bars positioned as a snack bar for those who are interested in a snack that is wholesome, convenient, tasty, healthy, and "economically sustainable and socially impactful."[37] It is a great snack for hikers and campers.
5. **Positioning by product class.** Focuses on product-class associations. A cleaning service that uses only green products and processes can position itself as the green choice in cleaning services. Healthy Homes Cleaning is an example of a green cleaning business.
6. **Positioning with respect to a competitor.** Comparing a small business brand to its competitors. Some comparisons will be very direct; others will be subtle.[38] A small manufacturer that does not miss delivery times and makes products that are free of flaws can position itself on the basis of timely delivery and manufacturing excellence.[39]

Joe's Redhots' Business Positioning Strategy

Joe's Redhots will sell premium-quality hot dogs and other ready-to-eat luncheon products to upscale business people in high-traffic urban locations. *Joe's Redhots* will be positioned versus other luncheon street vendors as "the best place to have a quick lunch." The reasons are that *Joe's Redhots* have the cleanest carts; the most hygienic servers; the purest, freshest products; and the best value. Prices will be at a slight premium to reflect this superior vending service. *Joe's Redhots* will also be known for its fun and promotional personality, offering consumers something special every week for monetary savings and fun.[40]

The challenge for a small business is to decide which approach to positioning a company or a brand is the best fit. This decision "often means selecting those associations which are to be built upon and emphasized and those associations which are to be removed or de-emphasized."[41] In the process of writing a positioning statement, something that is encouraged as a way to keep the business on track, be aware of the difference between a broad positioning statement and a narrow positioning statement. A broad statement should encompass enough to allow a company to add products without the need to create a new positioning statement on a frequent basis; a narrow positioning statement puts a company in a "specialist" position in its market.[42] The following are some examples:

- **Broad position statement.** "Professional money management services for discerning investors"
- **Narrow position statement.** "Equity strategies for low risk investors"
- **Broad position statement.** "Elegant home furnishings at affordable prices"
- **Narrow position statement.** "Oak furniture for every room in your house"[43]

Key Takeaways

- Differentiation and positioning considerations are relevant to each element of the marketing mix as well as the onground and online marketplaces.
- Differentiation and positioning can contribute to the competitive advantage of a small business.
- Differentiation is one of the most important and effective marketing tools available to a small business owner.
- Small businesses, both B2B and B2C, can differentiate their companies or brands in many different ways.
- Ideally, differentiation should be done in a way that cannot be imitated by the competition.
- Positioning is about placing a company or a brand in the mind of the consumer in relation to the competition. It is always comparative.
- Small businesses practice positioning as much as larger companies do, but they may not use the terminology.
- All small business owners should understand what positioning is and how they can use it to their advantage.

Exercises

1. Although The Mill has a very loyal following in New Glasgow, PEI, developing a marketing plan and strategy for the Summerside store will require specific statements of differentiation and positioning. What should they be? Remember that the New Glasgow market may be similar to the Summerside market, but the two markets should not be seen as identical.
2. Continuing with the scenario about the small manufacturer of hair-care products for children, how would you differentiate and position the product for competitive advantage?

Marketing Strategy and Product

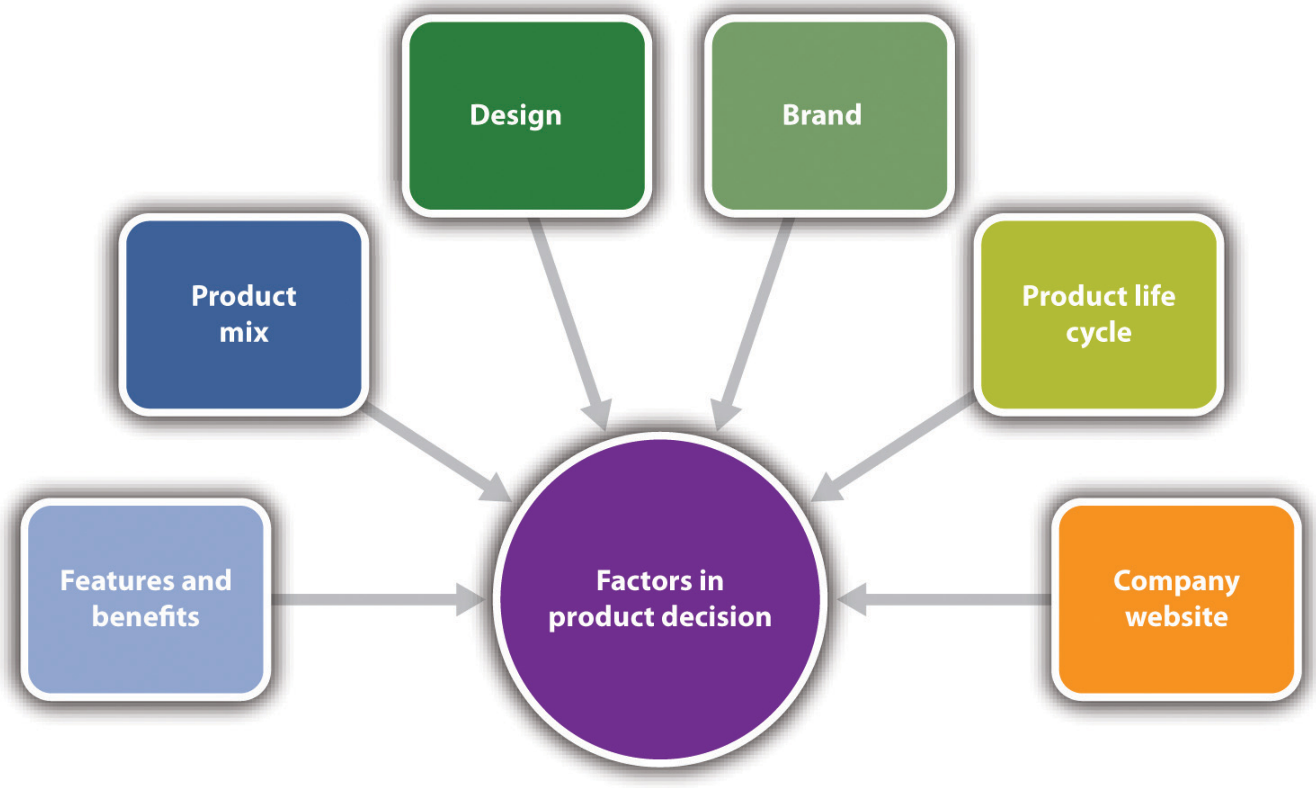
Learning Objectives

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

The key element in the marketing mix is the product. Without it, price, promotion, and place are moot. The same is true for marketing strategy. Fulfilling a company's vision and mission and achieving its marketing objectives must be led by the product.

There are multiple decisions and considerations that factor into product or service development: features and benefits, product mix, design, brand, the product life cycle, and the company website. Knowing product development issues can be very helpful for even the smallest business that is looking to keep its current product line responsive to the customers while also looking to expand its product line as the company grows (if growth is desired).

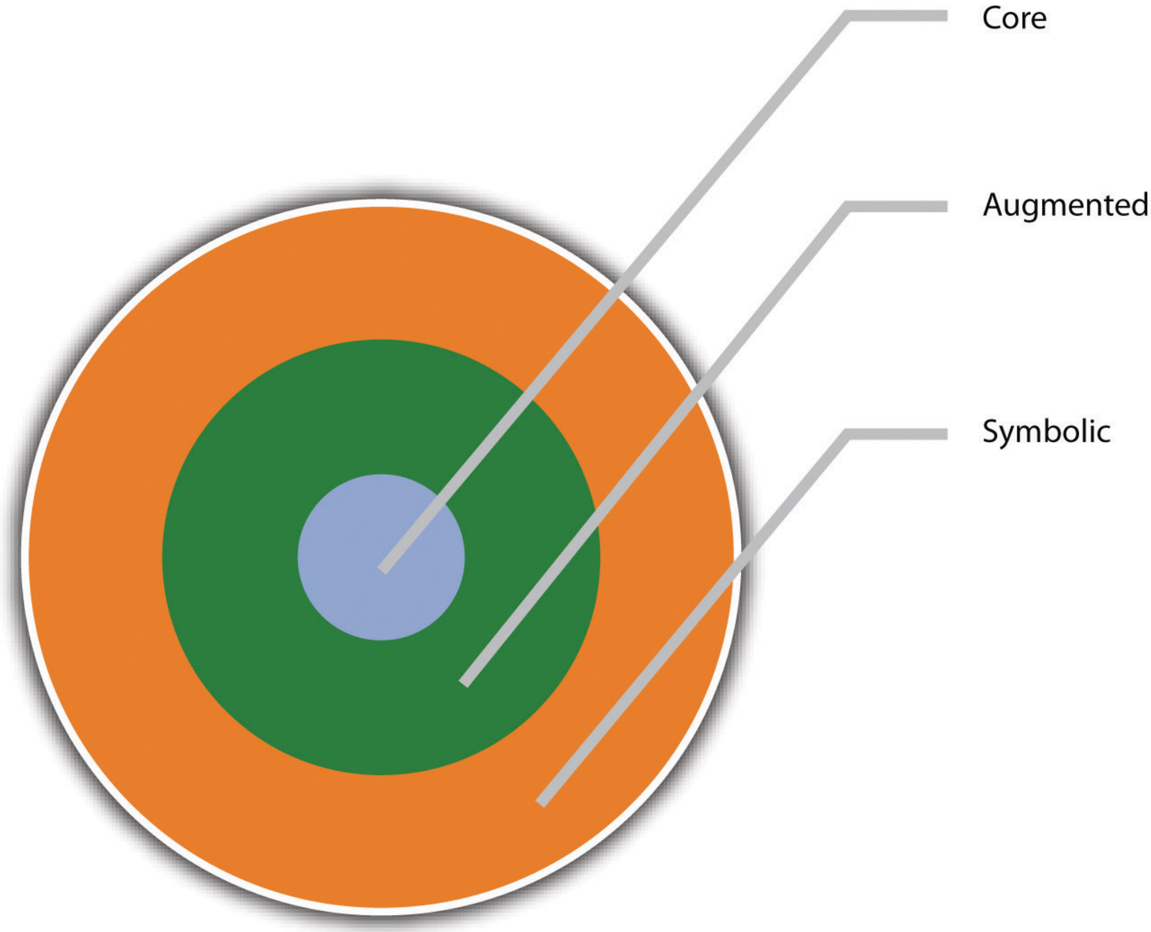
Figure 17.2 Factors in Product or Service Decisions



Product Features and Benefits

A product has multiple layers: core, augmented, and symbolic. These three layers can help a small business owner understand the product features and benefits that will best deliver value to current and prospective customers. These layers also provide the bases for differentiating and positioning the product. The product layers refer to both products and services and business-to-consumer (B2C) or business-to-business (B2B) customers.

Figure 17.3 The Product Layers



The ***core layer*** is the nuts and bolts of a product, its physical anatomy, and its basic features. It is also the basic benefit or problem solution that B2C or B2B customers are looking for. Someone buying an airline ticket, for example, is buying transportation.[44] Someone buying an ice cream cone is buying a delicious and fun treat. The core layer is also where considerations of ***quality*** begin. Quality "refers to overall product quality, reliability, and the extent to which [the product or the service] meets consumers' needs," and the perception of quality has the greatest impact on customer satisfaction.[45] Decisions about design, manufacturing, preparation, ingredients, service delivery, component parts, and process materials all reflect a business's philosophy about quality.

The ***augmented layer*** is where additional value is added via things such as packaging, promotion, warranties, guarantees, brand name, design, financing opportunities where appropriate, prompt and on-time service, and additional services that may enhance a product. The augmented layer for Southwest Airlines is its well-known brand name, its packaging and promotion as a "fun" flying experience, and its "bags fly free" policy. The ice cream cone that is purchased in an old-fashioned ice cream parlor will likely be considered of greater value to many customers than the ice cream cone purchased at a Dairy Queen. It is this layer where many marketing mistakes are made because opportunities are missed.

The ***symbolic layer*** captures the meaning of a product to a consumer—its emotional and psychological connections. There are many loyal customers of Southwest Airlines because they really enjoy flying with them. It is inexpensive, convenient, and fun. The old-fashioned ice cream parlor will engender nostalgia and create powerful emotional ties. The most serious marketing errors are made when the symbolic product layer is either ignored or not understood. The power of symbolism should never be underestimated.

Every small business should look at its products within the context of the product layers. It is the creativity and imagination of the small business owner with the product layers that can set a business apart. They provide an excellent basis for dissecting an existing product to see where opportunities may have been missed, features could be added or changed, and features or enhancements could be explained more effectively in promotional activities. The product layers should also be used to develop new products that the business plans to introduce.

Product Mix

All small businesses have a product mix, the selection of products or services that is offered to the marketplace. With respect to the product mix for small companies, a company will usually start out with a limited product mix. However, over time, a company may want to differentiate products or acquire new ones to enter new markets. A company can also sell existing products to new markets by coming up with new uses for its products.[46] No matter the approach, the product mix needs to be created so that it is responsive to the needs, wants, and desires of the small business's target market.

For small businesses engaged in e-marketing, product selection is a key element for online success. Part of the challenge is deciding which products to market online because some products sell better online than others.[47] If a business has a brick-and-mortar presence, a decision must be made whether all the inventory or only part of it will be sold online. Items that sell well online change over time, so it is important to keep up to date on the changes.[48] A second decision to be made is the number of items in the catalog (i.e., the number of items you will sell). Given intense online competition and shoppers' desires for good selections, there needs to be a critical mass of products and choices—unless a company is lucky enough to have a very narrow niche with high demand. If a company has only one or two products to sell, the situation should be evaluated to determine whether selling online will be profitable.[49]

Product Design

In his book, *Re-imagine! Business Excellence in a Disruptive Age,*[50] Tom Peters devotes two chapters to the importance of design to business success. He says that design is "the principal reason for emotional attachment (or detachment) relative to a product service or experience"—and he quotes Apple's CEO, Steve Jobs, in saying that design is the "fundamental soul of a man-made creation."[51] This is true whether the product comes from a big business or a small business.

Product design involves aesthetic properties such as color, shape, texture, and entire form, but it also includes a consideration of function, ergonomics, technology, and usability[52][53] as well as touch, taste, smell, sight, and sound. The pulling together of these things, as appropriate to the specific product or service being designed, should result in a design that matches customer expectations. "Design represents a basic, intrinsic value in all products and services."[54]

Design offers a powerful way to differentiate and position a company's products and services, often giving company a competitive edge.[55] Improved profit margins from increased sales and increased market share are often the result. It is essential to get the visual design of a product right for the market you are appealing to. It can make the difference between selling a product—or not.[56]

Design is particularly important in making and marketing retail services, apparel, packaged goods, and durable equipment. The designer must figure out how much to invest in form, feature development, performance, conformance, durability, reliability, repairability, and style. To the company, a well-designed product is one that is easy to manufacture and distribute. To the customer, a well-designed product is one that is pleasant to look at and easy to open, install, use, repair, and dispose of. The designer must take all these factors into account.

The arguments for good design are particularly compelling for smaller consumer products companies and start-ups that do not have big advertising dollars.[57]

Quirky.com is a small business that has taken product design to a whole new level: collaboration. First seen as a "bold but ultimately wild-eyed idea,"[58] Quirky recently secured $6 million in venture financing. A company like this could be very helpful to a small business that is looking to introduce a new product.

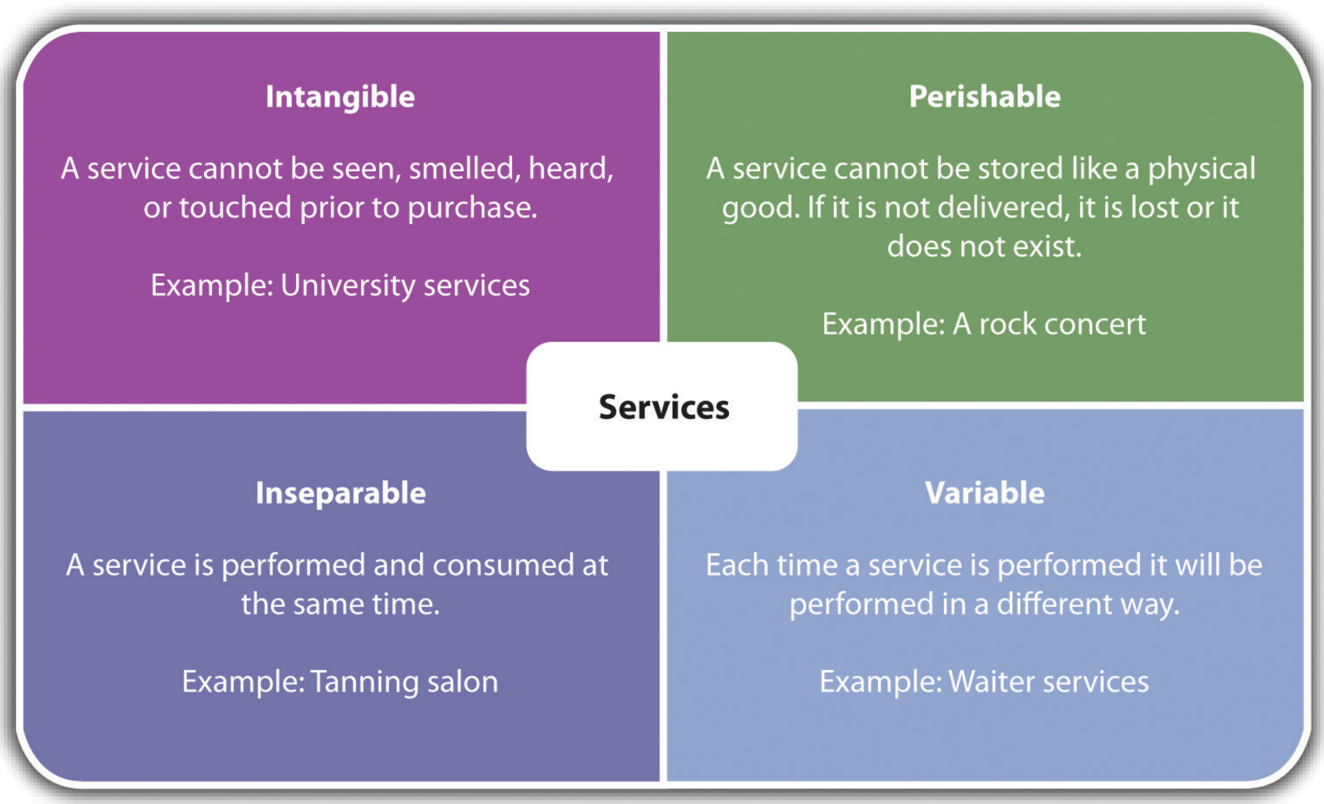
Video Clip 17.5 Quirky's Ben Kaufman on Innovation

https://youtube.com/watch?v=FFOvzxxQx8c

An innovative approach to product design: collaboration.

Design issues also apply to services. Some of the design issues for services that are delivered in a store (e.g., dry cleaning, repair, and restaurant) are the same as for any retail store: the design of the physical space, the appearance of the personnel, the helpfulness of the personnel, the ease of ordering, and the quality of service delivery. For services that are performed at a customer's home or at a business site, the design issues include timeliness; the appearance and helpfulness of personnel; the quality of installation, service, and repair; and the ease of ordering the service. The special characteristics of services (i.e., **intangibility**, ***perishability***, **inseparability**, and **variability**, as defined in Figure 17.4 "The Characteristics of Services") present design challenges that are different from those faced by physical products.

Figure 17.4 The Characteristics of Services



Source:[59]

Whether a small business is offering a product, a service, or a combination of the two to either the B2C or B2B marketplace, there is no question that excellent product design is a gateway to business success.

Packaging Design

The design of the product or the service package is another decision component of the product. ***Packaging*** can be defined as "all the activities of designing and producing the container for a product."[60] Packages "engage us consciously and unconsciously. They are physical structures but at the same time they are very much about illusion. They appeal to our emotions as well as to our reason."[61] Thus the package communicates both emotional and functional benefits to the buyer, and it can be a powerful means of product differentiation. A well-designed package can build brand equity and drive sales.[62] A poorly designed package can turn the customer off and can lead to wrap rage—the anger and frustration that results from not being able to readily access a product, which often leads to injuries. Although difficult-to-open packaging may be seen as necessary by the manufacturers and retailers, it does not do much for a positive customer experience.

Video Clip 17.6 Wrap Rage

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Wrap rage: what it is about, with examples.

Video Clip 17.7 Opening Plastic Clamshells with a Can Opener

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Plastic clamshell packages inspire wrap rage. They are easier to open if you start with a can opener.

Brand

A **brand** is defined by the American Marketing Association as "a name, term, sign, symbol, or design, or a combination of them, intended to identify the goods or services of one seller or group of sellers and to differentiate them from those of competitors…A brand may identify one item, a family of items, or all items of that seller. If used for the firm as a whole, the preferred term is trade name."[63] A brand is a promise to the consumer that certain expectations will be met, a promise that—if broken—may result in the loss of that customer. A company's brand is probably its most important asset.

Video Clip 17.8 A Brand Is More Than a Logo

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What a brand is all about.

Building a brand is an ongoing process for a small business because it wants a memorable identity. It is important for the business to constantly monitor its brand to ensure that it represents the core values and needs of its existing and potential customers.[64] The brand needs to reach people on an emotional level because customers ultimately make decisions on an emotional level, not a logical level.[65] For this reason, a small business should think in terms of tapping into as many senses as possible with its brand. "Almost our entire understanding of the world is experienced through our senses. Our senses are our link to memory and can tap right into emotion."[66] Scenting the air of a store with a fresh fragrance could be a powerful contributor to the store's brand.

Whether a small business wants to keep its brand (but may be monitoring it) or is looking to **rebrand**, there are four fundamental qualities of great brands that should be kept in mind:[67]

1. They offer and communicate a clear, relevant *customer promise*, such as fun, speedy delivery, or superior taste.
2. They *build trust* by delivering on that promise. Keeping a customer informed when something goes wrong can help build and retain trust.
3. They drive the market by *continually improving* the promise. A small business should always be looking to make things better for its customers. Think in terms of the total customer experience.
4. They seek further advantage by *innovating beyond the familiar*. If a small business focuses on the customer experience, there are undoubtedly ways to improve the brand by adding the unexpected.

The ultimate objective is to have a brand that delivers a clear message, is easy to pronounce, confirms a company's credibility, makes an emotional connection with the target market, motivates the buyer, and solidifies customer loyalty.[68][69]

Video Clip 17.9 Good Branding Will Build a Company

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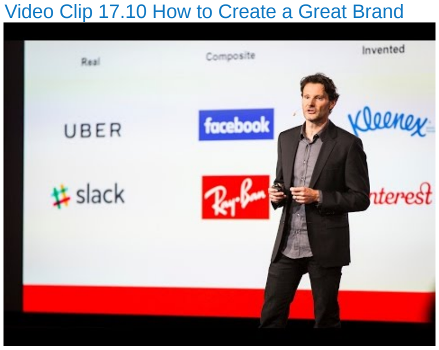
A strong branding and marketing strategy is an investment that will pay dividends for years to come.

Video Clip 17.10 How to Create a Great Brand



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

Video Clip 17.11 How to grow a small business

https://www.youtube.com/watch?v=D7tF-cY2M9o

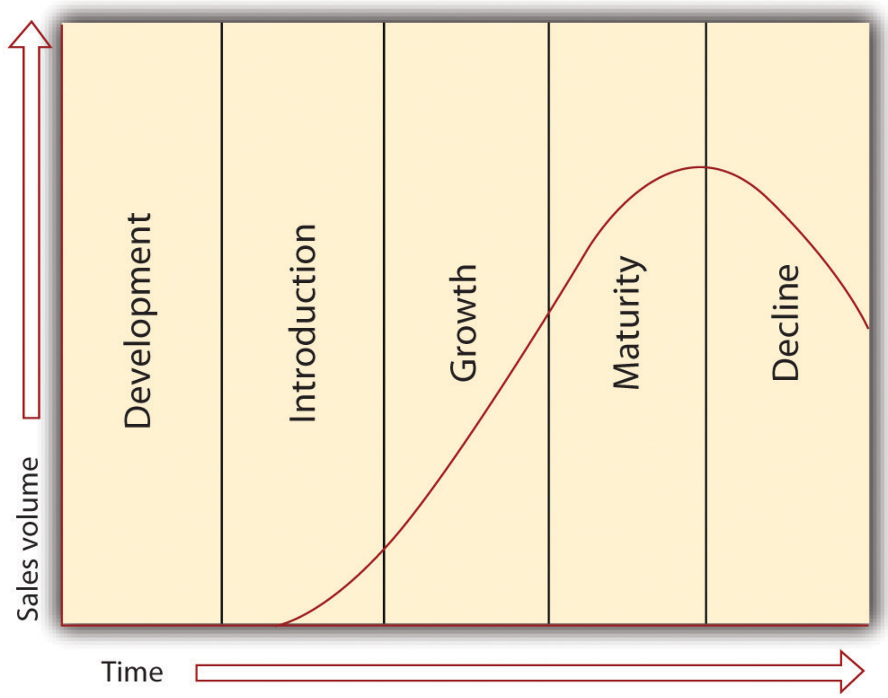
Jack Ma – Aliexpress.com; Alibaba Group

Product Life Cycle

Every product has a life span. Some are longer than others. The pet rock had a very short life span. The automobile is still going strong. Some products or services experience an early death, not able to make it very far out the door. Take, for example, Colgate Kitchen Entrees (yes, as in the toothpaste); Cosmopolitan Yogurt (off the shelves in eighteen months); and Ben-Gay Aspirin (the idea of swallowing Ben-Gay was not a winner).[70]

Even the big guys make mistakes, so small businesses are not immune from product goofs. The products that do make it, however, go through what is known as the **product life cycle (PLC)** defined as "the performance of the product in terms of sales and profits over time."[71] The traditional PLC is shown in Figure 17.5 "The Traditional Product Life Cycle".

Figure 17.5 The Traditional Product Life Cycle



Source:[72]

Small-business owners should understand the PLC because there are specific implications for marketing strategy. The ***product development (incubation) stage*** is when a product is being prepared for sale. There are costs but no sales. The ***product introduction stage*** is when a product is available to buy for the first time. Sales will generally be low but increasing, marketing expenses will be high, and profits will be typically low or nonexistent. The focus of the marketing strategy will be to create awareness, establish a market, and create demand for the product.[73][74][75]

The ***product growth stage*** is when sales grow rapidly as the target market adopts a product and competition enters the marketplace once it observes the success. Marketing strategy should focus on differentiation and building a brand preference. There is substantial profit improvement.[76][77][78] Rapid growth must be managed carefully so that the company does not succeed into failure.

The ***product maturity stage*** is characterized by slow growth because most of the buyers interested in a product have bought it. Sales may increase but slowly due to intense price competition. Profits stabilize or decline. The marketing strategy must focus on getting people to switch brands by using special promotions and incentives.[79][80][81]

The ***product decline stage*** is when sales decline and profits erode. A product has become obsolete because of an innovation (think VHS to DVD to Blu-Ray) or the tastes of the target market have changed. The marketing strategy works to reinforce the brand image of the product. The product may be dropped from the product line or rejuvenated if possible and practical.

There are many small business owners who may not see the PLC as applying to their products or services. After all, accounting services are accounting services, a luncheonette is a luncheonette, and hardware is hardware. Thinking this way would be a mistake. Accounting practices change, people's tastes change, hardware solutions change, and government regulation inserts itself. What is successful today may not be successful tomorrow. The PLC provides guidance for watching how a product or a service progresses in the marketplace so that the necessary marketing strategy steps can be taken.

The New Product Development Process

If the development of a new product is being considered, the following steps are suggested as guidance:

- **Generate new product ideas.** Search for ideas for new products.
- **Screen new product ideas.** Make sure the product fits the target market and the overall mission of the business.
- **Develop and evaluate new product concepts.** Develop product concepts and determine how consumers will view and use the product.
- **Perform a product business analysis.** Calculate projected business costs, return on investment, cash flow, and the long-term fixed and variable costs. Long-term fixed costs are production costs that do not vary with the number of units produced (e.g., annual rent). Long-term variable costs are production costs that vary with the number of units produced (e.g., selling more hot dogs will require more hot dogs, ketchup, mustard, and relish).
- **Design and develop the product.** Develop a product prototype. A product prototype is an exact match to the product description developed in the concept development and evaluation stages. It is a sample.
- **Test market the product.** Introduce the product to a market to find out how the product will be received when it is introduced for real. The test market should be as close as possible in terms of characteristics (e.g., demographics) as the target market. For a small business, an appropriate test market might be a few select customers.
- **Launch the product or the service.** The product is introduced to the full marketplace.[82]

The Company Website

A company's website is part of its product or service. The conventional wisdom is that all businesses should have a website. The reality is that there are many small businesses that do very well for themselves without a web presence. The small local deli, accounting or insurance services, a legal firm, a liquor store, or a dental office may not see the need for a website. At the same time, customers are increasingly expecting a web presence, so any small business that does not have a website runs the risk of losing sales because of it. The time may also be approaching when not having a website will be perceived as odd, with questions raised as to the seriousness of the business. Every small business without a website should determine whether this matters to them or not.

This section about the company website is targeted to the small business that has a web presence already or is planning to have one. A small business owner should have a basic understanding of website design to contribute to the discussion and communicate effectively when working with professionals[83]—as well as to organize the owner's visceral reaction when it is time to evaluate other websites, plan the company's website, or revise the company's current website.[84] In addition, any commitment to e-marketing requires a website.

Stanford University's Persuasive Technology Lab found that people quickly evaluate a website by visual design alone, with the visual design setting the tone for the user's experience.[85] "Image is everything online. Good design evokes trust, makes navigation clear, establishes branding, appeals to target customers, and makes them feel good about doing business with the website they are on. Design does not have to be expensive for it to work. It does, however, need to represent an organization and appeal to a visitor. Professional design is not something organizations spend money on; it is something *they invest in to support trust, positioning, and long-term marketing*" (emphasis added).[86]

This section of the chapter discusses website objectives and the fundamental design elements: layout, color, typography, graphics, interactivity, navigation, usability, content, and performance. User experience is also discussed.

Video Clip 17.12 Top Web Design Mistakes Small and Large Businesses Make

https://youtube.com/watch?v=022tMCnizgQ

Four mistakes that small businesses should watch for when designing their websites.

Website Objectives

"The goal of any Web site is to deliver quality content to its intended audience and to do so with an elegant design."[87]***Website objectives*** define what a company wants its website to do. For example, a website can build awareness of the business; build awareness of particular brands or services; distribute information to supporters, customers, and stakeholders on products or issues; sell products or services; build relationships with customers; develop a new marketing strategy or reinforce an existing strategy; manage an event (e.g., online registration and payment); build the company image; and gather marketing research by collecting data from users or conducting online surveys.[88] Clear-cut objectives will increase the chances that a company's website design and content will work to achieve those objectives.[89]

Website Layout

Layout refers to the positioning of the various elements that comprise a web page: where each text object will be positioned on each page or screen, the width and length of columns, the amount of space that will be placed between the lines of text, the alignment to be used (e.g., left or right), whether the page will be text only or use more advanced designs (e.g., multiple columns),[90][91] and the placement of graphics. Layout is important because it is one of the first things a visitor perceives when landing on a website. Research shows that "web users spend 69% of their time viewing the left half of the page and 30% viewing the right half, [so] a conventional layout is thus more likely to make sites profitable."[92]

Color

Color is a powerful component of design. It affects mood and emotion, and it evokes associations with time and place. For example, psychedelic color combinations take us back to the 1960s, and turquoise and yellow combinations remind us of art deco in the 1950s. For websites, color is important in defining a site's environment because "[P]eople see color before they absorb content."[93] A lasting color impression occurs within ninety seconds and accounts for 60 percent of acceptance. What are the implications for website design? Decisions regarding color can be highly important to success.

The key to the effective use of color in website design is "to match the expectations of the target audience. Financial services sites tend to use formal colors (e.g., green or blue) with simple charts to illustrate the text but not many pictures. Sites directed at a female audience tend to feature lighter colors, usually pastels, with many pictures and an open design featuring lots of white space. Game sites are one type of site that can get away with in-your-face colors, Flash effects, and highly animated graphics."[94]

Colors should be selected that reflect the purpose of the site and enhance the design. Understanding the meaning of color and the cultural use of color and how colors interact is important in website design to convey the right tone and message and evoke the desired response to the site.[95] The wrong choice could adversely affect a visitor's experience at the site,[96] which could adversely affect a company's sales and image.

Video Clip 17.13 Color Psychology in Web Design

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=190

Insights into color and its importance in website design.

Color Perceptions for Business

"The following list provides the traditional meanings of common colors and suggests compatible business usage:

- **Pink.** Romance, love, friendship, delicacy, feminine; ideal for relationship coaches, florists, and breast cancer awareness sites.
- **Purple.** Royalty, spiritual, transformation, creativity, new age; ideal for spirituality-based or new age businesses and businesses in the creative realm.
- **Blue.** Solid, communication, calm, wisdom, trust, reassuring; ideal for financial businesses, insurance companies, and lawyers.
- **Green.** Growth, money, abundance, fertility, freshness, health, environment; ideal for grocers, environmental businesses, therapists, healthcare businesses.
- **Red.** Energy, strength, passion; ideal for bold businesses based on power and for professionals; use in combination with black.
- **Black.** Power, sophisticated, elegant, formal, style, dramatic, serious; ideal for fine dining establishments; commonly used as an accent color.
- **Gold and yellow.** Wealth, wisdom, prestige, power, energy, joy, clarity, light, intelligence, optimism; ideal for the construction industry.

- **White.** Purity, goodness, simplicity, clean; ideal for almost every business.
- **Brown.** Friendship, earthy, comfort, content, reliable, sturdy; ideal for businesses involved in administrative support.
- **Orange.** Vibrant, enthusiasm, energy, warmth; ideal for creative businesses and teachers.
- **Gray.** Security, staid, quality, professional, stable; ideal for the legal industry."[97]

Typography

"**Typography** is the art of designing a communication by using the printed word."[98] More specifically, it is the use of **typefaces** (or fonts) in a design. Typeface refers to a particular type or font (e.g., Times New Roman and Arial). Typography is an integral part of web design and plays a role in the aesthetics of the website.[99] About 95 percent of the information on the web is written language, so it is only logical that a web designer should understand the shaping of written information (i.e., typography).[100] It is possible to blow away more than 50 percent of website visitors and readers by choosing the wrong typeface.[101]

Graphics

Graphics defined as pictures, artwork, animations, or videos, can be very effective if used correctly. Graphics can provide interest, information, fun, and aesthetics, but they can also take forever to load, be meaningless or useless, not fit on the screen, and use colors that are not **browser safe colors** (i.e., colors that look the same on PC and Macintosh operating systems). Images enhance a web page, but they should be selected and placed carefully.

Graphics should be used to "convey the appropriate tone of your message. As the old saying goes, a picture is worth a thousand words. Make sure your images correspond to the text and are appropriate to the business you offer. For example, an audiologist shouldn't use a picture of a woman holding her glasses because the spotlight should be on hearing."[102] Graphics should also help create a mood, or a sense of place. The use of the graphics has to be thoroughly considered because they slow the loading of a website.[103]

It has been shown that quality images boost sales and enhance the visitor experience. "Consumers who browse products on websites want to see the products they're considering for purchase represented by the highest quality image possible…People do not buy what they cannot see, so the higher the quality and resolution of [the] imagery, the better [the] results will be."[104] The key for any small business that wants graphics on its website is to consider how the graphics will add value to the user experience. The graphics should be for the direct benefit of the user, not the business. Do not get carried away with lots of images and animations because they can make a web page very hard to read. Graphics are a major part of the design, not just afterthoughts.[105]

Site Navigation

People will not use a website if they cannot find their way around it. If web users cannot find what they are looking for or figure out how the site is organized, they are not likely to stay long—or come back.[106] "The purpose of **site navigation** is to help visitors quickly and easily find the information they need on a website. Among the questions considered in site navigation are, How will visitors enter a site? How will visitors use the site? How will they find out what is available at the site? How will they get from one page to another and from one section to another? How will visitors find what they are looking for?"[107]

Site navigation must be easy, predictable, consistent, and intuitive enough so that visitors do not have to think about it.[108] "Designing effective navigation can also entice your visitors to try out the other things you offer on your site."[109] The key to understanding navigation is to realize that if it is too hard to use or figure out, web visitors will be gone in a nanosecond, perhaps never to be seen again. What does this mean to a small business? Lost sales and lost opportunities.

Site Usability

A ***website's usability***, or ease of use, "can make or break an online experience, and it is directly correlated to the success of the site."[110] Website usability measures the quality of a user's experience when interacting with a website,[111] and it works hand in hand with site navigation. According to usability.gov, usability is a combination of five factors:"[112]

1. **Ease of learning.** How fast can a user who has never seen the ***user interface*** before learn it sufficiently well to accomplish basic tasks? The user interface is the way a person interacts with a website.[113]
2. **Efficiency of use.** Once an experienced user has learned to use the website, how fast can he or she accomplish tasks?
3. **Memorability.** If a user has used the website before, can he or she remember enough to use it effectively the next time or does the user have to start over again learning everything?
4. **Error frequency.** How often do users make errors while using the website, how serious are these errors, and how do users recover from these errors?
5. **Subjective satisfaction.** How much does the user like using the website?

Usability is necessary for survival on the Internet. If a website is difficult to use, people will leave,[114] and they may be inclined to tell everyone they know on Facebook and Twitter about their negative experiences. It is as simple—and as serious—as that. Small-business owners should consider post-launch usability testing to help ensure the best user experience. Three free tools are HubSpot's Website Grader, SiteTuners, and Google Analytics.

Site Interactivity

Site interactivity is about things on a company's website site that prompt some kind of action from visitors.[115] Visitors become engaged with the site, they stay longer, they look deeper into the site to see what the company is offering, they are less likely to jump to another site, and they feel that they are part of a community and connected. This will keep them coming back to the site.[116]

There are many ways in which a small business can provide interactivity on its site. The following are some examples:[117][118]

- Free calculators for calculating payments when something is being financed
- Surveys, polls, or quizzes
- Blogs, bulletin boards, and discussion forums
- Facebook and Twitter links
- Searchable database of frequently asked questions
- Site search engine
- Interactive games, puzzles, and contests
- Articles that engage visitors, allowing them to add comments or opinions
- Three-dimensional flip-books (e.g., Gorenje Kitchens showcase a range of products, thus engaging the visitor while flipping through the book.)

The sources of interactivity on a website are limited only by a small business owner's creativity and, of course, budget. However, it should never be a question of saying yes or no to interactivity. It is a matter of how much, what kind, and where. Remember that when customers feel compelled to do something, they are that much closer to buying.[119]

Content

Content refers to all the words, images, products, sound, video, interactive features, and any other material that a business puts on its website.[120][121] It is the content that visitors are looking for, and it is what will keep them on the site. High-quality content will also keep people interested so that they come back for more. “A poorly and ineffectively ‘written’ website has an adverse impact on the efficiency of the website. Moreover, it also gives a negative impression of the brand [or company] behind it. Without good ‘content’ a website is an empty box.”[122]

Good content is relevant, customer-centric (i.e., it is written in the language and words of the target audience(s) that visit the website), and complies with what we know about how people read online content. They don’t. They scan it—because it takes 25 percent longer to read the same material online than it does to read it on paper.[123] If a company’s content does not fit its target audience(s), the website will not generate good results.[124]

Most small businesses may think that they must generate all website content. However, some of the best and most successful content may be the easiest to create: the content generated by website users. Interestingly, it is not uncommon for user-generated content to get higher search engine rankings than a business’s home page, not an insignificant fact.[125]User-generated content includes the following:[126]

- Message boards
- Product reviews
- New uses for a company’s products (e.g., using a dishwasher to cook a whole salmon)
- Testimonials or case studies (how users solved problems)
- Social media pages
- Twitter feeds
- Video contest submissions
- Interviews with users
- Online groups or communities such as LinkedIn or Ning

The gold standard of user-generated content is customer reviews. Customer reviews can increase site traffic by as much as 80 percent, overall conversions by 60 percent, and the average order value by 40 percent. With respect to the posting of both positive and negative reviews, it has been shown that “users trust organizations that post both negative and positive reviews of their product *if* organizations address the feedback constructively.”[127]

There are many factors that will contribute to the success of a small business website. However, the website will not do as well as it should, and it will not reach its full potential, without good quality content.[128]

Video Link 17.3

The Value of the About Page

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

videos.smallbusinessnewz.com/2011/01/26/the-value-of-the-about-page

Product Display

How a website displays products will impact the success of the website. As a result, product display should be seen as a website design issue. Key decisions that should be made for each category of product that is available on the website include the choice of which products to feature, how to provide product detail pages (an individual page for each product is preferable because there is more room for product details), the sort options that will be available to the shopper (e.g., price), and where items on special will be placed on the page (the upper right corner is recommended).[129]

Performance

No matter how well designed a website is, and no matter how high the quality of content, a website that takes too long to load will lose visitors. A website’s ***loading speed*** determines how fast the pages respond to a user request. Faster site speed is preferred by the users who want an optimal browsing experience, and the small business that wants increasing incoming connections and high sales. Users want faster speeds.[130]

Visiting a fast-loading site is a pleasant experience. Visiting a slow-loading site is not. Surveys now show that a person will wait less than three seconds (perhaps even less) for a webpage to load before leaving, with a one-second delay possibly meaning a 7 percent reduction in sales.[131] Google claims that the amount of site traffic drops by 20 percent for every 0.5 seconds of load time.[132]

There are several factors that slow down the loading time for a website, not the least of which is the connection speed of the user’s computer. This is out of the control of the web designer and the site owner (the small business). The biggest culprit, however, is a large graphic or several small graphics on a single page.[133] There are ways around this, known by any credible website designer. The impact of “slow down” features should be tested before the site launches and monitored afterwards.[134] The small business owner can take advantage of some of the popular tools that are available, usually for free, to measure a company’s website speed: YSlow (a Firefox extension); Google Page Speed (a Firefox add-on); or Webmaster Tools.[135][136] Once the problem areas have been identified, steps can be taken to make improvements. The goal is to have an interesting and speedy site.

Key Takeaways

- The key element in the marketing mix is the product. Without it, price, promotion, and place are moot.
- All products and services have three layers: core, augmented, and symbolic.
- All small businesses have a product mix, the selection of products or services that is offered to the marketplace.
- Product selection is a key element for online success because some products will sell better online than others.
- Product design is the principal reason for emotional attachment or detachment relative to a product, a service, or an experience. It presents a powerful way to differentiate and position a company’s products and services.
- The product or service package communicates both emotional and functional benefits to the buyer, and it can be an important means of product differentiation.
- A company’s brand is probably its most important asset.
- The product life cycle refers to a product’s life span.
- A company’s website is part of its product or service. Website objectives must be developed and decisions must be made about the fundamental design elements of layout, color, typography, graphics, interactivity, usability, content, product display, and performance.

Exercises

1. Go to "How to Rate a Web Site" at www.newentrepreneur.com/Resources/Articles/Rate_a_Web_Site/rate_a_web_site.html and download the Web Site Scorecard. Select two small business websites or use the websites specified by your professor. Working with the "How to Rate a Web Site" article and the Web Site Scorecard, evaluate the two sites. Be sure to note your impressions about the site's performance in each area.
2. The Mill has a very basic website: the store's location, hours, and some of the menu. Emily's son, Robert, has extensive experience with website design. How do you think he would advise his mother on fully using the website for competitive advantage?
3. For each of the following, describe the core, augmented, and symbolic layers.
    1. a gift shop
    2. a dry cleaner
    3. a dance studio
    4. highway paving materials
4. Some marketers believe that product performance (functions) makes the most difference when consumers evaluate products. Other marketers maintain that the looks, feel, and other design elements of products (form) are what really make the difference. *Make the case*: Product functionality is the key to brand success OR product design is the key to product success.[137]

Marketing Strategy and Price

Learning Objectives

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

Marketing, whether online or onground, is the only activity that generates revenue for most small businesses, and the price element in the marketing mix accounts for that. ***Price*** can be defined very narrowly as the amount of money charged for a product or a service. However, price is really more than that. It is "the sum of all values (such as money, time, energy, and psychic cost) that buyers exchange for the benefits of having or using a good or service."[138] Ultimately, the meaning of price will depend on the viewpoints of the buyer and the seller.[139]

Deciding on a price for its products or services is one of the most important decisions that a small business will make. The price of a product or a service must be a price that the company's target market is willing to pay and a price that generates a profit for the company. If this is not the case, the business will not be around for long."[140]

Choosing the right pricing strategy is not an easy thing to do because there are so many factors involved. For example, competition, suppliers, the availability of substitute products or services, the target market, the image and reputation of a business, cost and profit objectives, operating costs, government regulation, and differentiation and positioning decisions will all impact price. Pricing is a complex activity, often seen as an art rather than a science. For small businesses that are marketing or want to market online, pricing strategies are even more complicated. For example, online buyers have increasing power that leads to control over pricing in some instances (e.g., online bidding on eBay). There is also **price transparency** where buyers and sellers can easily and quickly view and compare prices for products sold online, and some companies use **dynamic pricing**.[141]

There are several pricing strategies available to the small business owner. However, having the lowest price is not typically a strong position for small businesses because larger competitors can easily destroy any small business that is trying to compete on price alone.[142] Think Walmart. The best choice for a small business will be the strategy that helps the business reach its sales and profit objectives, enhances the reputation of the company, satisfies the target market, and sends the correct price-quality signal. ***Price-quality signaling*** occurs when the cost of a good or a service reflects the perceived quality of that product or service.[143] However, pricing objectives must be formulated before a pricing strategy can be selected.

Pricing Objectives

Pricing objectives (i.e., what the company wants to accomplish with its pricing strategy) should be related to a company's objectives and should follow the decision about where a company wants to position its products or services.[144] Different small businesses in the same industry may have different pricing objectives based on size of the business; in-house capabilities; and whether the focus is on profit, sales, or government action.[145]

- **Sales-based objectives.** Increasing sales volume and market share relative to the competition may involve ***penetration pricing***, where a business prices a new product below that of the competition to quickly penetrate the market at the competitor's expense, acquire a large market share, and then gradually raise the price. This objective might be appropriate for a small business that is introducing a new product or service to a very competitive marketplace.
- **Profit-maximization objectives.** Quickly recovering the costs of product development while providing customer value may involve ***price skimming***, where a new product is priced higher than that of the competition to maximize profit. This objective would work for a small business with customers who are more concerned with quality, uniqueness, and status rather than price. However, a product's image and quality must warrant the high price.
- **Status-quo-based objectives.** Used to minimize the impact of competitors, government, or channel members and to avoid a sales decline, these objectives are reactive rather than proactive, so they should be adopted for the short term only. Small businesses must be able to meet the needs of their target market.

Pricing Strategy

Once the pricing objectives are set, a small business must determine a pricing strategy. The small business owner can consider a variety of approaches. Discount pricing, cost-based pricing, prestige pricing, even-odd pricing, and geographic pricing are discussed here. In general, traditional pricing strategies can also be applied to the online environment.[146] How goods and services are priced tells consumers a lot about what to expect from a small business.

Discount Pricing

A small business might choose discount pricing, offering quantity discounts to customers who buy in large quantities.[147] if it is looking to drive traffic and sales short term or if it wants to be permanently seen as the value leader in an industry.[148] Discount pricing is used with customers who buy in large quantities, customers who buy during off-peak times (seasonal), promotions used to increase traffic, and **loss leaders** (products that are discounted to get customers in the door in the hope that they will also buy more profitable products). Discount pricing can be used in the online environment in ways similar to brick-and-mortar stores. If the discounting is short term, inventory can be reduced, and revenues are increased temporarily.[149] An important disadvantage, however, is that customers often associate low price with low quality, particularly if a brand name is unfamiliar. A discount pricing strategy could lead to a product or a service being perceived as low quality. Also, price reductions can be easily matched by the competition, eliminating any but the earliest advantage.[150]

Cost-Based Pricing

Cost-based pricing is a very simple approach. A company figures out how much it costs to make a product or deliver a service and then sets the price by adding a profit to the cost. For example, if it costs a small toy manufacturer $10 to make its signature stuffed animal (taking into account fixed and variable costs) and the company wants a 20 percent profit per unit, the price to the retailer will be $12.[151]

Cost-based pricing is very easy to use. It is flexible (allowing different profit percentages to be added to different product lines), allows for easy price adjustments if costs go up or down, and is simple to calculate. On the downside, cost-based pricing ignores product demand, what the competition is doing with pricing, and positioning, and it provides no incentive for cost efficiencies.[152]

Prestige Pricing

Prestige pricing (or premium pricing) taps into the belief that a high price means high quality. Although this relationship exists in many instances, it is not true in all cases. Nonetheless, prestige pricing is "a strategy based on the premise that consumers will feel that products below a particular price will have inferior quality and will not convey a desired status and image."[153] A small children's clothing store that carries only top-of-the-line merchandise would use a prestige pricing strategy. Clothing from this store would be seen as having a higher perceived value than clothing from Macy's but perhaps comparable in value to clothing from Bloomingdale's, Nordstrom, or Neiman-Marcus.

Prestige pricing can be very effective at improving brand identity in a particular market. However, it is not typically used when there is direct competition because such competition tends to have a downward effect on pricing. Unique products usually have the best chance of succeeding with prestige pricing.[154]

Even-Odd Pricing

Also known as the "nine and zero effect,"[155]***Even-odd pricing*** can be used to communicate quality or value. It assumes that consumers are not perfectly rational, which is true. Emotion plays a much larger role in consumer behavior than rationality.

Even-numbered pricing, or setting selling prices in whole numbers (e.g., $20), conveys a higher-quality image. A small, high-end gift shop, for example, would use even pricing for most if not all its products, with odd-numbered prices (e.g., $18.97) used for products that are on sale. Odd-numbered prices give consumers the impression that they are getting a great value. It is a psychological effect with no basis in logic. But it does work in practice.

Geographic Pricing

Some small companies will use a ***geographic pricing*** strategy. This pricing strategy takes the geographic location of a customer into consideration, the rationale being that distribution can increase product delivery costs and thus the cost of the product.[156] Taxes, the cost of advertising, competitors who benefit from government subsidies, consumer demand, differences in costs of living, and the general cost of doing business are other factors that enter into the decision to use geographic pricing. Small businesses that sell outside the United States would likely encounter the need for geographic pricing. This strategy might also be appropriate when selling in different states.

Key Takeaways

- Marketing is the only activity that generates revenue for most small businesses.
- Price accounts for revenue.
- Determining a price for its products or services is one of the most important decisions that a small business will make.
- There are many factors involved in choosing the right pricing strategy.
- Having the lowest price is not typically a strong position for small businesses.
- Pricing objectives should be created before a pricing strategy is selected.
- In general, traditional pricing strategies can be applied to the online environment.
- Discount pricing, cost-based pricing, prestige pricing, even-odd pricing, and geographic pricing are pricing strategies that can be considered by a small business.
- How goods and services are priced tells consumers a lot about what to expect from a small business.

Exercises

1. The Mill is planning to significantly expand its takeout business. Currently, customers come into the restaurant and order from the menu. With the new Summerside facility and website, customers will be able to order online or fax an order to the restaurant. Emily and Robert have been arguing over how to structure the takeout portion of their operations. Emily wants to maintain the approach where customers order items from the menu. Robert believes that in today's world, it would be more convenient for customers to order complete prepackaged meals. Mother and son have argued about the nature of these meals. Emily has suggests a limited number of standard meals that could be prepared during the day and sold in the evening when commuters are returning home. However, this might mean that excess inventory would be built up on unwanted items. Robert wants to offer greater variety. These would include a main course, two side dishes, and a dessert. Because there could be a large number of combinations, most would have to be made after the receipt of an order. The "rush" to make these meals would drive up costs. How would you go about pricing these two types of meals?
2. Visit two small businesses—one that you think would use even-numbered pricing and one that you think would use odd-numbered pricing. Were you right? If not, how would you describe their pricing strategies? Be as specific as you can.
3. Visit NapaStyle, and analyze its pricing strategy.
4. Select a product or a service that you purchased recently from an onground small business and an online small business. The two businesses should be different. Evaluate the price that you paid. What appears to be the pricing strategy of each business? Do you think the price was fair? Why or why not? How would you assess the value that you received for the price you paid?Adapted from David L. Kurtz, *Contemporary Business* (Hoboken, NJ: John Wiley & Sons, 2011), 488.*Tip*: If you are not sure whether an online business can be considered a small business, type in the name of the business plus "corporate HQ" into Google or your preferred search engine. The search should return results that include the number of employees. As long as the company has fewer than five hundred employees, you are all set.

Marketing Strategy and Place

Learning Objectives

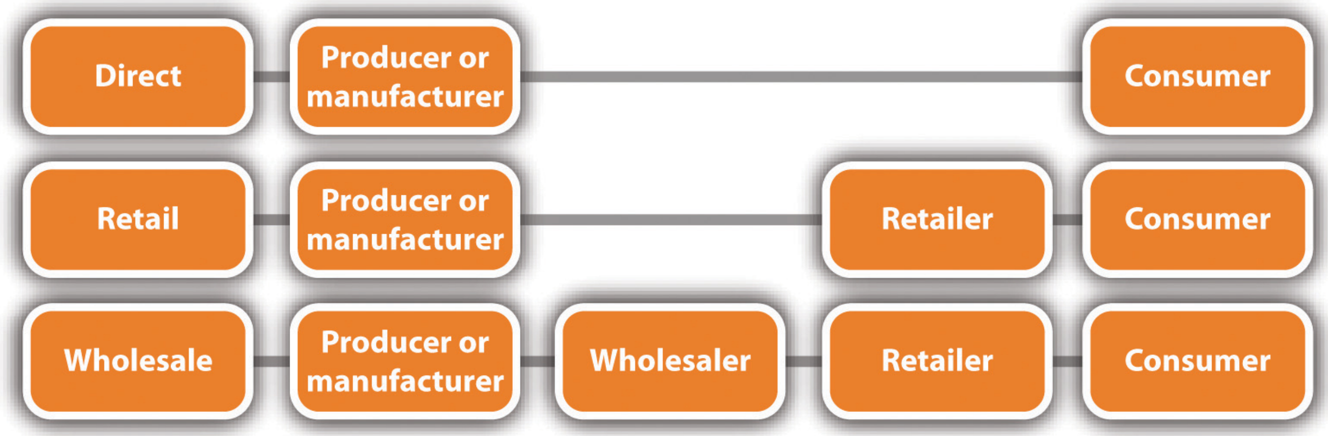
1. Understand the role of place in the marketing mix and the importance of place to a company.
2. Understand the different distribution strategies that a small business can follow.
3. Explain the importance of logistics to small businesses.

No matter how great a product or a service may be, customers cannot buy it unless it is made available to them onground or online or both. This is the role of the ***place*** in the marketing mix—to get a product or a service to the target market at a reasonable cost and at the right time. Channels of distribution must be selected, and the physical distribution of goods must be managed [citation redacted per publisher request].

Channels of Distribution

A small business may choose the direct, retail, wholesale, service, or hybrid channels. In general, business-to-business (B2B) distribution channels parallel those of business-to-consumer (B2C) businesses.

Figure 17.6 Channels of Distribution



Direct Channel

Many small businesses use the direct channel. The direct channel involves selling directly to the final consumer with no intermediaries. The direct channel provides close contact with the customer and full control of all aspects related to the marketing of a company's products.[157] The Sugar Bakery & Sweet Shop in East Haven, Connecticut (winner of the Food Network's 2010 "Cupcake Wars"), uses the direct channel, as does the local farmer when selling fruits and vegetables to the local population. Michael Dell started out by selling computers from his dorm room, and the founders of Nantucket Nectars began their business by selling their home-brewed fruit drinks to boaters in Nantucket Harbor. Many B2B sellers also use the direct channel. Consolidated Industries, Inc., for example, sells helicopter parts directly to Sikorsky Aircraft and airline parts directly to Boeing.

Video Clip 17.14 Sugar Bakery & Sweet Shop

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=190

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

Video Link 17.4 iPhone App Beefs Up Sausage Sales

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

money.cnn.com/video/technology/2010/09/16/t_turnaround_lets_be_frank_square.cnnmoney

Service businesses use the direct channel because there is no way to do otherwise. Services are performed and consumed at the same time, so there is no role for intermediaries. Tanning salons, home repair services, legal services, real estate services, and medical services all deliver directly to the consumer. Online services are also delivered directly to the final consumer, such as Carbonite and Legal Zoom.

The Internet has increased the opportunities for small businesses to use the direct channel as the only means of distribution or as an additional sales channel [citation redacted per publisher request]. For example, Vermont Teddy Bear in Shelburne, Vermont, uses the Internet as its primary sales channel. Its only other channel is its onground factory tours that are offered year-round.

Video Clip 17.15 Vermont Teddy Bear Company

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=190

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

Retail Channel

Many small businesses may choose to produce or manufacture products and distribute them to retailers for sale. This is considered an ***indirect channel***, because the retailer is an intermediary between the producer or manufacturer and the final consumer. If a small business that makes one-of-a-kind, handcrafted picture frames sells its frames to a picture-framing business that in turn sells the frames to its customers, this would be an example of using the retail channel. An online business that sells products made by several producers or manufacturers would also be using the retail channel—and would be called an **e-tailer**.

Video Clip 17.16 Future Vision of Retailing

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=190

Microsoft’s vision of future retailing.

Video Clip 17.17 YOUReality Retail Visualization Product

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=190

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

Although selling through retailers may expand the distribution coverage to a small business’s target market, the business must give up some control over pricing and promotion. In addition, the business should expect to get a wholesale price from the retailer that is significantly lower than what it would get if it sold directly to the final consumer.

Wholesale Channel

Wholesalers, a (large or small) business that sells to retailers, contractors, or other types of businesses but not to the general public are also *intermediaries*. A wholesaler is “a [large or small] business that sells to retailers, contractors, or other types of businesses (excluding farms), but not to the general public (or at least not in any significant amount).”[158] A small business that chooses to use wholesalers is also using an ***indirect channel*** of distribution. Using a wholesaler makes sense when a business makes a product that it wants to sell in many stores that would not be easily or conveniently reachable through the direct channel or the retail channel. For example, Kathleen King’s small gourmet baked goods company (now known as Tate’s Bake Shop) earns much of its annual revenue from the wholesale distribution of its baked goods to approximately one hundred gourmet shops on Long Island, in New York City, and in other states.[159] Her products can be viewed online at www.tatesbakeshop.com, and her story—including some valuable business lessons that she learned along the way.

Video Clip 17.18 Tate's Bake Shop

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=190

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

Although any small business that uses wholesalers will see a reduction in profit, there are several advantages to wholesaling. For example, wholesalers are able to sell and promote to more customers at a reduced cost, they can deliver more quickly to buyers because wholesalers are closer to them, and wholesalers can inventory products, thereby reducing inventory costs and risks to their suppliers and customers.[160] Small businesses that produce only one or a few products commonly use the wholesale channel of distribution. Retail outlets may not be placing orders from the small business because it is not known. The wholesaler can put the product in front of them.[161]

Multichannel Distribution

A small business may choose a **multichannel distribution system** (or hybrid channel). This channel option uses two or more channels of distribution to reach one or more customer segments, offering customers multiple purchase and communication options.[162][163] The multichannel approach offers three important advantages:[164]

1. **Increased market coverage.** More customers are able to shop for a company's product in more places, and customers who buy in more than one channel are often more profitable than one-channel customers.
2. **Lower channel cost.** Selling by phone or online is cheaper than selling via personal visits to small customers.
3. **More customized selling.** A technical sales force could be added to sell more complex equipment.

The hybrid approach works well for small businesses. Tate's Bake Shop sells directly through its store in Southampton, New York, and online. It sells indirectly to gourmet retailers such as Sugar and Spice in Chappaqua, New York, through its wholesalers. Local restaurants also use the multichannel approach when customers can order online or by phone and then pick up the food at the restaurant.

Physical Distribution (Logistics)

Physical distribution (logistics) involves "all the activities involved in the physical flow and storage of materials, semifinished goods, and finished goods to customers in a manner that is efficient and cost effective."[165] Logistics can be performed by the producer or the manufacturer, intermediaries, or the customer. Deciding on the right logistics solution may be the differentiator that puts a company ahead of its competition.[166] Logistics are relevant to both online and onground companies.

The costs of logistics can account for as much as 10–35 percent of a company's gross revenues, so any money that can be saved can lead to more affordable products for consumers and increased profitability. The costs will vary by several factors (e.g., industry sector, company location, and company size). Retailers that offer a wide assortment of products will spend more on logistics because transportation and storage costs will increase as the number of carried products increases.[167]

Video Clip 17.19 Logistics

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=190

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

Logistics involve the following four primary functions: transportation, warehousing, inventory control, and order processing.[168]

1. **Transportation.** The transportation choices for a small business will determine whether products will arrive at their destination in good condition and on time. Transportation costs will increase product price. The choices include truck, rail, air, water, and pipeline. Table 17.1 "Characteristics of Different Modes of Transportation" compares these choices. The selection of the best mode or combination of transportation modes depends on a variety of factors, including cost, speed, appropriateness for the type of good, dependability, and accessibility. All these things will affect customer value and customer satisfaction.

Table 17.1 Characteristics of Different Modes of Transportation

Mode	Percentage of Total Transportation	Cost	Speed	Product Examples*
Rail	42	Medium	Lower	Coal, stone, cement, oil, grain, lumber, and cars
*Small businesses are represented in each of the product examples given.				

Mode	Percentage of Total Transportation	Cost	Speed	Product Examples*
Truck	28	Higher	Higher	Perishables, clothing, furniture, and appliances
Pipeline	16	Lower	Low	Oil, gas, chemicals, and coal as a semifluid
Water	13	High	Low	Coal, stone, cement, oil, grain, and cars
Air	0.4	High	High	Jewelry, perishables, electronics, wine, and spirits
*Small businesses are represented in each of the product examples given.				

Source:[169]

2. **Warehousing.**[170] Producers and manufacturers must store goods before they are sold because production and consumption rarely match. Some inventory may be kept at or near the point of production or manufacture, but the rest is located in warehouses. Some warehouses also provide assembly, packaging, and promotional display construction services…all for a fee, of course.
3. **Inventory control*Inventory control*** is about ensuring that goods are where customers want them when they want them. In other words, it is about avoiding the "out of stock" situation that irritates customers. Small-business owners must understand how much inventory will be needed to address their customers' needs on a timely basis and at the appropriate cost (think pricing strategy). High inventories are undesirable because they may lead to obsolete products, depressed sales of new models, and liquidation prices that may change customer expectations in the future.[171] Small businesses should think of inventory as a wasting asset: it does not improve with time and, in fact, becomes less valuable with every day that passes—taking up space and incurring heat, light, power, handling, and interest charges. Every day that shows inventory and no sales will also show no profit. The goal is to keep inventory as low as possible.[172]
4. **Order processing.**[173] Every small business should want to shorten the elapsed time between an order's receipt, delivery, and payment. Although there are typically multiple steps involved, the reality is that the longer the cycle, the lower the customer's satisfaction, the higher the company's costs, and the lower the company's profits. Streamlining the process should be a priority.

There are several things that small businesses can do to increase the efficiency and the effectiveness of their logistics.[174] For example, a business can select a logistics company that is industry specific (e.g., wine or clothing) because that company will understand the shipping needs of the products or use small business logistics services from UPS or FedEx.

Logistics management also includes supply chain management.

Place and the Website

For small businesses that sell online or hope to sell online, the company website "places" the product or the service in the hands of the customer. As a result, there are several decisions that must be made to facilitate the process so that customers can have a good online experience[175][176] and be less inclined to abandon their shopping carts and leave the site without making a purchase.

- **Better sorting and searching.** Make it easier for shoppers to find what they are looking for.
- **Multibrand combinations in a single cart.** If multiple brands are carried, make it possible to combine shopping carts across brands and apply promotions on the entire cart.
- **Clarity on price and delivery rate.** Prices and delivery rates should be marked clearly, with no ambiguity.
- **Multiple payment options.** Offer more than credit cards. (See Chapter 4 "E-Business and E-Commerce" for a discussion of payment options.)
- **Check-out options.** Do not require a customer to register before completing checkout.
- **Provide a product search engine.** The larger and more complex the product selection, the more a product search engine is needed. Shoppers can search by product name; product type; price; product attributes, such as color, size, or material; or brand either alone or in combination.
- **Two clicks to buy.** The fewer the number of clicks to buy, the greater the chances that a shopper will do just that.
- **Customer support.** Offer customer support throughout the buying process. Make it easy to communicate with a real person; spell out the company's warranty, refund, and return policies; ensure privacy and security; and let shoppers know if you put cookies on their computers.
- **Fulfilling orders.** Ideally, send each customer an e-mail confirming when the order is completed, remind the shopper to print the order details, and provide a tracking number with a direct link to the carrier's website so that the shopper can follow the progress of shipment.

Shopping cart abandonment, or leaving a website without buying any of the items in the shopping cart, is something that affects almost every Internet retailer, including small businesses. Cart abandonment estimates range from 20 percent to 60 percent.[177] An understanding of why shoppers are abandoning their carts should lead to some serious thinking during website design and operation. Table 3.2 "Why Online Shoppers Abandon Their Shopping Carts" gives examples of why shoppers abandon a purchase. Because shipping is the number one reason why shoppers abandon their shopping carts, think very carefully about what the shipping charges will be.[178]

Table 17.2 Why Online Shoppers Abandon Their Shopping Carts

High shipping charges	46%
Wanted to comparison shop	37%
Lack of money	36%
Wanted to look for a coupon	27%
Wanted to shop offline	26%
Could not find preferred payment option	24%
Item was unavailable at checkout	23%
Could not find customer support	22%
Concerned about security of credit card data	21%[179]

Key Takeaways

- Understand that place is about getting the product or the service to the target market where customers want it, when they want it, and at a reasonable cost.
- A small business may choose the direct, retail, wholesale, service, or hybrid channels or some combination of these channels.
- In general, B2B distribution channels parallel those of B2C businesses.
- The direct channel involves selling to the final customer with no intermediaries involved.
- Service businesses use the direct channel only because services are performed and consumed at the same time.

- The retail channel is considered indirect because the retailer is an intermediary between the producer or manufacturer and the final customer.
- The wholesale channel is also an indirect channel. The wholesaler is placed between the producer or manufacturer and the retailer.
- The multichannel distribution system (hybrid channel) uses two or more channels to reach one or more customer segments.
- Logistics are about getting materials, semifinished goods, and finished goods to customers efficiently and cost effectively. They can be handled by the producer or the manufacturer, intermediaries, or the customer.
- Logistics include decisions related to warehousing, transportation, inventory control, and order processing. These decisions are relevant to both online and onground companies.
- Websites play an important role in "placing" goods and services into the hands of customers.
- It is important to reduce the number of customers who abandon their shopping carts (i.e., leave the website without purchasing the items in their shopping carts).
- Shopping cart abandonment is common among online retailers. Shoppers abandon their carts for a variety of reasons, the most important one being high shipping charges.

Exercises

1. Assume that you own a small business that specializes in gift baskets for children. You have been satisfied with your success so far but are anxious to spread your wings. You sell online as well as onground and have received several notes from potential online customers expressing their disappointment that you distribute the gift baskets only in the Charlottetown area. You have decided to find out what logistics would be involved in shipping to Nova Scotia; Newfoundland; Quebec; and British Columbia. Discuss the transportation mode(s) that would best fit your company for each area.
2. Visit Levenger, Carbonite, and ZipCar. How do these small businesses get their products or services "into the hands" of the customer? Think broadly and creatively.

Marketing Strategy and Promotion

Learning Objectives

1. Understand the role of promotion in the marketing mix and its importance to a company.
2. Understand the different ways that a small business can promote its products or services.
3. Explain the differences and similarities in the marketing communications mix of online and onground businesses.

Promotion, the fourth P in the marketing mix, is now more commonly referred to as **marketing communications**. Marketing communications can be defined as "the means by which firms attempt to inform, persuade, and remind customers—directly or indirectly—about the products and brands they sell. In a sense, marketing communications represent the 'voice' of the company and its brands and are a means by which it can establish a dialogue and build relationships with consumers."[180] Marketing communications are all about getting the word out about a company's products and services because customers cannot buy what they do not know about, and, in the process, creating more of a two-way relationship with customers than was typical of the more traditional notion of promotion. A further conceptual iteration is the term ***integrated marketing communications (IMC)*** which is "[T]he coordination and integration of all marketing communication tools, avenues, and sources within a company into a seamless program designed to maximize the communication impact on consumers, businesses, and other constituencies of an organization."[181] Small-business owners should be familiar and comfortable with all three terms because at least one of them will be the basis of conversations with vendors, employees, and other businesses. However, from a small business management perspective, IMC should be the guiding philosophy for a company.

Prior to selecting and designing any communications, however, objectives must be established for the marketing communications program.

IMC Objectives

Every small business must decide what it wants to accomplish with its IMC plan. Although many IMC plans may be oriented toward a single objective, it is possible for a program to accomplish more than one objective at a time. The problem is that this may be confusing to potential customers.[182] IMC objectives can fall into seven major categories: increase demand, differentiate a product (stressing benefits and features not available from competitors), provide more information about the product or the service (more information seen as being correlated with greater likelihood of purchase), build brand equity (the value added to a brand by customer perceptions of quality and customer awareness of the brand), reduce purchase risk (important for new products and gaining new customers of current products), stimulate trial (to build new brands and rejuvenate stagnant brands),[183] and brand recognition. As with all objectives, IMC objectives must meet the SMART (specific, measurable, achievable, realistic, and time-based).

Marketing Communications Mix

The **marketing communications mix** for a small business, either pure-play or brick-and-click, will consist of some combination of the following major modes of communication: advertising, sales promotion, events and experiences, public relations (PR) and publicity, direct marketing, interactive marketing, word-of-mouth communication, and personal selling.[184] Each mode of communication has its own advantages and disadvantages, which should all be considered carefully before any final selections should be made.

Figure 17.7 The Marketing Communications Mix

Source:[185]

Advertising

Advertising is "any paid form of nonpersonal presentation and promotion of ideas, goods, or services by an identified sponsor."[186] Advertising is around us all the time—for example, ads are on television and radio, in newspapers and magazines, in train stations and on trains, on the sides and inside of buses, in public restrooms, in taxis, on websites, and on billboards. Ads can also be found in other places, and the locations are limited only by the creativity of the company placing the ads.

Small businesses must choose **advertising media** (e.g., radio, television, newspapers, billboards, the Internet, and magazines) based on its product, target audience, and budget. A local travel agency selling spring getaways to college students, for example, might post flyers on campus bulletin boards, run ads in the campus newspaper (for the students) and local newspapers (for the parents), and run ads on the college radio station. Examples of tried and true advertising media for small businesses include the yellow pages, newspaper and magazine advertising, direct mail, business cards, vehicle advertising, radio and cable television advertising, bench/bus stop advertising, local website advertising, e-mail advertising, eBay listings, community involvement, and cross-promotion (joining forces with other businesses). [187][188] Even advertising in the big leagues is not out of the question for a small business. Salesgenie.com decided to advertise during Super Bowl XLII in February 2008, choosing to risk major capital to connect with the huge Super Bowl customer base.[189]

Advertising on the Internet is also a consideration for the marketing communications mix of any business with a web presence. According to Lorrie Thomas, author of *Online Marketing*,[190] online advertising "can rocket your web marketing into the stratosphere" if it is done correctly. If not done correctly, however, it will "blast a giant crater in your budget." Online advertising includes the following entities: banner ads (image ads that range in size and technical capability); e-mail advertising (ads in newsletters, an ad in another company's e-mail, e-mailing a list with a dedicated message, or a company advertising to its own customers with its own e-mail list); news site advertising (placing ads on news, opinion, entertainment, and other sites that the audience frequents); blog advertising (buying ads directly on popular blogs); social media advertising (advertising on sites such as Twitter, Facebook, and LinkedIn); and affiliate marketing (company A places an ad for its product on the site of company B; company A then pays company B an agreed-on fee when a customer clicks on the ad and buys something).[191] Another possibility is Google AdWords. A small business can promote itself alongside relevant Google search results and on Google's advertising network. This allows a business to reach people who are already looking online for information about the products and services that a business offers.[192]

Video Link 17.5 Attracting Consumer Attention through Advertising

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

videos.smallbusinessnewz.com/2011/01/31/attracting-consumer-attention-through-advertising

Advertising offers several advantages to the small business. For example, advertising is able to reach a diverse and geographically dispersed audience; it allows the seller to repeat a message many times; and it provides the opportunity for dramatizing the company and its products through the artful use of print, color, and sound. However, the audience does not feel obligated to pay attention or respond to an ad.[193] Whether the advantages of advertising outweigh the costs and disadvantages is something that must be decided by each small business.

Sales Promotion

Given the expense of advertising and the fact that consumers are exposed to so many advertising messages every day, many companies correctly believe that advertising alone is not enough to get people to try a product a product or a service. Enter lower-cost sales promotion techniques. ***Sales promotion*** refers to the variety of short-term incentives to encourage trial or purchase of a product or a service. Examples of commonly used sales promotions include contests, sweepstakes, coupons, premiums and gifts, product samples, rebates, low-interest financing, price discounting, point-of-sale displays, and frequent user or loyalty programs.[194][195] These promotions can be used by and offer several advantages to small businesses:[196]

- **Attracting new customers with price.** A reduced price could lure customers away from the competition. For example, a small electronics store that is competing with a large retailer could offer a discounted price on a popular cell phone for a limited time.
- **Gain community favor.** By offering a promotion that helps a worthy cause, you can create a good name for the business. Donate a portion of sales to the local food bank, buy clothing for the homeless, or donate to the local animal shelter to help pay veterinarian bills.
- **Encourage repeat purchases.** Rewards and loyalty programs can be very successful for small businesses. Coffee clubs are popular (buy so many coffees at the regular price and you get one cup free), but this approach can work for sandwiches at a deli, bags of bird food or dog food at the local pet store, shoe repairs at the local cobbler, dry cleaning services, and virtually any other kind of business.
- **Entice reluctant customers.** Giving away a free product or service is usually a good way to get people to try a product or a service for the first time, the hope being that it will lead to a purchase. However, the product or the service has to be good enough to stand on its own so that when the "free" unit is gone, the person will come back to buy.
- **Providing information.** It can be very effective if you run a promotion that helps provide information to potential customers to help them make a decision. This works especially well for products or services that are complicated or unfamiliar to customers, for example, software or product usage (particularly for business-to-business [B2B] customers), financial services, investment services, or estate planning. Free onground seminars or ***webinars*** or ***webcasts*** (seminars or presentations that are delivered online and that are typically an hour in length) can be very effective at gaining new customers or clients.

Sales promotions can be delivered to the customer in a variety of ways, such as snail mail (US Postal Service), in person, in local new newspapers and regional editions of national magazines, on television and radio, in e-mail, on websites, and in electronic coupons that are sent to a customer's mobile device. Groupon, which is described as the hottest thing in retail marketing right now, offers customers coupons at local businesses: everything from restaurants to spas to painting lessons to sleigh rides.

Video Clip 17.20 Learn How Groupon Works!

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=190

A hot new source of coupons for local businesses.

Events and Experiences

Events and experiences are "company-sponsored activities and programs designed to create daily or special brand interactions."[197] A small business could choose to sponsor a Halloween costume event for pets,[198] or an entertainment event, such as a battle of the bands, to raise money for local scholarships. Participation in a local business fair could provide exposure for a product or a service and the opportunity to experience the product if that is possible. A local restaurant could participate in a chili competition. Factory tours and company museums, both of which can also be virtual, can offer great experiences for customers.

There are several advantages to events and experiences:[199] (1) A well-chosen event or experience can be very effective because the consumer gets personally involved. (2) Experiences are more actively involving for consumers because they are real time. (3) Events are not hard sell, and most consumers will appreciate the softer sell situation.

Events and experiences also tap into the importance of the customer experience. Today, customers "[W]ant products, communications, and marketing campaigns to deliver experiences. The degree to which a company is able to deliver a desirable customer experience—and to use information technology, brands, and integrated communications and entertainment to do so—will largely determine its success."[200] By having special events, a small business will stand out from the rest:[201] and they will create desirable publicity for the company.

Public Relations and Publicity

Public relations (PR) and **publicity** are designed to promote a company's image or its individual products.[202] A small business can also use PR to clarify information in response to negative publicity. Publicity usually being "an outcome of PR that is produced by the news media and is not paid for or sponsored by the business involved."[203] Traditional PR tools include press releases and press kits that are sent to the media to generate positive press on behalf of the business. A press kit, the most widely used PR tool, pulls together company and product information to make a good, solid first impression.[204] A press kit can be particularly useful for small businesses, although the smallest of businesses may not see the need. Other common platforms include speeches, seminars (online and offline), brochures, newsletters, annual reports, charitable donations, community relations, and company magazines.[205] Increasingly, companies are using the Internet: interactive social media, such as blogs, Twitter, and Facebook; home-page announcements for specific occasions (e.g., messages of sympathy for the victims of a disaster); and e-mail.

Social media services such as Google Alerts and TweetBeep can be very helpful for managing a company's reputation. ***Reputation management*** "[I]s the process of tracking other's opinions and comments about a company's actions and products, and reacting to those opinions and comments to protect and enhance the company's reputation."[206] Both services notify the business when the company name is mentioned. Addressing extremely negative comments immediately is very important for any small business with a web presence.

Most small businesses are not likely to have PR departments. Instead, there will be one person whose job includes—among many other things—PR and publicity. The key is for PR and marketing to work closely together so that "every piece of communication produced by the company speaks with one voice."[207]

Getting publicity for a small business is usually free. Stories about events and experiences might be of interest to the media. One great idea is to have a group of people outside the business with positive picketing, holding signs such as "Low prices" or "Beware of friendly employees." This was actually done by a small business, and it resulted in the business being on the front page of the local paper.[208]

Video Link 17.6 Obtaining Publicity for a Business

Information and tips for small businesses.

videos.smallbusinessnewz.com/2009/08/28/obtaining-publicity-for-your-business

PR and publicity tend to be underused by all businesses. However, PR and publicity should be particularly appealing to the small business because of the following three distinct qualities:[209]

- **High credibility.** News stories and features are more authentic and credible to readers.
- **Ability to catch buyers off guard.** PR can reach prospects who prefer to avoid salespeople and advertisements.
- **Dramatization.** PR has the potential for dramatizing a company or a product.

Direct Marketing

Direct marketing is the "promotion of a product from the producer directly to the consumer or business user without the use of any type of channel members."[210] Common direct marketing platforms include catalogs; direct mailing; telemarketing; television shopping; electronic shopping; fax mail; voice mail; blogs; websites;[211] E-mail; direct response radio, television, and Internet;[212] Social media, such as Facebook and Twitter; and mobile devices. Because channel members are bypassed, direct marketing normally allows for greater profitability; perhaps more importantly, however, it can develop stronger brand loyalty with customers.[213]

Video Link 17.7 What Is Direct Marketing?

A brief explanation of direct marketing.

www.videojug.com/expertanswer/small-business-advertising/what-is-direct-marketing

Direct marketing is about using information to educate, establish trust, and build a company (or someone in it) as an authority. This can be accomplished in multiple ways, such as website copy, a one-time piece of direct mail, a series of articles that build on one another,[214] a webcast or webinar, or a blog. There is no one more qualified to educate the market about a need than a small business owner: "They're the ones who will know their audience and what they'll find unique, irresistible and compelling. They're the best people to craft the message. Everything else in the organization can be outsourced, but the knowledge that a small business owner has about the people they serve, that can't be replicated."[215]

Direct marketing offers several advantages to both the business-to-consumer (B2C) and B2B small businesses:[216]

- **Flexible targeting.** A business can identify, isolate, and "talk" with well-defined target markets. This can translate into a higher conversion and success rate than if you tried to communicate with everyone in the mass market.
- **Customized messages.** Can be prepared to appeal to the addressed individual.
- **Up-to-date.** Messages can be prepared quickly.
- **Multiple uses.** Direct marketing can be used to sell, but it can also be used to test new markets, trial new products or customers, reward existing customers to reward loyalty, collect information for future campaigns, or segment a customer base.
- **Lower cost per customer acquisition.** The cost can be significantly less than other marketing methods.
- **Control and accountability.** Direct marketing offers great control and accountability than other marketing methods.
- **Swift and flexible.** Direct marketing is swift and flexible in achieving results.

Interactive Marketing

Interactive marketing refers to "[O]nline activities and programs designed to engage customers or prospects and directly or indirectly raise awareness, improve image, or elicit sales of products and services."[217] Everything is personalized and individualized—from the website content to the products being promoted.[218] The audience is engaged with the brand, with customers getting the chance to reshape and market it in their own unique way.[219] Forrester Research forecasts that interactive marketing expenditures will reach $55 billion by 2015, accounting for 21 percent of all expenditures on marketing. The greatest growth is projected to come from social media, with the next biggest growth sector being mobile marketing.[220]

Common interactive marketing tools include e-mail, websites, online shopping, videos, webinars and webcasts, blogs, and social media such as Facebook and Twitter. Because e-mail, websites, online shopping, webinars and webcasts have been mentioned previously, the focus here will be on videos, blogs, and social media. Using online videos has become an increasingly popular strategy in small business marketing. Consumers are much more likely to visit a company after viewing its video, and they can be up to 40 percent more likely to make some sort of contact.[221] Online video content is becoming increasingly popular with avid Internet users, so a small business should consider creating a video for its website. The content can be created easily, and it can be posted on the company's website as well as in other locations on the Internet (YouTube or on the company's blog, for instance) to get more page views.[222] According to Ad-ology's 2011 Small Business Marketing Forecast, 45 percent of US small businesses with fewer than 100 employees plan to use online video. This reflects the fact that small businesses are becoming increasingly savvy about how to use the Internet to market their products and services.[223]Paul Bond Boots, a small US maker of custom-made cowboy boots that are individually handmade to fit, features five really cool videos on its website. Recently, the company has turned to the Internet for most of its sales.

A ***blog*** "is a web page made up of usually short, frequently updated posts that are arranged chronologically—like a what's new page or a journal." Business blogs, as opposed to personal blogs, are used as a company communication tool to share a company's knowledge and expertise, build additional web traffic, connect with potential customers, develop niche markets, give the business a human face, help reputation management, and provide a free avenue for press releases.[224] For an example, visit Michael Chiarello's blog at www.michaelchiarello.com. If his name is not familiar, he is the founder of NapaStyle, a high-end small business retailer with both an onground and online presence.

Blogs are fairly simple to set up, and they are a great way to keep website content fresh. However, even though small businesses hear much about blogs these days, creating one must be considered carefully. Blogs today "have evolved into multimedia communities where bloggers (and the blogging community) have grown in size, stature, and impact to eclipse all but the largest media outlets."[225] But this does not mean that it is essential for every small business to have a blog. Maintaining a blog takes a lot of time and energy —and then there need to be people to read it. After careful consideration, it may be better to focus a company's promotional efforts elsewhere.

Social media "generally refers to websites featuring user-generated content or material created by visitors rather than the website publishers. In turn, these sites encourage visitors to read and respond to that material."[226] Social media is changing the way that people communicate and behave. Social media outlets such as Facebook, LinkedIn, and Twitter are, among other things, driving purchases—and they should be seen "like a virtual cocktail party where all attendees can discuss [a company's] products, services, experiences, and new ideas."[227]

The top four social media networks are Twitter, Facebook, LinkedIn, and YouTube. This is true in general and for small businesses in particular.[228] Overall, small businesses use social media sites for lead generation, monitoring what is being said about their businesses, keeping up with the industry, improving the customer experience, and competitive intelligence.[229] Many small businesses in the B2B sector are already using social media for business as a resource, to engage in initiatives, or both. However, companies with more than one hundred employees are more active than smaller companies.[230]

Despite the hype surrounding social media, and the fact that many small businesses are already connected, small businesses must still consider the use of social media just as carefully as the other modes of marketing communications. Social media has not worked out well for some small businesses that have used it, so each business must decide what social media is expected to do for the company, and then it must be used well and strategically. When considering whether or how to factor social media into an IMC strategy, consider these words from Lisa Barone, cofounder and chief branding officer at *Outspoken Media*, "In 2011, if you're not using social media to gain attention over your competitors, you can bet they're using it to gain attention over you."[231] This will undoubtedly continue to be the case.

Video Clip 17.21 Social Media

https://youtube.com/watch?v=lvbs-oQr5ms

The top five things you should know about social media.

Personal Selling

A small business owner needs to connect with customers before a sale can take place. Sometimes personal selling is the best way to do that. ***Personal selling***, "The process of communicating with a potential buyer (or buyers) face-to-face with the purpose of selling a product or service,"[232] is absolutely essential in the marketing communications mix of a small business. History has shown that the most successful entrepreneurs have been skilled salespeople who were able to represent and promote their companies and products in the marketplace.[233] It stands to reason that successful small business owners should have the same sales skills.

Although personal selling plays an important role in the sale of consumer products, it is even more important in the sale of industrial and business products. More than four times as many personal selling activities are directed toward industrial and business customers than toward consumers.[234] Regardless of the type of customer or consumer, however, the objectives of personal selling are the same:[235]

- **Building product awareness.** A salesperson should educate customers and consumers on new product offerings.
- **Creating interest.** Because personal selling is a person-to-person, and often a face-to-face, communication, it is a natural way for getting customers and consumers to experience a product for the first time. Creating interest goes hand-in-hand with building product awareness.
- **Providing information.** A large part of the conversation with the customer focuses on product information.
- **Stimulating demand.** The most important objective of personal selling by far is persuading customers and consumers to make a purchase.
- **Reinforcing the brand.** Most personal selling focuses on building long-term relationships with customers and consumers. However, strong relationships can be built only over time, and they require regular communication.

Like all other forms of marketing communications, personal selling offers both advantages and disadvantages. On the plus side, personal selling is flexible and dynamic, providing companies with the best opportunity to tailor a message to satisfy customers' needs. Personal selling's interactive nature also makes it the most effective promotional method for building relationships with customers, particularly in the B2B market, and it is the most practical promotional method for reaching customers who are not easily reached through other methods.[236] Personal selling can help a small business build strong, loyal relationships with customers and consumers.

On the minus side, the biggest disadvantage may be the negative perceptions that many people have of salespeople: pushy, annoying, slippery, and willing to do anything for the sale—whether legal or not. The reality, of course, is that most salespeople (unfortunately, not all) do not fit this stereotype. The successful salesperson is the person who focuses his or her efforts on satisfying customers over the long term as opposed to his or her own selfish interests. Also on the negative side is the high cost of personal selling. Personal sales contacts are very expensive, with the costs incurred (compensation plus sales support) whether the sale is made or not.[237] Then there are the costs of training the sales staff on product knowledge, industry information, and perhaps selling skills.[238] Depending on the size of the company, small businesses will have varying numbers of salespeople, so some of the costs will vary as well.

The traditional sales process is typically seen as a series of six steps:[239][240][241]

1. **Prospecting and qualifying.** Locating potential customers who have a need for a product and the ability to pay for it. For example, prospects for a small electric motor company would be all the businesses that use small electric motors. Prospects can be found through a variety of sources, including current customers, trade directories, business associates, and newspaper or magazine articles.
2. **Preapproach.** It is important to learn as much about a prospect as you can. For example, you want to know about the prospect's needs, attitudes about available products and brands, critical product attributes and benefits desired, and current vendor(s).
3. **Presentation and demonstration.** This is where the salesperson tells the product "story" to the buyer: the product's features, advantages, benefits, and value. It is important not to spend too much time on product features because benefits and value will most directly influence the purchase decision. It is also important to ask questions and listen carefully to a prospect's answers because they will provide valuable insights into the prospect's needs.
4. **Overcoming objections.** You should expect customers to pose objections. The key to overcoming these objections is to maintain a positive approach, ask the prospect to clarify the objections, and respond to the objections by reiterating the major benefits of the product or the service and pointing out additional features, guarantees, service, and anything else that would address the objections.

5. **Closing.** This is when the salesperson asks the prospect to buy the product. The request can be direct, or the salesperson can encourage the purchase by using a trial closing approach like asking, “Would you like us to finance product A for you?” Closing the sale is understandably the most difficult step for many salespeople because of the fear that the prospect will say no.
6. **Follow-up and maintenance.** These activities are necessary for customer satisfaction and repeat business. They are key to establishing the strong long-term relationships that every small business desires and needs. The salesperson should schedule a follow-up call to ensure proper installation, instruction, servicing, and troubleshooting and resolution should any problems be detected. Always remember that unhappy customers will defect to competition—and they will spread negative comments about the company. Because it is much cheaper to retain an old customer than to obtain new ones, it is in a company’s best interests to provide good follow-up and maintenance services.

Although these steps are helpful as a way to summarize the kinds of things that are relevant to personal selling, the Internet has revolutionized the selling process.[242] The traditional process just described has become largely obsolete, with roles changing. Web searches and online content help prospective customers or clients do their own prospecting and qualifying. This eliminates the most time-consuming part of the traditional sales process. A company’s website becomes the first sales presentation and, as a result, is critical in moving a prospect toward a sale. In short, all employees must be fully integrated into web marketing because web marketing is the primary driver of the sales process. The more web-savvy you are, the greater the chances that your selling will beat the competition.[243]

Video Link 17.8 Small Business Selling

An overview of personal selling.

www.videojug.com/interview/small-business-selling

Key Takeaways

- Promotion and marketing communications are relatively synonymous terms.
- IMC is about pulling all the marketing communications together to convey a consistent message.
- Small-business owners should be familiar and comfortable with the terms *promotion*, *marketing communications*, and *integrated marketing communications (IMC)*.
- There are multiple categories of IMC objectives.
- The marketing communications mix for a small business will consist of some combination of advertising, sales promotion, events and experiences, PR and publicity, direct marketing, interactive marketing, and personal selling. This mix is applicable to both pure-play and brick-and-click businesses.
- There is a lot of hype about blogs and social media. They can be very effective, but they have not worked well for all small businesses that have used them. They should be considered carefully before inclusion in a company’s IMC strategy.

Exercises

1. The Mill restaurant has historically taken a very low-key approach to promoting the business, choosing to rely on word-of-mouth communication. Robert believes that Emily needs to increase the sophistication of the marketing communications. Design an IMC plan for Emily’s The Mill Restaurant. Keep the following in mind: (1) Emily’s is a small business with a very limited IMC budget; (2) advertising in prime time and national television are not options; and (3) Emily is selling both food and its catering sauces.
2. Choose two products or services that you purchased recently from small businesses, one from an online business and one from an onground business. The products should be different from those chosen for price. For each product or service, identify the various media that were used to promote the product or the service and analyze the marketing communications mix. Do you agree with the marketing communications mix that was used? What recommendations would you make for change?[244]*Tip*: If you are not sure whether an online business can be considered a small business, type in the name of the business plus “corporate HQ” into Google or your preferred search engine. The search should return results that include the number of employees. As long as the company has fewer than five hundred employees, you are all set.

The Three Threads

Learning Objectives

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

Customer Value Implications

Marketing plays a key role in creating and delivering value to the customer, but it is the establishment of a strong link between customer value requirements and the major value-producing activities of a firm that is the foundation on which the delivery of superior customer value is based.[245] Marketing strategy provides that strong link.

A customer’s decision to buy will always be contingent on the strategic effectiveness of the marketing mix: the ability of the product or the service to meet the needs, wants, and desires of the customer; a price that is attractive when compared with possible alternatives; the availability of the product or the service in an onground or online place that is in sync with the customer’s needs; and an ***integrated marketing communications (IMC)*** program that creates awareness, provides information, and persuades. Although the different elements of the marketing mix will be of differing importance depending on the customer and the situation, it all begins with the product. Well-designed and well-made products will usually come out ahead on the customer value scale. Innovative channels of distribution, such as Redbox for DVDs, gourmet and ethnic food carts, kiosks in airports for selling small electronics products, and conducting financial transactions on a smartphone, can all add to customer value. Social media as a part of the IMC mix can be a particularly great way to create customer value because a consumer’s social network can be used as a communication channel to spread the word about a product’s characteristics, quality, benefits, and value.[246] Salespeople also create value for customers by helping to identify creative and cost-effective solutions to customer problems, making the customer buying process easier, and creating a positive customer experience. Pricing is always tricky, but there should be a clear and positive link between the price that customers pay and what customers see as the value received in return.

Cash-Flow Implications

An efficient and effective marketing strategy will keep costs down and stimulate sales. A small business owner could not ask for more as a way to realize a positive cash flow. However, the reality is that things will not go as planned most of the time, and this will wreak havoc with cash flow. This means that the marketing strategy should be developed and implemented within the context of a cash-flow strategy so that when things do not go as planned, you can make appropriate adjustments.

One of the biggest temptations for creating cash flow when money is tight is cutting the price as a way to stimulate sales. Think very carefully before doing this. The price reduction may generate more sales, but you may send unintended negative signals to customers about quality and value. You may also trigger a price cut by competitors that eliminates the benefits of your own price cut. A better strategy would be to maintain the price and offer the customer more value—as long as that additional value does not end up costing you more in money in the long run.[247]

Digital Technology and E-Environment Implications

The opportunities for using digital technology and the e-environment in marketing strategy have exploded as the technologies continue to develop and become more sophisticated. Strategic decisions can be made more quickly, with information that can be compiled and analyzed more completely and faster than ever before. The Internet offers an information bonanza and myriad opportunities for implementing the marketing strategy.

Mobile commerce continues to be one of the biggest trends to affect small business owners. More than 48 percent of Americans who own smartphones use them for shopping, so integrating mobile commerce into the marketing strategy should be strongly considered. Many small businesses that already use mobile commerce are seeing positive results. Aaron Maxwell, founder of Mobile Web Up, reported that one client has already seen 10 percent growth per month.[248] Since early 2011, small companies have increasingly been drawn to ***quick-response (QR) codes***. These high-tech bar codes are scanned with smartphone cameras, after which company and/or product content pops up on the screen. The customer then chooses to act or not act based on the content. The Ethical Bean Coffee Company in Vancouver, British Colombia, uses this technology in its train ads. Customers scan the code in an ad, a coffee menu pops up on their screens, and they can order a cup of coffee to be picked up at one of the Ethical Bean coffee shops. There are some challenges with using this technology, including cost,[249] but it is worth considering for the marketing communications strategy.

Mobile technologies, such as wireless Internet and cellular Internet access, have significantly impacted personal selling, making it possible for salespeople to access needed information at any time. Key business applications are increasingly being made available through a browser rather than being loaded on a salesperson's computer—again being accessible anywhere or anytime. Online video conferencing and web or phone conferencing allow for electronic presentations in lieu of face-to-face meetings. Sales training can be delivered over the Internet, and RSS feeds or e-mail enable salespeople to be notified quickly when new training material is available.

The marketing strategy of a small bank could include targeting the increasing number of small business owners that are starting to do their banking on the go. Customers can check balances, transfer funds, and take and send pictures of checks for remote deposit. It has been estimated that at least 50 percent of small businesses will do their banking through mobile devices by the end of 2013.[250] For the very small business, raising cash to proceed with the marketing strategy can actually be done through **crowdfunding**, securing small amounts of money from multiple contributors online. Margaret Broom of New Haven, Connecticut, used Peerbackers.com to raise money for renovating a new space for a yoga studio. In 45 days she raised $10,000 from more than 100 contributors, with average contributions of $15 to $20. The funds do not need to be paid back because they are contributions. However, some businesses give their contributors products or services from the business as an appreciation.[251]

Video Clip 17.22 Susie's Lemonade Stand

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=190

How wireless technology can provide communication and distribution support.

Key Takeaways

- Marketing strategy plays a key role in delivering customer value.
- Marketing strategy should be developed within the context of a cash-flow strategy.
- Digital technology and the e-environment continue to offer significant opportunities for small businesses.

Exercises

You run a small, specialized electronics firm that produces unique and highly sophisticated products. Your sales are evenly split between military contracts and commercial aviation. Two years ago, during a recent economic downturn, your business was under considerable cost pressure. To reduce costs, you switched from two American-based suppliers to a Taiwanese manufacturer. Last week, a national newspaper released a story that revealed that this Taiwanese manufacturer was using counterfeit chips produced in mainland China. This is clearly illegal, but things were made even worse by the speculation that the Chinese-made chips might be mechanisms that could be used in cyber warfare. It looks as though there will be at least one congressional investigation that will examine the national security issues associated with the counterfeit chips. Unfortunately, your firm was prominently mentioned in the article as one of the firms that had purchased a large number of these chips. This could have a major impact on a firm of your size.

1. What should you do?
2. How would you develop a marketing communications plan to deal with this crisis?
3. How would you deal with the anticipated cash-flow crisis?
4. How should you handle the issue of customer value?

Disaster Watch

Robert has spent the last year building his Internet business. He registered his domain name shortly after developing his idea. Three months were then spent waiting for his web developer to create a custom website built to his specifications. Just when Robert thought his online venture was going to die on the vine, his web guru called to ask if Robert wanted to see the site.

Robert quickly typed in the URL of his domain. There, for all to see, was his website. The online catalog was complete, the merchant account had been set up—and has been for two weeks because he has been paying the monthly fees in anticipation of the site launch date. The e-mail at the domain is configured, and Robert's online business is underway.

Search engine optimization helps to drive traffic to Robert's site. He sends out e-mail messages to everyone on his mailing list to let them know that his online venture is now open for business. Sales started slowly, as expected, but they grew steadily. The twenty-third sale was as exciting as the first.

On the morning of the business's one-year anniversary since buying his domain name, Robert goes to the office and turns on his computer with thoughts of checking his e-mail. His e-mail program announces an error. Something about "could not connect to server."

Robert's first thought was that perhaps the hosting company was having a network issue. He decides to wait for half an hour…but gets the same error. He decides to wait another ten minutes and try again. If it still does not work then, he plans to call his hosting company.

Ten minutes go by. The error keeps showing up. One more try. The error pops up again. Robert picks up the phone and calls the hosting company. Once he gets a tech on the phone, he explains the situation, saying that he needs his e-mail up and running so that he can follow up on the orders that came into the store last night. The next ten minutes are spent double-checking settings on the e-mail program. Still nothing works.

Eventually, someone at the hosting company thinks to check the domain name. **DISASTER!** The domain name had expired at midnight. No business can be conducted, and some people may think he has gone out of business.

What does Robert have to do now?[252]

Elegant Touch

Source: Used with permission from Anita Bruscino.

Anita Bruscino, the sole proprietor of Elegant Touch, began her career as a mechanical engineer. She worked in her family's manufacturing business until she and her father left because of too many factions in the company. This provided her with the opportunity to start her own business, something she had always known in her heart that she wanted to do.

Anita was inspired to open a gift shop by a family friend who had owned her own gift shop. She gave Anita advice on starting her own business, and Elegant Touch opened in 1994. Anita has since expanded the business and is celebrating the shop's eighteenth anniversary, with the last six years in its larger location. The shop is warm, lovely, and comfortable, featuring unique gifts for all occasions and specializing in American handcrafted gift items and gift baskets. Shoppers will also find maternity gifts, items for the sweet tooth, specialty foods, special seasonal sections[253] —and a friendly smile from Anita. One thing that you will not find at Elegant Touch is what you find in other gift shops in her market area. When selecting products for her shop, Anita asks vendors whether other stores in the area carry the gift line she is considering. She will not carry duplicates. She likes to see new things and follows the trade magazines to help her do that. When asked how she chooses the products to carry, she described the process as instinctive—"from the gut."

Anita describes her customer demographics as mostly women, between thirty and seventy years old, married, and established with a home. Because many of her customers are repeat customers, the reason for fresh products is clear. A stale product line is not something that she can afford. Her pricing strategy is consistent with common practice in the industry, but many of her customers have commented that she delivers very high value for the prices she charges. She is not interested in selling online because she does not want to expand any further. She is at a nice comfort level and does not want to deal with the additional inventory implications or the need to hire additional employees. As a result, the Elegant Touch website is for basic information only. In promoting Elegant Touch, Anita says that word of mouth works the best. She advertises in the local paper occasionally, supports local events, and is preparing for her first e-mail blast. She is exploring a Facebook presence but is not yet convinced that it will be of much value to her business.

Like all small businesses, Elegant Touch has been impacted by the ups and downs in the economy, with some times being tougher than others. Because Anita has only two part-time employees, however, she has not been faced with the employee layoffs that have hit other small companies. When asked what keeps her going in the rough times, she answered, "You have to love it." Just walk into her gift shop, and you will see clearly that she does.[254]

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CHAPTER OVERVIEW

7: Globalisation

7.1: Chapter 18- Going Global- Yes or No?

Figure 18.1 Center Rock Inc. Reprinted with permission from Center Rock, Inc.

Brandon Fisher, the founder of Center Rock Inc., is shown on the left side in the picture. The man to his right is Richard Soppe, the senior drilling application engineer. The number 33 is the number of Chilean miners who were rescued in 2010. Brandon and his company, now at seventy-five employees, are true American heroes.

Center Rock manufactures and distributes a complete line of air drilling tools and products. At its state-of-the-art manufacturing facility in Pennsylvania, they build stock and made-to-order products that are used by leading drilling, oil and gas, foundation, construction, roadway, and mining contractors across North America, Europe, Asia, Russia, and Australia. Fisher entered the global market four years ago as a way to expand the business. He was able to finance the expansion internally, so financing was not an issue.

Center Rock Inc., founded in 1998 by then twenty-six-year-old Brandon Fisher, began as a drilling company. He designed and built his own horizontal drilling rig and, shortly thereafter, began focusing on making Center Rock an air and rock drilling supplier and manufacturer. He recognized the need for a manufacturing company that was reactive to customer needs, with innovative products and 24/7 customer service and support. Working with his high-tech engineering and design team, Fisher created a company different from its competitors with its unique products and service capabilities.

"I love what I do," says Fisher. "There is always a challenge in this industry to find new ways to drill into the earth, and the challenge feeds the excitement."[1]

US Small Business in the Global Environment

Learning Objectives

1. Understand and appreciate the role of small businesses in the global environment.
2. Learn about the global growth opportunities for small businesses.
3. Understand the advantages and the disadvantages of a small business going global.

Although small businesses make up a disproportionately large share of the number of companies that export and import, this represents only about 1 percent of the total number of small businesses. Thus many small businesses have yet to compete globally. The opportunities are there. "So much of what America makes is in great demand," said US Commerce Secretary Gary Locke in an interview, adding further that the growth potential for small companies is outside the United States. Dale Hayes, vice president of US marketing for UPS concurs, observing that the demand for high-quality American products is huge.[2][3] It may be that a small business is already competing globally because foreign-owned companies are competing in our own backyards.[4]

Yet the global marketplace is not relevant to most small businesses. Given that 99 percent of the small businesses in the United States are not operating globally—preferring to grow (if they want to) locally, regionally, and perhaps nationally—it is reasonable to conclude that going global will interest only a few. Those few, however, must undertake careful analyses before jumping into the global arena.

The Small Business Global Presence

It may seem to many that the global market is the domain of the large corporations, but the statistics tell a very different story. Small businesses actually account for close to 97.6 percent of US exporters and 32.8 percent of the value of US exports as well as 97.1 percent of all identified importers and 31.9 percent of the known import value.[5] Consider the following additional facts:[6]

- Small businesses account for 96.4 percent of all manufacturing exporters, which is 17.2 percent of the sector's $562 billion in exports.
- Nearly 100 percent (99.2 percent) of exporting wholesalers were small businesses, which is 61.1 percent of the sector's $218 billion in exports.
- Of other companies with exports, 96.9 percent were small businesses. These companies include manufacturing companies of prepackaged software and books, freight forwarders and other transportation service firms, business services, engineering and management services, gas and oil extraction companies, coal mining companies, and communication services, to name a few.
- Small businesses account for 93.6 percent of all manufacturing importers, which is 12.9 percent of the sector's $602 billion in imports.
- Nearly 100 percent (99.2 percent) of wholesaler importers were small businesses, contributing 56.8 percent of the sector's $451 billion in imports.
- Small businesses accounted for 94.3 percent of the companies that both exported and imported, accounting for 29 percent of the export value and 27 percent of the import value.

This tells us that small businesses are very active in the global marketplace, and small business success in international markets is extremely important to the welfare of the United States."[7] Although it is true that small businesses are major users of imported goods, the focus of this chapter is on small business exporting because exporting can be an effective way to diversify the customer base, manage market fluctuations, grow, and become more competitive.[8]

Small businesses are limited in the products and the services that they export. Small business exports are concentrated in four main product categories: computers and electronic products, chemicals, machinery, and transportation equipment. However, the leading product categories in terms of market share were wood products, apparel and accessories, tobacco products, beverages, and leather products.[9]

Although the United States is one of the world's largest participants in global services trade, very little information exists with respect to services exports by small businesses. What is known is that it is increasingly common for most US services firms to establish a ***foreign affiliate*** —a branch or a subsidiary of the parent company established outside the national boundaries of the parent company's home market—because most services are better supplied in close proximity to the principal or final customers.[10] Additionally, in some business sectors, foreign regulations may restrict the delivery of some services to affiliates only. For example, to comply with domestic solvency requirements, some countries require that personal lines of insurance be carried out only by affiliates. Another example is the protection of intellectual property rights. This is often accomplished through the services of affiliates, thus intellectual property is kept in-house.[11]

What is particularly interesting is that most of the service exporting occurs in businesses with 0–19 employees, with the least service exporting done by small businesses with 300–499 employees. This may be the exact opposite of what you would expect.

The Advantages of Going Global

The flexibility of a smaller company may make it possible to meet the demands of global markets and redefine a company's programs more quickly than might occur in the larger ***multinational corporation.*** [12] A multinational corporation is a company that operates on a worldwide scale without ties to any specific nation or region; it is organized under the laws of its own country.[13] This flexibility of the smaller company is particularly true of the ***micromultinationals***, a relatively new category of tiny companies that operate globally, having a presence and people in multiple countries. [14][15]

These micromultinationals outsource virtually everything to specialists all over the world and sell to people all over the world through the Internet.[16] The Internet is inexpensive technology, and the services designed to help small businesses make it possible for the small company to operate across borders with the same effectiveness and efficiencies as large businesses.[17]

Micromultinationals

Generation Alliance is a branding and design firm that provides services to clients all over the world. They have core employees in Australia and specialist contractors in New Zealand, the United Kingdom, Germany, Switzerland, Jamaica, Dubai, and Singapore. One of their more interesting projects was to rebrand the country of Botswana for the global market.[18]

Worketc operates in the large and competitive business software market. Their focus is small businesses, selling web-based customer relationship management (CRM), project management, billing, shared calendars, help desk, and document management software. The company is headquartered in Sydney, Australia, and it claims happy customers in sixteen countries. The United States accounts for 86 percent of its customers.[19][20]

There are many reasons why small businesses should consider going global:[21][22][23][24]

- A small business that thinks and sells only domestically may be reaching only a small share of its potential customers because 95 percent of the world's consumers live outside the United States.
- Exporting enables companies to diversify their portfolios and weather changes in the domestic economy. This stabilizes seasonal and cyclical market fluctuations.
- Exporting helps small businesses grow and become more competitive in all their markets, which reduces the dependence on existing markets.
- Exporting increases sales and profits, also extending the sales potential of existing products. Research has shown that exporting can expand total sales 0.6 percent to 1.3 percent faster than would otherwise be the case.
- Exporting companies are able to sell excess production capacity.
- Exporting companies are nearly 8.5 percent less likely to go out of business.
- There are higher worker earnings as well, which contributes to the betterment of the community.

According to the US Small Business Administration (SBA),[25] US exporting businesses experience faster annual employment growth by 2 to 4 percentage points over their nonexporting counterparts. Workers employed in exporting companies have better paying jobs and better opportunities for advancement. Research has estimated that blue-collar worker earnings in firms that export are 13 percent higher than those in nonexporting plants, 23 percent higher when comparing large plants, and 9 percent higher when comparing small plants. White-collar employees also benefit from higher salaries, 18 percent more than their nonexporting counterparts. Less skilled workers also earn more at companies that export. Lastly, the benefits that all workers receive at exporting plants are 37 percent higher and include improved medical insurance and paid leave.

Video Link 18.1 Why Export?

Why small businesses should consider entering the global marketplace.

www.inc.com/exporting/whyexport.htm

The Disadvantages of Going Global

There is no question that the benefits of going global are considerable. However, disadvantages or barriers must also be considered. For example, a small business will incur additional costs, such as modifying its product or its packaging (perhaps even changing the name of its product so that it does not convey negative meanings outside the United States), developing new promotional materials, administrative costs (such as hiring staff to launch the export expansion and dedicating personnel for traveling), traveling to foreign locations (very important), and shipping.[26][27] It may also be necessary for the owner to subordinate short-term profits to long-term gains, wait longer for payments, apply for additional financing, and obtain special export licenses.[28] There will be differences in consumer needs, wants, and usage patterns for products; differences in consumer response to the elements of the marketing mix and differences in the legal environment may conflict with those of the United States.[29] Then, of course, there are cultural and language issues along with the all-too-familiar fear of the unknown. [30] A recent survey of exporting and nonexporting members of the National Small Business Association (NSBA) and the Small Business Exporters Association (SBEA) reported the following main barriers to small businesses selling their goods and/or services to foreign customers:[31]

- I do not have goods and/or services that are exportable: 49 percent.
- I do not know much about it and am not sure where to start: 38 percent.
- I would worry too much about getting paid: 29 percent.
- It is too costly: 27 percent.
- It would take too much time away from my regular, domestic sales: 17 percent.
- I cannot obtain financing to offer products or services to foreign customers: 7 percent.

Three things were identified as the single largest challenge: worrying about getting paid (26 percent), feeling that exporting is confusing and difficult to do (24 percent), and having limited goods and/or services that are exportable (18 percent).

Richard Ginsburg in the SBA's Office of International Trade has commented that most US small businesses simply do not understand the value of taking their business global, further noting that "the number-one barrier to trade is the psychological acceptance that global business is necessary.[32]

Small businesses also face some resource constraints that reduce their ability to export. For example, small businesses are more likely than larger firms to face scarcities of financial and human resources that limit their ability to take advantage of global opportunities. Limited personnel, the inability to meet quality standards, the lack of financial backing, and insufficient knowledge of foreign markets are important constraints affecting the ability of small businesses to export.[33] Fortunately, being proactive, innovative, and willing to take risks have helped small businesses overcome export impediments and improve export performance.[34]

The disadvantages of going global may warrant a go-slow approach, but they should not be viewed as knockout factors. If a business's financial situation is weak, the timing may not be right for becoming an exporter…but perhaps exporting makes sense in the future. In any case, very careful thinking should precede the decision to export.

2010 Winner of the Growth through Global Trade Award

Source: SteelMaster Buildings. Reprinted with permission.

The UPS Growth through Global Trade Award recognizes businesses with fewer than five hundred employees that are excelling in international trade. The inaugural winner was SteelMaster Buildings LLC, in Virginia Beach, Virginia, a manufacturer, designer, and supplier. The UPS award was followed up by two other national awards and four regional awards related to SteelMaster's increases in global trade plus a mention in a September 2010 speech by the former US Secretary of Commerce, Gary Locke, at a trade conference. The company earned first place in the 2011 Export Video Contest cosponsored by the SBA and VISA.

Video Link 18.1 Starting an Import/Export Business

A YouTube element has been excluded from this version of the text. You can view it online here: https://pb.libretexts.org/maritime/?p=200

How to start an Import/Export business.

SteelMaster employs fifty people, excluding distributors. It exports to more than forty countries and has distributorship relationships in more than fifty international markets (e.g., South Korea, Romania, Mexico, Angola, Chile, Peru, Slovakia, South

Sudan, and Australia). This distributor network has provided an important source of market differentiation. Since the company began exporting in 2006, in response to the very competitive and saturated US market, the company's revenue has quadrupled, and exporting now represents over 20 percent of its total revenue. In addition,

- The SteelMaster website is user-friendly and offers a bilingual choice for Spanish-speaking viewers. Live chat is also available. In addition, various parts of the website have been translated to other languages (i.e., Korean, French, Romanian, Portuguese, and Arabic) to serve the company's international customers in their own languages.
- SteelMaster buildings are environmentally friendly and can be recycled. Green buildings are offered that protect against nonuniform weathering and reduce energy loads on buildings due to a long-term, bright service that helps heat reflectivity.
- SteelMaster's Galvalume Plus coated steel has been approved by the ENERGY STAR program for both low-slope and high-slope applications.
- The SteelMaster product can be easily used in the wake of natural disasters, such as earthquakes, flooding, or hurricanes. The company has participated in humanitarian relief efforts, specifically in Haiti.[35][36][37][38] The company stands ready to provide safe and reliable construction solutions to people in need around the world.

Key Takeaways

- Small businesses make up a disproportionately large share of the number of companies that export and import. However, this is only about 1 percent of the total number of small businesses.
- The growth potential for small companies outside the United States is huge because of the demand for high-quality American products.
- Small businesses account for close to 98 percent of US exporters and 33 percent of the value of US exports.
- Small business success in international trade is extremely important to the welfare of the United States.
- There are many advantages and disadvantages of a small business going global. These must be analyzed very carefully before deciding to enter the global marketplace.
- A recent survey of small business owners revealed that the number one barrier to exporting was the feeling that their businesses did not have exportable goods and/or services. The number one challenge was worrying about getting paid.

Exercises

1. Go to www.trade.gov/mas/ian/statereports. Select your state and prepare a profile of small business exporting. Review additional sites as well, for example, websites sponsored by your state's commerce and/or economic development departments. When looking at government sites, you may see the term *small- and medium-sized businesses* or something similar. They are simply referring to businesses with fewer than five hundred employees. This is the small business group for your purposes.

What You Should Know Before Going Global

Learning Objectives

1. Learn about the different ways that a business can export.
2. Understand the importance of an industry analysis.
3. Understand that it is important to carefully assess a business.
4. Learn about the marketing decisions that must be made.
5. Learn about the kinds of legal and political issues that will affect the exporting activities of a business.
6. Understand why the currency exchange rate is important to determining price.
7. Learn about the different sources of financing.

Although expanding into global markets offers many important benefits, not the least of which is increased profits, it will also introduce new complexities into the operations of a small business. There are several key decisions (see Figure 18.1) that will need to be made, including the following:[39]

- Determine which foreign market(s) to enter.
- Analyze the expenditures required to enter a new market and determine the source(s) of financing.
- Determine the best way to organize the overseas operation in concert with the US organization.
- Determine the extent to which, if any, the marketing mix will need to be adapted to the needs of the foreign market(s).
- Figure out the best way for the business to get paid.

These decisions, and others, will be based on an assessment of the ways to export, an analysis of the industry and the business, marketing and cultural factors, legal and political conditions, currency exchange issues, and sources of financing.

Video Link 18.2 A Family Business Goes Global

A small business specializing in leather-care products gets a lesson in expanding beyond its old fashioned clientele.

money.cnn.com/video/fsb/2008/09/10/fsb.pecard.makeover.fsb

Figure 18.1 Factors Affecting the Decision to Go Global

Ways to Export

Small businesses can choose from two basic ways to export: directly or indirectly.[40] There are advantages and disadvantages of each that should be understood before making a choice.

Direct Exporting

In ***direct exporting***, a small business exports directly to a customer who is interested in buying a particular product. The small business owner makes all the arrangements for shipping and distributing the product overseas, is responsible for the marketing research, and collects payment. This approach gives the owner greater control over the entire transaction and entitles him or her to higher profits—although these higher profits are accompanied by the need to invest significantly more resources and efforts (see Table 18.1). It also requires a significantly changed internal organizational structure, which entails more risk.[41][42][43]

Table 18.1 Advantages and Disadvantages of Direct Exporting

Advantages	Disadvantages
Potential profits are greater because intermediaries are eliminated.	It takes more time, energy, and money than an owner may be able to afford.
The owner has a greater degree of control over all aspects of the transaction.	It requires more "people power" to cultivate a customer base.
The owner knows customers, and the customers know the owner. Customers feel more secure in doing business directly with the owner.	Servicing the business will demand more responsibility from every level in the organization. The owner is held accountable for whatever happens. There is no buffer zone.

Advantages	Disadvantages
Business trips are much more efficient and effective because an owner can meet directly with the customer responsible for selling the product.	The owner may not be able to respond to customer communications as quickly as a local agent can.
The owner knows whom to contact if something is not working. The owner gets slightly better protection for trademarks, patents, and copyrights.	The owner must handle all the logistics of the transaction. If it is a technological product, the owner must be prepared to respond to technical questions and provide on-site start-up training and ongoing support services.
The owner is presented as fully committed and engaged in the export process and develops a better understanding of the marketplace. As a business develops in the foreign market, the owner has greater flexibility to improve or redirect marketing efforts.	

Source: [44]

Indirect Exporting

Indirect exporting involves entering "into an agreement with an agent, distributor, or a traditional exporting house for the purpose of selling (or marketing and selling) the products in the target market."[45] Many small businesses choose this option, at least at the outset. It is the simplest approach, particularly when a business does not have the necessary human and financial resources to promote products in foreign markets in any other way (see Table 18.2).[46][47] The easiest way to export indirectly is to sell to an intermediary in the United States because the business will normally not be responsible for collecting payment from the overseas customer or coordinating the shipping logistics.[48]

Table 18.2 Advantages and Disadvantages of Indirect Exporting

Advantages	Disadvantages
Does not require a lot of organizational effort or staff workers.	Not all types of goods lend themselves to indirect exporting (e.g., technically complex goods and services).
The producer of the goods is subject to only small dangers and risk (e.g., a short-term drop in the exchange rate).	The profits of a business will be lower, and control over foreign sales is lost.
It is an almost risk-free way to begin. It demands minimal involvement in the export process. It allows the owner to continue to concentrate on its domestic business.	A business very rarely knows who its customers are, thus losing the opportunity to tailor its offerings to their evolving needs.
The business has limited liability for product marketing problems. There is always someone else at which to point the finger.	When an owner visits, he or she is a step removed from the actual transaction and feels out of the loop.
The owner learns on the fly about international marketing. Depending on the type of intermediary with which the owner is dealing, the owner does not have to be concerned with shipment and other logistics.	The intermediary might be offering products similar to a particular business's products, including directly competitive products, to the same customers instead of providing exclusive representation.
A business can field-test its products for export potential. In some instances, the local agent can field technical questions and provide necessary product support.	The long-term outlook and goals for an export program can change rapidly, and if a business has put its product in someone else's hands, it is hard to redirect efforts accordingly.

Source: [49][50]

Industry Analysis

Before jumping into the global pond, it is a good idea to identify where an industry currently is and then look at the trends and directions that are predicted over the next three years. This will be true whether a business is only on the ground, only online, or both brick and click.

A business should try to determine how competitive an industry is in the global market.[51] Try to get as good a picture of the market as possible because the better informed a business is, the better its chances of a successful global entry. Learn a product's potential in a given market, where the best prospects for success seem to be, and common business practices.[52]

A small business owner may be reticent about conducting market research before going global, particularly if domestic research efforts have been limited or nonexistent. However, the global market is a very different animal compared to the domestic market. It is even more important to conduct thorough market research to help identify possible risks in advance so that the appropriate steps can be taken to avoid mistakes. This ultimately portrays the business as forward-thinking, trustworthy, and credible.[53]

- Several resources should be consulted. However, the best guide to exporting for the small business comes from the US government.[54]
- The SBA is a great place to start to find information to help a business break into the global game. The information on exporting and importing is comprehensive and easily understood.
- The US government portal Export.gov provides online trade resources and one-on-one assistance for global businesses. Export.gov provides particularly helpful information on regulations, licenses, and trade data and analysis. Trade data can help a business identify the best countries to target for exports. A business can gauge the size of the market for a product or a service and develop a pricing strategy to become competitive.[55]
- The US International Trade Commission offers market information, trade leads, and overseas business contacts. Trade professionals are available to help a business every step of the way with information counseling that can reduce costs, risks, and the mystery of exporting.[56]
- The US Department of Commerce provides trade opportunities for US business, export-related assistance, and market information.[57]
- Information about protecting intellectual property abroad can be found at http://www.stopfakes.gov. This is important because counterfeiting and piracy cost the world economy approximately $650 billion per year.[58]

Other sources to be consulted include people in the same business or industry, industry-specific magazines, trade fairs, seminars,[59] and export training and technical assistance that is available to small businesses through the states and the federal government. The Federation of International Trade Associations is a global trade portal that provides trade leads, market research, links to eight thousand import/export websites, and even travel services. WorldBid.com describes itself as the largest network of international trade marketplaces in the world, providing trade leads and new business contacts.[60]

The Internet makes it possible to gather and view tremendous amounts of information. If a business is thinking seriously about going global, there is no better time to take advantage of this quick-and-easy access than now.

Video Link 18.3 Knowing the Export Environment

Government experts identify challenges and debunk some myths.

www.inc.com/exporting/exportsuccess.htm

Business Assessment: Are You Ready?

It is important to honestly self-evaluate a business to determine whether it is really ready to go global or not…or at least not yet.[61]If a business is thinking about expanding globally, it is probably already doing something right to have reached this point. However, that does not preclude the importance of assessing its strengths and its weaknesses to determine the approach that should be taken in the global market.[62] This will be true no matter what role e-commerce plays in a business. Even a micromultinational business should assess its strengths and its weaknesses, although its instantaneous presence as a global business means that the assessment must be done at start-up and then must continue as products and services move from country to country.

There are several issues that should be addressed. The following are some of the questions that should be asked:[63][64][65][66]

- Why is a business successful in the domestic market? What is its growth rate? What are its strengths?
- What products have export potential? Do the products fill a niche that is exclusive to the US market? Are they packaged in a way that can be understood by non-English-speaking consumers? Do they violate any cultural taboos or contain ingredients that will prohibit their sale in a foreign market? Identify the key selling features of the products, identify the needs that they satisfy, and identify any selling constraints.
- What are the competitive advantages of a particular business's products over other domestic and international businesses?
- What competitive products are sold abroad and by whom?
- Does the product require complementary goods and technologies? If so, who will provide them?
- How will the business provide customer service?
- Can production handle a wider demographic? Can the business increase output without sacrificing quality?
- Does the business have the money to market globally?

- Is the entire business (including all staff) committed to a global effort?

If a product is an industrial good, a business will want to know things such as what firms will likely use it, whether its use or life might be affected by climate, and whether geography will present transportation problems that will affect purchase. In the case of a consumer good, a business will want to know who will consume it; how frequently it will be purchased; whether it will be restricted abroad; whether climate or geography will negatively impact accessibility for purchase; and—perhaps most importantly—whether it conflicts with traditions, taboos, habits, or the beliefs of customers abroad.[67]

A helpful tool to assess readiness is the export questionnaire available at www.export.gov/begin/assessment.asp. This questionnaire highlights characteristics common to successful exporters and identifies areas that need to be strengthened to improve export activities.

Video Link 18.4 Where Will Your Next Customer Come From?

Small businesses looking to grow should look beyond US borders to find new customers.

www.sba.gov/content/where-will-your-next-customer-come

Marketing

Just as it is necessary to offer a different marketing mix (see Figure 18.2) for different target markets, it will generally be necessary to adapt the marketing mix to the global market in general and different countries in particular. A business's unique value proposition (the set of benefits offered to customers to satisfy their needs and wants consisting of some combination of products, services, information, and experiences)[68] is what will differentiate one marketplace offering from the competition. Given the more diversified competition in the global marketplace, identifying the value proposition is even more critical—and most likely more difficult—than in the domestic market.[69]

Figure 18.2 The Marketing Mix

Product

The ideal situation is when a product developed for the US market can be sold in a foreign country without any changes. Although some kinds of products can be introduced with no changes (e.g., cameras, consumer electronics, and many machine tools),[70]most products usually have to be altered in some way to meet conditions in a foreign market.[71] From a small business perspective, the owner will want to market products that do not require drastic changes to be accepted. Relatively minor packaging changes, such as size or the language on the package, can be made inexpensively, but more drastic changes should be avoided. If a product must be changed drastically to market it globally, conduct an in-depth cost analysis to determine whether the additional costs will outweigh the anticipated benefits.[72] If a product is a food or a beverage, for example, is the business prepared to make the changes necessary to appeal to widely varying tastes? [73]

Products need to be adapted for many reasons, including the following:[74][75]

- Different physical or mandated requirements must be met (e.g., electrical goods will need to be rewired for different voltage systems).
- The legal, economic, political, technological, and climatic requirements of the local marketplace vary (e.g., varying laws will set specific packaging sizes and safety and quality standards).
- The product or the company name must translate flawlessly to the new target market so that it does not convey an unintended, perhaps very negative, meaning. One of the most well-known examples of a translation blunder is the Chevy Nova. In Spanish, "nova" means "no go."
- The package label may need to be changed. Imagine the horror of a well-known baby food producer that introduced small jars of baby food in Africa when it found out that the consumers inferred from the baby picture on the jars that the jars contained ground-up babies. This shows us that even big companies can make big mistakes.
- A change in flavor or fragrance may be necessary to bring a product in line with what is expected in a culture. The pine and hints of ammonia or chlorine scents that are popular in the United States were flops in Japan because many Japanese sleep on the floor on futons. With their heads so close to the floor, a citrus scent is more pleasing.

The less economically developed a market happens to be, the greater may be the need for product adaptation. Research has found that only one in ten products can be marketed in developing countries without some kind of product adaptation.[76]

Cultural Differences

It is important to know that cultural and social differences are intertwined with the perceived value and importance that a market places on a product.[77] "A product is more than a physical item: It is a bundle of satisfactions (or *utilities*) that the buyer receives. These include its form, taste, color, odor, and texture; how it functions in use; the package; the label; the warranty; the manufacturer's and retailer's servicing; the confidence or prestige enjoyed by the brand; the manufacturer's reputation; the country of origin; and any other symbolic utility received from the possession or use of the goods. In short, the market relates to more than a product's physical form and primary function."[78]

The values, customs, rituals, language, and taboos within a culture will determine the acceptability of a product or a service. Cultural sensitivity is particularly important in cyberspace. Website visitors may come from anywhere in the world. Icons and gestures that seem friendly to US visitors may shock people from other cultures. For example, a high-five hand gesture would be insulting to a visitor from Greece.[79] Knives and scissors should not be given as gifts in South America because they symbolize the severing of a friendship. [80]

The ***psychological attributes*** of a product (features that have little to do with the primary function of the product but add value to customer satisfaction, e.g., color, size, design, brand name, and price)[81] can also vary across cultures, and the meaning and the value assigned to those attributes can be positive or negative. It may be necessary to adapt the nonphysical features of the product to maximize the positive meanings and eliminate the negative ones.[82] When Coca-Cola, the number one global brand, introduced Diet Coke to Japan, it found that Japanese women do not like to admit to dieting. Further, the idea of diet was associated with medicine and sickness. Coca-Cola ended up changing the name to Coke Light.[83] This happened in Europe as well, so if a product is associated with weight loss, a business must be very careful with its marketing.

The Package

The package for a product includes its design, colors, labeling, trademarks, brand name, size, product information, and the actual packaging materials. There are many reasons why a package may have to be adapted for a particular country. There may be laws that stipulate a specific type of bottle or can, package sizes, measurement units, extraheavy packaging, and the use of particular words on the label.[84] In some cases, the expense of package adaptation may be cost prohibitive for entering a market. Consider the following examples:[85]

- In Japan, a poorly packaged product is seen as an indicator of product quality.
- Prices are required to be printed on the labels in Venezuela, but putting prices on labels or in any way suggesting the retail price in Chile is illegal.
- A soft-drink company from the United States incorporated six-point stars as decoration on its package labels. But it had inadvertently offended some of its Arab customers who interpreted the stars as symbolizing pro-Israeli sentiment.
- Soft drinks are sold in smaller sizes in Japan to accommodate the smaller Japanese hand.
- Descriptive words such as giant or jumbo on a package or a label may be illegal in some countries.

The message here is clear. Before going global with a product, examine the packaging so that each element is in compliance with appropriate laws and regulations so that nothing will offend prospective customers.

Global Packaging

Canada's oldest candymaker, Ganong Brothers, is located about one mile from Maine. The company chairman, David Ganong, can see the US border from his office window. You would think it would be easy for Ganong Brothers to sell to the US market. Not so. In Canada, nutritional labels read *5 mg*, with a space between the number and the unit of measurement. Ganong's jellybeans cannot get into America unless the label reads *5mg*, without the space. This difference, as well as differences in Canada's nutritional guidelines, means that Ganong must produce and package its US products separately, which reduces its efficiency. Small differences can and do have a significant effect on cross-border trade. This may be the reason why there is not as much trade between the United States and Canada as you would think.[86] This notwithstanding, however, Canada remains the number one exporting destination for US small businesses.[87]

The Business Website

As part of product preparations, a business will need to make its website ready for international business. Remember that the website is a very cost-effective way to sell a product or a service across borders. Here are four ways to ready the website:[88]

1. **Internationalize website content.** A business must account for language differences, and cultural differences may require different graphics and different colors. One way to deal with the additional costs is to translate text or provide country-specific sites only for the country or countries where the most products are sold. One organization that provides resources to help businesses localize their products and resources is the Globalization and Localization Association.
2. **Calculate the buyer's costs and estimate shipping.** Shipping internationally will take longer, is more complicated, and will be more expensive than shipping domestically. Fortunately, there are shipping management software packages available that will automatically figure the costs and delivery times for overseas orders, giving a close estimate. Large shipping carriers, such as UPS and FedEx, offer such software; other companies include E4X Inc., eCustoms, and Kewill Systems Plc.[89]
3. **Optimize site and search marketing for international web visitors.** With the increase in cross-border selling, websites can be optimized for visitors from specific countries, and techniques can be used to attract international visitors through search engines and search ads. This is a growing specialty among search marketers. A business should definitely check out the cost of hiring such a marketer as a consultant. It would be well worth the investment.
4. **Comply with government export regulations.** A business does not need government approval to sell most goods and services across international borders. There are, of course, notable exceptions. For example, the US government restricts defense or military goods, and agricultural, plant, and food items may have restrictions or special labeling requirements. Such restrictions should be addressed on the website. It may be necessary to restrict the sale of certain products to certain countries only.

Video Link 18.5 Finding Your First Customer

To find the first customer, visit the selected country.

www.inc.com/exporting/findingfirst.htm

Translation Blunders in Global Marketing

We often hear it said that something was lost in the translation. Here are some global marketing examples of translation blunders. Something important to note is that most of these blunders were committed by the "big guys," companies that are extremely marketing-savvy—proof positive that no one is immune from this kind of error.

- When Coca-Cola was first translated phonetically into Chinese, the result was a phrase that meant "bite the wax tadpole." When Coca-Cola discovered the error, the company was able to find a close phonetic equivalent that could be loosely translated as "happiness in the mouth."[90]
- When Pope John Paul II visited Miami in 1987, an ambitious entrepreneur wanted to sell t-shirts with the logo, "I saw the Pope" in Spanish. The entrepreneur forgot that the definite article in Spanish has two genders. Instead of printing "El Papa" ("the Pope"), he printed "La Papa" ("the potato"). Needless to say, there was no market for t-shirts that read "I saw the potato."[91]
- Sunbeam got into trouble when it did not change the name of its Mist-Stick curling iron when marketing it in Germany. As it turned out, "mist" is German slang for manure. Not surprisingly, German women did not want to use a manure stick in their hair.[92]

- A proposed new soap called "Dainty" in English came out as "aloof" in Flemish (Belgium), "dimwitted" in Farsi (Iran), and "crazy person" in Korean. The product was dropped.[citation redacted per publisher request]. The company either did not have the resources to research a new name or did not want to take the time and incur the costs to do so.
- Kellogg's Bran Buds sounded like "burned farmer" in Swedish.[93]

Given that misunderstanding foreign languages can destroy a brand, it is worth the investment to hire someone who is proficient in the native language in the intended market—including the use of slang. This will help a small business avoid a fatal mistake because it does not have the resources of the big companies to fix the mistakes.[94] This concern must be extended to the web presence as well because the website is an integral part of the product.

Price

Pricing for the global market is not an easy thing to do. Many factors must be taken into account, the first of which are traditional price considerations: fixed and variable costs, competition, company objectives, proposed positioning strategies, the target group, and willingness to pay.[95] Add to these factors things such as the additional costs that are incurred due to taxes, tariffs, transportation, retailer margin, and currency fluctuation risks;[96][97] the nature of the product or industry, the location of production facility, and the distribution system;[98] the psychological effects of price; the rest of the marketing mix; and the price transparency created by the Internet[99] and a business can begin to appreciate the challenges of global price setting. About the only thing that can be seen as a certainty is that a small business should expect the price of its product or service to be different, usually higher, in a foreign market.[100] The specifics of that difference need to be worked out carefully, with thorough analysis.

Setting the right price for a product or a service is critical to success. It will be a challenge to navigate the pricing waters of each different country—to learn why, for example, a product sells for $16 in the United States but $23 in Britain.

Place

As challenging as distribution may be for a small business in the domestic market, it is even more so for the global market. No matter the product, it has to go through a **distribution process**—the physical handling and distribution of goods, the passage of ownership or title, and the buying and selling negotiations between producers and middlemen and middlemen and customers.[101] It would make sense to be able to take advantage of existing transportation systems, retailers, and suppliers to sell goods and provide services. Unfortunately, adequate distribution systems do not exist in all countries, so a business will need to develop ways to get products to customers in as cost-effective a manner as possible.[102]

Video Link 18.6 Getting Your Product from Here to There

Small businesses rely on freight forwarding and shipping experts to move products around the world.

www.inc.com/exporting/heretothere.htm

Before deciding on a channel or channels of distribution, a business needs information. The following are some basic questions as a starting point:

- Is the selected market dominated by major retailers or is the retail sector made up of small independent retailers?[103]
- How many intermediaries will be involved? In Japan, for example, a product must go through approximately five different types of wholesalers before it reaches the final consumer.[104]
- Can we use the manufacturer, wholesaler, retailer, or consumer channel or can we export directly to a retailer?
- Should we work with a foreign partner? Unless a business plans to establish a retail operation on foreign soil, it will need to establish business-to-business (B2B) sales relationships. Then products can be sold directly to foreign retailers or foreign distributors who will sell to those retailers. A foreign partner can provide valuable insights about local import regulations, product marketability, and local customs. The US Department of Commerce website contains directories of foreign buyers.[105] Small businesses excel at forming strategic partnerships.[106]
- Where can we attend a trade show or a trade mission? Going to these events can help a business find distribution channels.
- Is the Internet commonly used to distribute my product?

Video Link 18.7 Understanding Partnerships and Distributors

Partnerships help many thriving US businesses overseas.

www.inc.com/exporting/partnerships.htm

Video Link 18.8 Identifying Marketing Channels/Activities

How research and planning inform business growth.

www.inc.com/exporting/marketingchannels.htm

In the final analysis, the behavior of distribution channel members will be the result of the interaction between cultural, economic, political, legal, and marketing environments. A small business that is looking to go global—or is already there—will encounter channel structures that range from a minimally developed marketing infrastructure, such as in emerging markets, to highly complex, multilayered systems, such as in Japan.[107]

When deciding to enter the global marketplace, a determination must be made as to whether the current channel structure in the selected country (or countries) will meet the business's needs or whether some additional arrangements will be needed. The means of distribution will necessarily be a country-by-country decision. No matter the arrangement, however, figure on the costs being greater than in the United States.

Promotion

It is understandable that a small business owner may want to use the same integrated marketing communications (IMC) programs used in the home market to inform customers in foreign markets and persuade them to buy. This "one voice" approach offers the advantage of enabling a business or a product to gain broader recognition in the global marketplace; it also helps reduce costs, minimize redundancies in personnel, and maximize the speed of implementation.[108][109] However, things are not that easy. Cultural, social, language, and legal differences from country to country will usually make it necessary to modify IMC messages to not offend current or prospective customers. Modification is more of a challenge for the small business because the resources needed to make the changes are more limited.

A business communicates with its customers through some combination of its website, advertising, publicity, public relations, sales promotion, sales personnel, e-mail, and social media. The actual mix will be a function of the selected country or countries. For example, in some less-developed countries, the major portion of the promotional effort in rural and less-accessible parts of the market is sales promotion; in other markets, product sampling works especially well when the product concept is new or has a very small market share.[110] In Saudi Arabia, there is an appreciation for fancy packaging, and point-of-sale advertising elicits the best reaction.[111] However, the appropriateness of IMC activities for a small business will depend on the product being marketed, the industry in which it is competing, and the country in which it hopes to sell the product.

Of all the four Ps, decisions involving advertising are thought to be those most often affected by cultural differences in foreign markets. Consumers respond in terms of their culture, style, feelings, value systems, attitudes, beliefs, and perceptions. Because advertising's function is to interpret or translate the qualities of products and services in terms of consumer needs, wants, desires, and aspirations, emotional appeals, symbols, persuasive approaches, and other characteristics in an advertisement must coincide with cultural norms if the ad is to be effective.[112]

Examples abound of international advertising mistakes that have offended different cultures. Three are presented here. Although they are linked to large corporations, there are lessons to be learned by small businesses. No business is immune from making mistakes from time to time.

- Burger King ran in-store ads for three restaurants in Spain that depicted the Hindu goddess Lakshami on top of a ham sandwich. The caption read, "a snack that is sacred." Many Hindus are vegetarian and were offended by the ad. Burger King pulled it.[113]
- Burger King ran a campaign in Europe for the Texican Whopper that featured a lanky American cowboy; a short, round Mexican draped in a cape resembling Mexico's flag; and the caption, "the taste of Texas with a little spicy Mexican." There was an immediate uproar, with the Mexican ambassador to Spain objecting publicly.[114]
- During a time when Fiat was trying to take advantage of auto sales growth in China, it released an ad in Italy in which actor Richard Gere drove a Lancia Delta from Hollywood to Tibet. The ad did not air in China, but it caused an online uproar nonetheless. Richard Gere is hated in China because he is an outspoken supporter of the Dalai Lama. His selection as the Fiat spokesperson was a major faux pas by Fiat.[115]

The reality of international advertising is that its cost and the effort required to prepare and place the ads correctly may be prohibitive for most small businesses, therefore pushing the emphasis on other elements of the IMC mix. However, a business will not know that for sure until it does the proper research before making a decision. Consider the characteristics of the target market, how the market uses media in that country, and which media are actually available. Some countries do not have commercial television, and some do not have advertising in newspapers. There will be newspaper and magazine circulation differences from country to country; in countries with a low literacy rate, radio and television advertising (if available) will be more effective than print media.[116]

Fortunately, small businesses that want to go global can look to social media for assistance. The social web is a low-cost way to catapult a small business brand into the global arena.[117] Facebook, the most popular social networking site in the world, has developed a self-serve advertising tool that has created the greatest interest among small businesses that might not have had the means to launch a global advertising campaign before. This would be a good place to start—along with a map of the world's most popular media applications country by country and culture by culture, which is available at www.appappeal.com/the-most-popular-app-per-country/social-networking.

No matter the mix of the IMC program, and no matter whether a business is business-to-consumer (B2C) or B2B, the way a business communicates internationally will be a major determinant of success. Each IMC component is a communication channel in its own right. A business must consider the appropriateness of each message in each channel. For example, is the message adequate? Does it contain correct cultural interpretations? Are the colors and graphics right? In the case of advertising, have the media been chosen that match the behavior of the intended audience? Have you correctly assessed the needs and wants or the thinking processes of the target market?[118]

Careful consideration of these and other communication issues will not guarantee success, but it should help reduce the chances of making a major marketing blunder.

Legal and Political Issues

It is impossible for any small business to know all the laws that pertain to exporting from the United States. Thus it is important to consult an attorney who is knowledgeable about the legal implications of globalization: international trade laws, tax laws, local regulations,[119] international border restrictions, customs rules, and duties and taxes.[120]

To varying degrees, each small business must be concerned with the following. However, this list is not exhaustive; it is a sampling only.

- The Foreign Corrupt Practices Act makes it illegal for companies to pay bribes to foreign officials, candidates, or political parties. The challenge for all US businesses is that bribery is a common business practice in many countries, even though it is illegal.[121] Interestingly, private business bribes are tax deductible in Germany as long as the German businessperson discloses both his or her identity and the recipient of the bribe(s). Although it is supposedly rarely used, it is available.[122]
- Specific licenses and permits are required or additional paperwork must be completed if the following specific products are exported or imported: agricultural products, automobiles (not a likely product for a small business), chemicals, defense products, food and beverage products, industrial goods, and pharmaceutical and biotechnology products.[123]
- There is heightened sensitivity since September 11, 2011, about exporting products that could even remotely be used in a military or a terrorist capacity.[124]
- Brand names, trademarks, products, processes, designs, and formulas are among the more valuable assets a small business can possess. These need to be protected—domestically and internationally. US officials estimate that $300 billion of intellectual property assets are ripped off every year.[125]
- There are commercial laws within countries related to marketing, environmental issues, and antitrust.

Video Link 18.9 Understanding Legal Considerations

Important legal considerations for small businesses that want to go global.

www.inc.com/exporting/legal.htm

In addition to legal considerations, no small business can conduct global business without understanding the influence of the political environments in which it will be operating.[126] Every nation has the sovereign right to grant or withhold permission to do business within its political boundaries and control where its citizens do business, so the political environment of countries is necessarily a critical concern to any small business.[127] Political issues include the stability of government policies (a stable and friendly government being the ideal), the forms of government (with some being more open to foreign commerce than others), political parties and their influence on economic policy, the degree of nationalism (the greater the nationalism, the greater the bias against foreign business and investments may be), fear and/or animosity that is targeted toward a specific country, and trade disputes.[128] One or all these things create political risk that must be assessed. The most severe political risk is confiscation, the seizing of a company's assets without payment.[129]

Currency Exchange Issues

The ***exchange rate*** is the rate at which one country's currency can be exchanged for the currency of another country.[130] For example, assume that on a particular day, $1 exchanged for 0.75643 euros and 49.795 Indian rupees.[131][132] These exchange rates then changed the next day, when $1 exchanged for 0.6891 euros and 49.845 Indian rupees, meaning that the value of the US dollar *increased* in value with respect to the euro and *decreased* in value against the Indian rupee. Currency exchange rates change daily, and they are important because currency fluctuations can present additional problems for the small business looking to go global. The appreciation and depreciation of a currency will have an effect on the prices of goods and services. For example, as the dollar declines in value against the euro, the price of goods and services from the European Union for US customers will increase, likely reducing their purchases.[133] The following are other implications of exchange rate fluctuations:[134][135]

- Inattention to exchange rates in long-term contracts could result in large unintended discounts.
- Rapid and unexpected currency fluctuations can make pricing in local currencies very difficult.
- Shifts in exchange rates can influence the attractiveness of various business decisions, not the least of which is whether doing business in a particular country is worthwhile.

Different strategies may be needed when the dollar is weak versus when it is strong. For example, when the US dollar is weak, a business should stress price benefits. When the dollar is strong, a business can engage in nonprice competition by improving quality, delivery, and after-sale services.[136] To navigate these challenging currency exchange waters, it will be necessary to tap into accounting and finance expertise.

Sources of Financing

How a business finances an export project is often a critical factor in its success. Financing decisions extend to working capital and export transactions. Working capital is needed to finance operations before and after a sale, and money is needed to sustain a business until it is paid for the goods and services that have been provided (export transactions). The International Trade Association in the US Department of Commerce identifies the following factors as important to consider when making financing decisions.[137]

- **The need for financing to make the sale.** Offering favorable payment terms can make a product more competitive.
- **The length of time the product is being financed.** The term of the loan required determines how long a business will have to wait before the buyer pays for the product, which will influence the choice of how to finance the transaction.
- **The cost of different methods of financing.** Interest rates and fees will vary, and a business should probably expect to assume some of the financing costs. Before providing an invoice to the buyer, a business must understand how these costs will affect price and profit.
- **The risks associated with financing the transaction.** The riskier the transaction, the more difficult and costly it will be for a business to finance it because there will likely be a higher chance for default. The level of risk will be influenced by several things, not the least of which is the political and economic stability of the buyer's country. In risky situations, the financing provider may require the most secure method of payment—a letter of credit or export credit insurance.
- **The need for preshipment financing and postshipment working capital.** Working capital could experience unexpected and severe strains with the production of an unusually large order or a surge of orders. Inadequate working capital can limit exporting growth—even during normal periods.

Where to Go

Small businesses have reported that problems with access to financing for their exporting operations are a major barrier to exporting. The difficulties they experience in obtaining both trade finance and working capital often prevent small businesses from financing purchases by foreign buyers. This encourages foreign buyers to choose suppliers that are able to extend credit. Small businesses must also face the perception of lending institutions that they are a higher risk than larger companies coupled with a lack of familiarity with exporting by community banks.[138]

Despite any anticipated difficulties, small businesses need to find export financing. They can look for financing in several places. The first place to look is internally. Does it already have the funds to finance global efforts? If the answer is yes, then all is well. This was the case for Center Rock, the small business featured at the beginning of this chapter. If the answer is no, which will most likely be the case, it will be necessary to look for external financing. A range of options is available for small businesses to consider (see Table 18.3). As you will see, most financing sources are available from the government. A small business must become familiar with the financing, insurance, and grant programs that are available to help it finance transactions and carry out export operations.[139]

Table 18.3 Sources of Export Financing for the Small Business

Source	Information
Extending credit to foreign buyers working with commercial banks	Liberal financing can enhance export competitiveness, but extending credit must be weighed carefully. Some commercial bank services used to finance domestic business, including revolving lines of credit for working capital, are often needed to finance export sales until payment is received. However, commercial banks prefer to establish an ongoing business relationship instead of financing solely on the basis of an individual order. Most US banks do not lend against export orders, export receivables, or letters of credit.
Export Express 7(a) Loan Programs	Offered by the SBA, this streamlined program helps small businesses develop or expand their export markets. A business may be able to obtain SBA-backed financing for loans and lines of credit up to $500,000.
Export Working Capital Program (EWCP) 7(a) Loan Programs	This SBA loan program targets small businesses that are able to generate export sales but need additional working capital to support these sales. The SBA provides lenders guarantees of up to 90 percent on export loans to ensure that qualified exporters do not lose viable export sales due to a lack of working capital.
International Trade Loan Program 7(a) Loan Programs	Loans are available for businesses that plan to start or continue exporting or have been adversely affected by competition from imports. The loan proceeds must enable the borrower to be in a better position to compete. The program offers borrowers a maximum SBA-guaranteed portion of $1.75 million.
Export-Import Bank	An independent federal agency that provides working capital loan guarantees, export-credit insurance, and other forms of financing for US exporters of all sizes. The funds are aimed at offsetting the added risks of doing business abroad, from complex trade rules to unpaid bills.
Using export intermediaries	Many export intermediaries, for example, trading companies and export management companies, can help finance export sales. The intermediaries may provide short-term financing or may purchase the goods to be exported directly from the manufacturer, thus eliminating any risks to the manufacturer that are associated with the export transaction as well as the need for financing.

Source: [140][141][142]

Video Link 18.10 Financing

Some of the ways small businesses can finance their exporting projects.

www.inc.com/exporting/financing.htm

Key Takeaways

- Expanding into global markets introduces new complexities into small business operations.
- The decision to go global should be based on an assessment of the ways to export, an analysis of the industry and a particular company, marketing and cultural factors, legal and political conditions, currency exchange rates, and sources of financing.
- There are two basic ways to export: direct or indirect. In direct exporting, a small business exports directly to a customer who is interested in buying the product. Indirect exporting involves using a middleman for marketing and selling the product in the target market.
- Industry analysis involves looking at where an industry currently is and the trends and directions predicted over the next three years so that a business can try to determine how competitive an industry is in the global market.
- It is important to honestly self-evaluate a business to determine whether it is ready to go global or not.

- It will generally be necessary to adapt the marketing mix to the global market in general and different countries in particular.
- Legal issues include international trade laws, tax laws, and local regulations.
- No small business can conduct global business without understanding the influence of the political environments in which it will be operating.
- Currency exchange rates are important because currency fluctuations can present additional problems for a small business that is looking to go global. In particular, the appreciation and depreciation of a currency will have an effect on the prices of goods and services.
- How a business finances an export project is often a critical factor in its success.
- Working capital is needed before and after the sale, and money is needed until the goods and services that have been provided have been paid for.
- Many—perhaps most—of the sources for small business exporting activity are governmental.

Exercises

1. Comment on the following: a small business owner firmly believes that because a product is successful in Chicago, Illinois, it will be successful in Tokyo or Berlin.[143] Be as specific as you can in your comments.
2. There has been tremendous growth in online business, which has introduced new elements to the legal climate of global business. Patents, brand names, copyrights, and trademarks are difficult to monitor because there are no boundaries with the Internet. What steps could a small business take to protect its trademarks and brands in this environment? Prepare at least five suggestions.[144]
3. Find a local small business that exports its products. Talk to the owner about his or her experiences. Ask questions such as the following: What convinced you to export? How did you decide on the product(s) to export? Did you have to adapt your product(s) in any way? What were the greatest barriers you had to face?

Key Management Decisions and Considerations

Learning Objectives

1. Understand the organizational support that will be needed for exporting activities.
2. Understand the need to select the best market to entry.
3. Identify and describe each possible market entry strategy.
4. Learn about the different approaches to getting paid.
5. Appreciate the importance of business etiquette when traveling to visit customers.
6. Understand the importance of an export plan.

After a business decides to jump into the global pond, several key management decisions must be made (Figure 18.3). Among them are organization for the global project, selecting the best market to enter, the level of involvement desired, and how to get paid. There should also be consideration of global etiquette and travel.

Figure 18.3 Management Decisions

Several important questions about the global venture should be answered before making any management decisions or considerations.[145] Less than satisfactory answers to these questions may put the global venture in jeopardy.

1. Do the company's reasons for pursuing export markets include solid objectives, such as increasing sales volume or developing a broader, more stable customer base, or are the reasons frivolous, such as the owner wants an excuse to travel?
2. How committed is top management to the export effort? Is it viewed as a quick fix for a slump in domestic sales? Will the company neglect its export customers if domestic sales pick up?
3. What are management's expectations for the export effort? Will they expect export operations to become self-sustaining quickly? If so, how quickly?
4. What level of return on investment is expected from the export project?

Organization for the Global Project

It will be important to have some kind of structure or team within the business to handle the global side of the business. It does not have to be large, but it should be dedicated to ensuring that export sales are adequately serviced, and there should be a clear indication of who will be responsible for the organization and staffing.[146] Having the right resources for the global effort is critical, so a business should make the most of skills already held by staff members, for example, languages or familiarity with a range of foreign currencies. If these and other needed skills are not already available on staff, a small business should seek assistance from external experts.[147]

Other organizational issues that small businesses must address before going abroad include the following:[148][149][150]

- **Getting internal buy-in.** Because going overseas to do business is a larger undertaking than many businesses realize, make sure that senior management and the people who are responsible for implementing and supporting the overseas effort know what the goals are and what is expected of them with respect to oversight and management. Knowing how much senior management time should be and could be allocated is an important part of getting internal buy-in. Look for support from people in all functions of the business.
- **Making sure that the full costs of overseas hiring are understood.** If people from overseas will be hired, employment regulations and practices are very different. For example, outside the United States, employment benefits often represent a larger percentage of an employee's salary than in the United States; in the European Union, for example, a full-blown employment contract is needed, not just an offer letter. This tilts the balance of power to the employee at the expense of the company, making termination very difficult. Understanding the full ramifications of hiring people outside the United States has significant implications for a company's financial success.

- **Thinking about how the business will manage overseas employees' expectations.** Different time zones and countries wreak havoc with keeping employees on the same page. Employees hired locally may have very different ideas about what is considered acceptable than a US employee does. Unless expectations and responsibilities are clearly conveyed at the beginning, problems will undoubtedly arise. They may anyway, but perhaps they will not be as serious.

Market Selection

A business must select the best market(s) to enter. The three largest markets for US products are Canada, Japan, and Mexico, but these countries may not be the largest or best markets for a particular product.[151] If a business is not sure where the best place for doing global business is, one good approach is to find out where domestic competitors have been expanding internationally. Although moving into the same market(s) may make good sense, a good strategy might also be to go somewhere else. Three key US government databases that can identify the countries that represent significant export potential for a product are as follows:[152]

1. The SBA's Automated Trade Locator Assistance System
2. Foreign Trade Report FT925
3. The US Department of Commerce's National Trade Data Bank

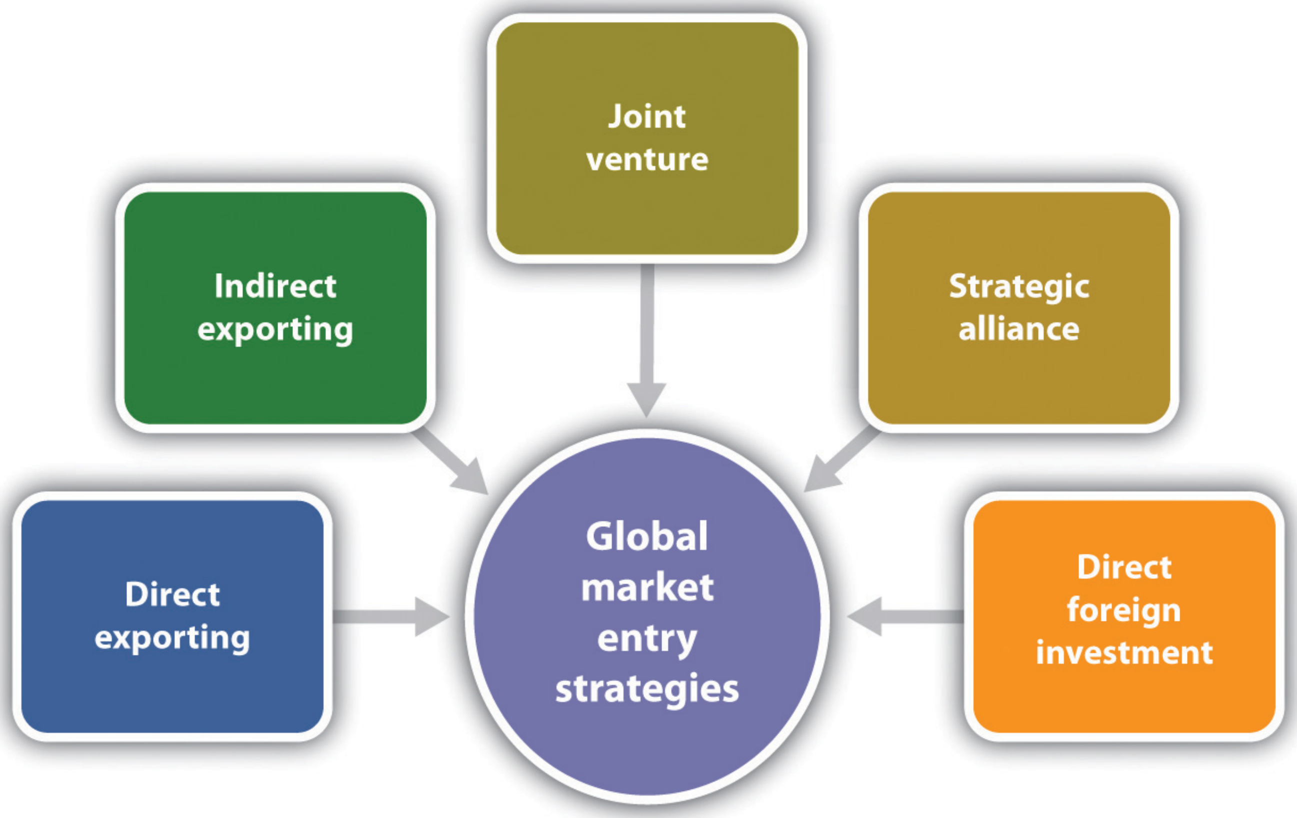
After identifying the country or countries that may offer the best market potential for a product, serious market research should be conducted. A business should look at all the following factors: demographic, geographic, political, economic, social, cultural, market access, distribution, production, and the existence or absence of **tariffs** and nontariff trade barriers. Tariffs are taxes imposed on imported goods so that the price of imported goods increases to the level of domestic goods. Tariffs can be particularly critical in selecting a particular country because the tariff may make it impossible for a US small business to profitably sell its products in a particular country.

Nontariff trade barriers are laws or regulations enacted by a country to protect its domestic industries against foreign competition.[153] These barriers include such things as import licensing requirements; fees; government procurement policies; border taxes; and packaging, labeling, and marking standards.[154]

Market Entry Strategies

A small business must decide how it wants to enter the selected foreign market(s). Several choices might look attractive for a business (see Figure 18.4). Direct and indirect exporting, strategic alliances, joint ventures, and direct foreign investment are discussed in this section. The benefits and risks associated with each strategy depend on many factors. Among them are the type of product or service being produced; the need for product or service support; and the foreign economic, political, business, and cultural environment to be penetrated. A firm's level of resources and commitment and the degree of risk it is willing to incur will help determine the strategy that the business thinks will work best.[155]

Figure 18.4 Examples of Export Market Entry Strategies



- ***Joint venture (JV)*** is a partnership with a foreign firm formed to achieve a specific goal or operate for a specific period of time. A legal entity is created, with the partners agreeing to share in the management of the JV, and each partner holds an equity position. Each company retains its separate identity. Among the benefits are immediate market knowledge and access, reduced risk, and control over product attributes. On the negative side, JV agreements across national borders can be extremely complex, which requires a very high level of commitment by all parties.[156][157][158] Because some countries have restrictions on the foreign ownership of corporations, a JV may be the only way a small business can purchase facilities in another country.[159]
- ***Strategic alliance*** is very similar to a JV in that it is a partnership formed to create competitive advantage on a worldwide basis.[160] An agreement is signed between two corporations, but a separate business entity is not created.[161] The business relationship is based on cooperation out of mutual need, and there is shared risk in achieving a common objective. Growing at a rate of about 20 percent per year, strategic alliances are created for many reasons (e.g., opportunities for rapid expansion into new markets, reduced marketing costs, and strategic competitive moves).[162] "Small businesses excel at forming strategic partnerships and alliances which make them look bigger than they are and offer their customers a global reach.[163]
- ***Direct foreign investment*** is exactly what it sounds like: investment in a foreign country. If a business is interested in manufacturing locally to take advantage of low-cost labor, gain access to raw materials, reduce the high costs of transportation to market, or gain market entry, direct foreign investment is something to be considered. However, the complicated mix of considerations and risks—for example, the growing complexity and contingencies of contracts and degree of product differentiation—makes decisions about foreign investments increasingly difficult.[164]

Getting Paid

Being paid in full and on time is of obvious importance to a business, so the level of risk that it is willing to assume in extending credit to customers is a major consideration.[165] The credit of a buyer will always be a concern, but potentially more worrisome is the lessened recourse a business will have when it comes to collecting unpaid international debts. Extra caution must be exercised. Both the business owner and the buyer must agree on the terms of the sale in advance.[166]

The primary methods of payment for international transactions are payment in advance (the most secure), letters of credit, documentary collection (drafts), consignment, and open account (the least secure), which are described as follows:[167][168]

- **Cash in advance.** This is the ideal method of payment because a company is relieved of collection problems and has immediate use of the money. Unfortunately, it tends to be an option only when the manufacturing process is specialized, lengthy, or capital intensive and requires partial or progress payments. Wire transfers are commonly used, and many exporters accept credit cards.
- **Documentary letter of credit.** This is an internationally recognized instrument issued by a bank on behalf of its client, the purchaser. A letter of credit represents the bank's guarantee to pay the seller, provided that the conditions specified in the letter are fulfilled.
- **Documentary collection or draft.** This involves the use of a draft, drawn by the seller on the buyer. It requires the buyer to pay the face amount either on sight (sight draft) or on a specified date in the future (time draft). The draft is an unconditional order to make payment in accordance with its terms, which specify the documents needed before title to the goods will be passed. All terms of payment should be clearly specified so that confusion and delay are avoided.
- **Open account.** With an open account, the exporter bills the customer, who is then expected to pay under agreed-on terms at a future date after the goods are manufactured and delivered (usually with fifteen, thirty, or sixty days). This payment method works well if the buyer is well established, has a long and favorable payment record, or has been thoroughly checked for being creditworthy. This approach is considered risky in international business because a business has limited recourse if debts are unpaid. Small businesses considering this option must examine the political, economic, and commercial risks very thoroughly.
- **Consignment sales.** Goods are shipped to a foreign distributor, which sells them on behalf of the exporter. Title to the goods remains with the exporter until they are sold, at which point payment is sent to the exporter. The exporter has the greatest risk and least control over the goods with this method, and payment may take a while. Risk insurance should be seriously considered with consignment sales.

When buyers default on their payments, it can be time-consuming, difficult, and expensive to obtain payments. A business should contact the buyer and try to negotiate payment. If negotiation fails and the amount of the debt is large enough to make a difference in that business, obtain the assistance and advice of the business's bank, legal counsel, and the US Commercial Service, an organization that can resolve payment problems informally. If arbitration becomes necessary, the International Chamber of Commerce is the place to go. It handles most international arbitrations and is usually acceptable to foreign companies because it is not affiliated with any single country.[169]

Business Etiquette and Travel

Having a successful global business requires getting to know the history, the culture, and the customs of the country or countries in which a business hopes to expand. Each country is different from another and the United States in some ways. Some of these differences have been discussed earlier in this chapter. Among the cultural differences to be faced are business styles, attitudes toward business relationships and punctuality, negotiating styles, gift-giving customers, greetings, the significance of gestures, the meanings of colors and numbers, and customs regarding titles. For example, engaging in small talk before conducting business is standard practice in Saudi Arabia, and gift giving is an important part of doing business in Japan.[170]

Before traveling to the chosen country or countries, knowing any and all cultural differences is critical. It is also important to educate stateside employees who will be working with international customers.

Being successful in global operations will depend on the relationships that are built. The best way to build them is by traveling to the selected country. Travel there…but do so with the cultural knowledge and understanding that will allow the conduct of business without inadvertently offending a potential customer.

Video Link 18.11 Meet Your Customers: Traveling There

Building relationships for success in exporting businesses.

www.inc.com/exporting/travelingthere.htm

The Export Plan

After deciding to sell products or services abroad, a carefully researched export plan is a source of direction. An export plan helps a business act on—rather than react to—the challenges and risks encountered in global business. The plan will also help a business obtain financial assistance and find investors, strategic partners, and JV partners that may be needed for success.[171]

There are many elements of an export plan, including a description of the company; its market and industry; its objectives; information on its products or services; an analysis of the target market and industry, including trends and forecasts; an examination of competitors and their strengths and weaknesses; international marketing strategies, including customer profiling and the development of sales and distribution channels; employment and training issues; after-sales and customer service, and financial requirements and forecasts.[172] "Many companies launch their export activities haphazardly and are unsuccessful in their early efforts because of poor or no planning, which often leads them to abandon exporting altogether."[173]

Video Link 18.12 Providing Good Customer Service

Small business owners talk about what they have learned by serving international customers.

www.inc.com/exporting/customerservice.htm

A business's first export plan should be simple, only a few pages because important market data and planning elements may not be easily available or completely unavailable. The plan should be written and seen as a flexible management document, not a static document that sits on a shelf somewhere gathering dust. Objectives need to be compared against actual results, just as a business would do with its marketing plan and its overall business plan. A business should be open to revising the plan as necessary as new information becomes available and experience is gained.[174]

Video Link 18.13 Creating an Export Business Plan

Small business owners agree that developing a strategic plan is the first step toward exporting success.

www.inc.com/exporting/businessplan.htm

Key Takeaways

- Before taking a business global, desire to pursue export markets for good rather than frivolous reasons.
- Management commitment must be present for successful global operations.
- A business must decide on some kind of structure to handle its global side. It should be dedicated to ensuring that export sales are adequately serviced.
- Getting internal buy-in is critical.
- A business will need to select the best market(s) to enter. Although Canada, Japan, and Mexico are the largest markets for US products, these countries may not be the best markets for specific products or services.
- Tariffs and nontariff trade barriers can pose serious constraints.
- A business must decide how to enter a foreign market. For example, it can choose direct and indirect exporting, strategic alliances, JVs, and direct foreign investment.
- Being paid in full and on time is of obvious importance, especially considering the difficulties a business will encounter in collecting an unpaid international debt. The most secure method of payment is cash in advance. The least secure is an open account.
- Learning and understanding the business etiquette of the country or countries to which a business is exporting is a very important part of building business relationships.
- A carefully researched export plan is a source of direction, and it will help a business act on—rather than react to—the challenges and risks it will encounter in global business.

Exercises

1. Go to the Coca-Cola website (www.coca-cola.com/en/index.html) and select one website from each of the following geographic areas: Latin America, Europe, Eurasia, Africa, and Asia Pacific. Compare the home pages of these sites to the US home page—even though you will not understand the language (unless you are bilingual). Look at the graphics, layout, and uses of color. What are the similarities? What are the differences? To what would you attribute the differences? How would these similarities and differences inform the design of a small business website for conducting global business?

The Three Threads

Learning Objectives

1. Understand how to contribute to customer value in exporting activities.
2. Explain how exporting can impact cash flow.
3. Explain how technology and the e-environment impact exporting.

Customer Value Implications

Always remember that customers make the decision about whether the appropriate value is present, and that value will always be as they perceive it. Carefully adapting a product to the targeted country for an exporting venture is an important first step in providing customer value. This means knowing about the sources of value in a product or a service and then acting on them. It can mean a minor product adaptation—for example, serving beer in McDonald's in Germany or wine in McDonald's in France and Italy—or a new twist on distribution—for example, Procter & Gamble selling shampoo in single-use tubes in newsstands in India. Although these are large-company examples, the experiences can be easily translated into small business exporting practice.

Another important source of customer value is the company website. Whether the website is the only selling platform of a business or is part of a brick-and-click exporting business, foreign buyers are much more likely to buy if a business's website is in their language. Although translation and country-specific sites can be a costly proposition, the text, graphics, and colors of the website can either enhance or detract from an exporting business. A small business owner should find out what organizational services and website designers can provide assistance. It may be possible to link the website to the Google translation tool to get a rough translation in seconds.[175]

Once a sale is made, do not make the mistake of thinking that it is the end of the relationship between the business and an overseas customer. Providing after-sale service must be an integral part of a company's export strategy from the very beginning.[176] This service should include regular thank-yous for their business; a plan for regular communication; and offering customers 24/7 availability via some combination of fax, Twitter, e-mail alerts, a wiki, a Skype account, and telephone voicemail services where messages can be retrieved around the clock. This level of access will be of great value to foreign customers because it lets them know that you are reliable, dependable, ready to serve, and willing to minimize risk. It is this proper care and feeding of customers that will keep them coming back because the business provides value that makes it worth their while.[177]

There is something else to consider as well. Research has shown that global online shoppers demand live customer service, with this service being more important than price.[178] This has implications not only for how customer service is designed for the targeted country for exports but for buyers from other countries as well.

Cash-Flow Implications

A small business exporter will face the same cash-flow challenges that affect any small business, but being an exporter presents additional cash-flow challenges that are unique to selling products overseas. One of these challenges comes from the value-added tax (VAT) in Europe. Having the proper VAT registration can be key because all non–European Union businesses must collect and remit the VAT on applicable transactions. A business is required to charge the VAT, and compliance requires periodic VAT filings, which means keeping VAT records on file and available for inspection by local tax authorities and anyone else who has reason and authority to inspect them. A failure to comply can result in significant penalties and cash-flow problems.[179]

Shipping costs pose another threat to cash flow. Shipping products overseas is very expensive, with the fees sometimes being as high as the cost of shipping the merchandise itself. Add to that the differences in currencies and taxes, and a business is faced with the possibility of having to pay all or most of the shipping costs up front. While waiting for customers to pay, paying these costs will have a negative impact on cash flow.[180] Fortunately, there are cost-cutting approaches available. For example, Michael Katz, a small business owner who ships portfolio and art cases overseas, was able to reduce the extra expenses by negotiating a discount with UPS, cutting his shipping costs to 50 percent of the list rate.[181]

Implications of Technology and the E-Environment

Inexpensive technology and the Internet have made it possible for small businesses to operate internationally with some of the same efficiencies as larger companies.[182] The global reach of the Internet makes it cost-effective for small businesses to sell products and services overseas. Small businesses can broaden their presence internationally by adopting e-commerce and e-business practices that are user-friendly for non-English-speaking countries.[183]

The small business owner can also look to several other sources of assistance for global endeavors. Consider the following three examples:

1. The self-service advertising product developed by Facebook gives small businesses an opportunity to reach a global audience.[184]
2. Shipping management software packages will automatically figure the costs and the delivery times for overseas orders, giving a close estimate. They also convert the currency for the buyer. Integrating this software into the website of a small business will

provide a seamless experience for the customer, making an important contribution to customer value.[185]
3. The Internet and mobile devices lower information and communication costs, providing new channels of distribution and permitting 24/7 global reach through Twitter, wikis, e-mail alerts, and Skype.

Key Takeaways

- A small business can offer customer value in its global activities by carefully adapting its products to the targeted country, having a website that caters to the language and culture of the buyers, and providing excellent after-sale service.
- The small business faces potential cash-flow problems from the VAT and shipping costs.
- Inexpensive technology and the Internet have made it possible for small businesses to operate internationally with some of the same efficiencies as larger companies.

Exercises

1. How can mobile devices be used to help the exporting operations of a small business?
2. How does the advertising product developed by Facebook work? How can it help increase the global reach of a small business? What are the costs for a small business?

Disaster Watch

Michael has been very successful with his exporting business. Instead of choosing Canada, Japan, or Mexico, the top three countries for small business exporting, he decided on Babalacala, a small country in the Middle East that has a history of political stability even though it has been ruled by one man for more than thirty-five years. The risk has been worth it so far. Michael identified the demand for his product, and he was right on target with his marketing research.

Michael has a small manufacturing plant that employs 150 locals and 5 people from the United States. He has successfully adapted his product to the local cultural, legal, and economic environments. His prices and promotion strategy are good fits, and his distribution structure—with some minor tweaking—is proving to be very efficient and effective. Needless to say, Michael and his investors are very happy campers.

But not for much longer.

Michael awakened one morning to a large-scale revolt against the current governor of Babalacala. The streets of the capital city were filled with protestors. Things were peaceful at first, but violence erupted in the afternoon. Many of Michael's local workers left the factory to protest or because they were afraid. Telecommunications were out, transportation was spotty, and there was only intermittent power. Most of the local stores closed. The word on the street was that the protestors were in for the long haul. They planned to keep protesting until the current governor resigned or left the country.

What should Michael do? He has a lot of money, time, and passion invested in his exporting business, and there are investors to think about. He does not want to leave Babalacala, but this is a serious situation.

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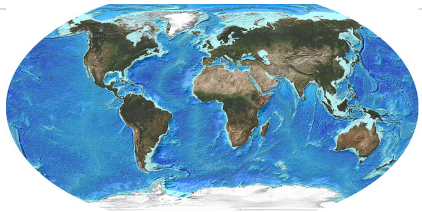
7.2: Chapter 19- Business in a Global Environment



Kevin Gill – GEBCO_08 with Shaded Blue Marble Landmass – CC BY-SA 2.0.

Do you wear Nike shoes or Timberland boots? Buy groceries at Tops Friendly Markets, Giant Stores, or Stop & Shop? Listen to Beyonce, Pitbull, Britney Spears, Jennifer Lopez, the Dixie Chicks, Foster the People, or the Dave Matthews Band? If you answered yes to any of these questions, you're a global business customer. Both Nike and Timberland manufacture most of their products overseas. The Dutch firm Royal Ahold owns all three supermarket chains. Sony Music, the label that records Beyonce, J. Lo, the Dixie Chicks, and the other artists mentioned, belongs to a Japanese company.

Take an imaginary walk down Orchard Road, the most fashionable shopping area in Singapore. You'll pass department stores such as Tokyo-based Takashimaya and London's very British Marks & Spencer, both filled with such well-known international labels as Ralph Lauren Polo, Burberry, Chanel, and Nokia. If you need a break, you can also stop for a latte at Seattle-based Starbucks.

When you're in the Chinese capital of Beijing, don't miss Tiananmen Square. Parked in front of the Great Hall of the People, the seat of Chinese government, are fleets of black Buicks, cars made by General Motors in Flint, Michigan. If you're adventurous enough to find yourself in Faisalabad, a medium-size city in Pakistan, you'll see locals riding donkeys, camels pulling carts piled with agricultural produce, and Hamdard University, located in a refurbished hotel. Step inside its computer labs, and the sensation of being in a faraway place will likely disappear: on the computer screens, you'll recognize the familiar Microsoft flag—the same one emblazoned on screens in Microsoft's hometown of Seattle and just about everywhere else on the planet.

The Globalization of Business

Learning Objectives

1. Explain why nations and companies participate in international trade.
2. Describe the concepts of absolute and comparative advantage.
3. Explain how trade between nations is measured.

The globalization of business is bound to affect you. Not only will you buy products manufactured overseas, but it's highly likely that you'll meet and work with individuals from various countries and cultures as customers, suppliers, colleagues, employees, or employers. The bottom line is that the globalization of world commerce has an impact on all of us. Therefore, it makes sense to learn more about how globalization works.

Figure 19.1 World Commerce Meeting; Richter Frank-Jurgen – Horasis Global China Business Meeting 2013 – CC BY-SA 2.0.

World commerce has become increasingly international, so understanding how global business works is key to a successful career.

Never before has business spanned the globe the way it does today. But why is international business important? Why do companies and nations engage in international trade? What strategies do they employ in the global marketplace? What challenges do companies face when they do business overseas? How do governments and international agencies promote and regulate international trade? Is the globalization of business a good thing? What career opportunities are there for you in global business? How should you prepare yourself to take advantage of them? These are the questions that we'll be addressing in this chapter. Let's start by looking at the more specific reasons why companies and nations engage in international trade.

Why Do Nations Trade?

Why does the United States import automobiles, steel, digital phones, and apparel from other countries? Why don't we just make them ourselves? Why do other countries buy wheat, chemicals, machinery, and consulting services from us? Because no national economy produces all the goods and services that its people need. Countries are *importers* when they buy goods and services from other countries; when they sell products to other nations, they're *exporters*. (We'll discuss importing and exporting in greater detail later in the chapter.) The monetary value of international trade is enormous. In 2010, the total value of worldwide trade in merchandise and commercial services was $18.5 *trillion*.[1]

Absolute and Comparative Advantage

To understand why certain countries import or export certain products, you need to realize that every country (or region) can't produce the same products. The cost of labor, the availability of natural resources, and the level of know-how vary greatly around the world. Most economists use the concepts of *absolute advantage* and *comparative advantage* to explain why countries import some products and export others.

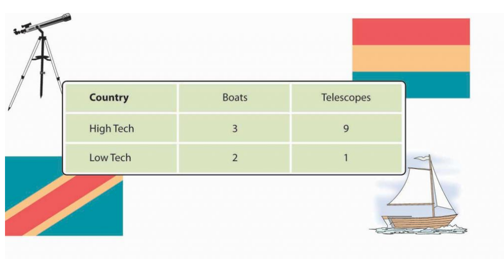
Absolute Advantage

A nation has an absolute advantage if (1) it's the only source of a particular product or (2) it can make more of a product using the same amount of or fewer resources than other countries. Because of climate and soil conditions, for example, France had an absolute advantage in wine making until its dominance of worldwide wine production was challenged by the growing wine industries in Italy, Spain, and the United States. Unless an absolute advantage is based on some limited natural resource, it seldom lasts. That's why there are few, if any, examples of absolute advantage in the world today.

Comparative Advantage

How can we predict, for any given country, which products will be made and sold at home, which will be imported, and which will be exported? This question can be answered by looking at the concept of comparative advantage, which exists when a country can produce a product at a lower opportunity cost compared to another nation. But what's an *opportunity cost*? Opportunity costs are the products that a country must decline to make in order to produce something else. When a country decides to specialize in a particular product, it must sacrifice the production of another product.

Let's simplify things by imagining a world with only two countries—the Republic of High Tech and the Kingdom of Low Tech. We'll pretend that each country knows how to make two and only two products: wooden boats and telescopes. Each country spends half its resources (labor and capital) on each good. Figure 19.2 "Comparative Advantage in the Techs" shows the daily output for both countries: High Tech makes three boats and nine telescopes while Low Tech makes two boats and one telescope (They're not highly productive, as we've imagined two *very* small countries).



Country	Boats	Telescopes
High Tech	3	9
Low Tech	2	1

Figure 19.2 Comparative Advantage in the Techs

First, note that High Tech has an *absolute* advantage (relative to Low Tech) in both boats and telescopes: it can make more boats (three versus two) and more telescopes (nine versus one) than Low Tech can with the same resources. So, why doesn't High Tech make *all* the boats and *all* the telescopes needed for *both* countries? Because it lacks sufficient resources to make all the boats and all the telescopes, High Tech must, therefore, decide how much of its resources to devote to each of the two goods. Let's assume that each country could devote 100 percent of its resources on *either* of the two goods. We'll pick boats as a start. If both countries spend *all* their resources on boats (and make no telescopes), here's what happens:

- When we assumed that High Tech spent half of its time on boats and half of its time on telescopes, it was able to make nine telescopes (see Figure 19.2 "Comparative Advantage in the Techs"). If it gives up the opportunity to make the nine telescopes, it can use the time gained by not making the telescopes to make three more boats (the number of boats it can make with half of

- its time). Because High Tech could make three more boats by giving up the opportunity to make the nine telescopes, the opportunity cost of making each boat is three telescopes (9 telescopes ÷ 3 boats = 3 telescopes).
- When we assumed that Low Tech spent half of its time on boats and half of its time on telescopes, it was able to make only one telescope (Figure 19.2 "Comparative Advantage in the Techs"). If it gives up the opportunity to make the telescope, it can use the time gained by not making the telescope to make two more boats. Because Low Tech could make two more boats by giving up the opportunity to make one telescope, the opportunity cost of making each boat is half a telescope (1 telescope ÷ 2 boats = 1/2 of a telescope).
- Low Tech, therefore, enjoys a *lower opportunity cost*: Because it must give up less to make the extra boats (1/2 telescope vs. 3 telescopes), it has a comparative advantage for boats. And because it's better—that is, more efficient—at making boats than at making telescopes, it should specialize in boat making.

Now to telescopes. Here's what happens if each country spends all its time making telescopes and makes no boats:

- When we assumed that High Tech spent half of its time on boats and half of its time on telescopes, it was able to make three boats (Figure 19.2 "Comparative Advantage in the Techs"). If it gives up the opportunity to make the three boats, it can use the time gained by not making the boats to make nine more telescopes. Because High Tech could make nine more telescopes by giving up the opportunity to make three boats, the opportunity cost of making each telescope is one-third of a boat (3 boats ÷ 9 telescopes = 1/3 of a boat).
- When Low Tech spent half of its time on boats and half of its time on telescopes, it was able to make two boats. If it gives up the opportunity to make the two boats, it can use the time to make one more telescope. Thus, if High Tech wants to make only telescopes, it could make one more telescope by giving up the opportunity to make two boats. Thus, the opportunity cost of making each telescope is two boats (2 boats ÷ 1 telescope = 2 boats).
- In this case, High Tech has the *lower opportunity cost*: Because it had to give up less to make the extra telescopes (1/3 of a boat vs. 2 boats), it enjoys a comparative advantage for telescopes. And because it's better—more efficient—at making telescopes than at making boats, it should specialize in telescope making.

Each country will specialize in making the good for which it has a comparative advantage—that is, the good that it can make most efficiently, relative to the other country. High Tech will devote its resources to telescopes (which it's good at making), and Low Tech will put its resources into boat making (which it does well). High Tech will export its excess telescopes to Low Tech, which will pay for the telescopes with the money it earns by selling its excess boats to High Tech. Both countries will be better off.

Things are a lot more complex in the real world, but, generally speaking, nations trade to exploit their advantages. They benefit from specialization, focusing on what they do best, and trading the output to other countries for what *they* do best. The United States, for instance, is increasingly an exporter of knowledge-based products, such as software, movies, music, and professional services (management consulting, financial services, and so forth). America's colleges and universities, therefore, are a source of comparative advantage, and students from all over the world come to the United States for the world's best higher-education system. Many people study in the United States to take advantage of one of the world's premier education systems.

France and Italy are centers for fashion and luxury goods and are leading exporters of wine, perfume, and designer clothing. Japan's engineering expertise has given it an edge in such fields as automobiles and consumer electronics. And with large numbers of highly skilled graduates in technology, India has become the world's leader in low-cost, computer-software engineering.

Figure 19.3 Graduation Photo; Merrimack College – Graduate Commencement 2014 – CC BY-NC-ND 2.0.

How Do We Measure Trade between Nations?

To evaluate the nature and consequences of its international trade, a nation looks at two key indicators. We determine a country's balance of trade by subtracting the value of its imports from the value of its exports. If a country sells more products than it buys, it has a favorable balance, called a trade surplus. If it buys more than it sells, it has an unfavorable balance, or a trade deficit.

For many years, the United States has had a trade deficit: we buy far more goods from the rest of the world than we sell overseas. This fact shouldn't be surprising. With high income levels, we not only consume a sizable portion of our own domestically produced goods but enthusiastically buy imported goods. Other countries, such as China and Taiwan, which manufacture primarily for export, have large trade surpluses because they sell far more goods overseas than they buy.

Managing the National Credit Card

Are trade deficits a bad thing? Not necessarily. They can be positive if a country's economy is strong enough both to keep growing and to generate the jobs and incomes that permit its citizens to buy the best the world has to offer. That was certainly the case in the United States in the 1990s. Some experts, however, are alarmed at our rapidly accelerating trade deficit. Investment guru Warren Buffet, for example, cautions that no country can continuously sustain large and burgeoning trade deficits. Why not? Because creditor nations will eventually stop taking IOUs from debtor nations, and when that happens, the national spending spree will have to cease. "Our national credit card," he warns, "allows us to charge truly breathtaking amounts. But that card's credit line is not limitless."[2]

By the same token, trade surpluses aren't necessarily good for a nation's consumers. Japan's export-fueled economy produced high economic growth in the 1970s and 1980s. But most domestically made consumer goods were priced at artificially high levels inside Japan itself—so high, in fact, that many Japanese traveled overseas to buy the electronics and other high-quality goods on which Japanese trade was dependent. CD players and televisions were significantly cheaper in Honolulu or Los Angeles than in Tokyo. How did this situation come about? Though Japan manufactures a variety of goods, many of them are made for export. To secure shares in international markets, Japan prices its exported goods competitively. Inside Japan, because competition is limited, producers can put artificially high prices on Japanese-made goods. Due to a number of factors (high demand for a limited supply of imported goods, high shipping and distribution costs, and other costs incurred by importers in a nation that tends to protect its own industries), imported goods are also expensive.[3]

Balance of Payments

The second key measure of the effectiveness of international trade is balance of payments: the difference, over a period of time, between the total flow of money coming into a country and the total flow of money going out. As in its balance of trade, the biggest factor in a country's balance of payments is the money that comes in and goes out as a result of imports and exports. But balance of payments includes other cash inflows and outflows, such as cash received from or paid for foreign investment, loans, tourism, military expenditures, and foreign aid. For example, if a U.S. company buys some real estate in a foreign country, that investment counts in the U.S. balance of payments, but not in its balance of trade, which measures only import and export transactions. In the long run, having an unfavorable balance of payments can negatively affect the stability of a country's currency. Some observers are worried about the U.S. dollar, which has undergone an accelerating pattern of unfavorable balances of payments since the 1970s. For one thing, carrying negative balances has forced the United States to cover its debt by borrowing from other countries. [4] [5]Figure 19.4 "U.S. Imports, Exports, and Balance of Payments, 1994–2010" provides a brief historical overview to illustrate the relationship between the United States' balance of trade and its balance of payments.

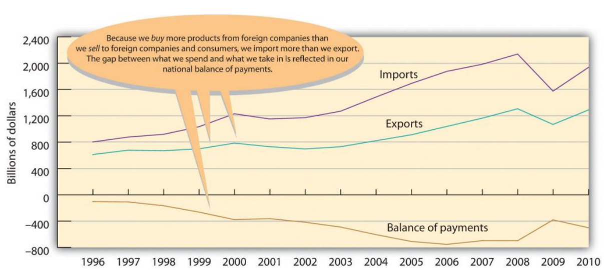


Figure 19.4 U.S. Imports, Exports, and Balance of Payments, 1994–2010. Note: Figures are for "goods" only, not "goods and services." Source: U.S. Census Bureau, Foreign Trade Division.

Key Takeaways

- Nations trade because they don't produce all the products that their inhabitants need.
  1. They import those that they need but don't produce and export those that are needed elsewhere.
  2. To understand why certain countries import or export certain products, you need to realize that not all countries are good at producing or are able to produce the same products.
  3. The cost of labor, the availability of natural resources, and the level of know-how vary greatly around the world.
- To explain how countries decide what products to import and export, economists use the concepts of *absolute* and *comparative advantage*.
  1. A nation has an **absolute advantage** if it's the only source of a particular product or can make more of a product with the same amount of or fewer resources than other countries.
  2. A **comparative advantage** exists when a country can produce a product at a lower *opportunity cost* than other nations.
- Nations trade to exploit their advantages: they benefit from specialization, focusing on what they do best and trading the output to other countries for what *they* do best.
- To evaluate the impact of its international trade, a nation looks at two key indicators: balance of trade and balance of payments.
- We determine a country's **balance of trade** by subtracting the value of its imports from the value of its exports.
  1. If a country sells more products than it buys, it has a favorable balance, called a **trade surplus**.
  2. If it buys more than it sells, it has an unfavorable balance, or a **trade deficit**.
- The **balance of payments** is the difference, over a period of time, between the total flow coming into a country and the total flow going out.
  1. As in its balance of trade, the biggest factor in a country's balance of payments is the money that comes in and goes out as a result of exports and imports.
  2. But balance of payments includes other cash inflows and outflows, such as cash received from or paid for foreign investment, loans, tourism, military expenditures, and foreign aid.

Exercises

1. **(AACSB) Analysis**

Consultant	Write a report	Prepare a presentation
John	80 hours	40 hours
Jennifer	150 hours	60 hours

   Using the information contained in the grid above, answer each of the following questions:

2. **(AACSB) Analysis**

   Now let's change *you* to *the United States*. The United States has just run up one of the largest one-year trade deficits in history—for 2010 the trade deficit was almost $500 billion. Respond to the following items:

Opportunities in International Business

Learning Objectives

1. Define importing and exporting.
2. Explain how companies enter the international market through licensing agreements or franchises.
3. Describe how companies reduce costs through contract manufacturing and outsourcing.
4. Explain the purpose of international strategic alliances and joint ventures.
5. Understand how U.S. companies expand their businesses through foreign direct investments and international subsidiaries.
6. Understand the arguments for and against multinational corporations.

The fact that nations exchange billions of dollars in goods and services each year demonstrates that international trade makes good economic sense. For an American company wishing to expand beyond national borders, there are a variety of ways it can get involved in international business. Let's take a closer look at the more popular ones.

Importing and Exporting

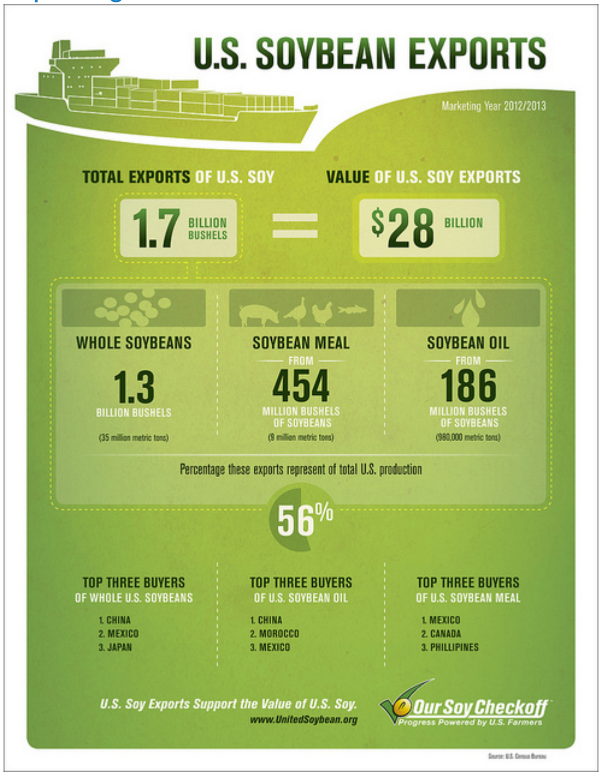


Figure 19.5 Import/Export Statistics; The United States exports billions of dollars of soybeans to China annually. United Soybean Board – US Soybean Exports Infographic – CC BY 2.0.

Importing (buying products overseas and reselling them in one's own country) and exporting (selling domestic products to foreign customers) are the oldest and most prevalent forms of international trade. For many companies, importing is the primary link to the global market. American food and beverage wholesalers, for instance, import the bottled water Evian from its source in the French Alps for resale in U.S. supermarkets.[6] Other companies get into the global arena by identifying an international market for their products and become exporters. The Chinese, for instance, are increasingly fond of fast foods cooked in soybean oil. Because they also have an increasing appetite for meat, they need high-protein soybeans to raise livestock.[7] As a result, American farmers now export over $9 billion worth of soybeans to China every year.[8]

Licensing and Franchising

A company that wants to get into an international market quickly while taking only limited financial and legal risks might consider licensing agreements with foreign companies. An international licensing agreement allows a foreign company (the *licensee*) to sell the products of a producer (the *licensor*) or to use its intellectual property (such as patents, trademarks, copyrights) in exchange for royalty fees. Here's how it works: You own a company in the United States that sells coffee-flavored popcorn. You're sure that your product would be a big hit in Japan, but you don't have the resources to set up a factory or sales office in that country. You can't make the popcorn here and ship it to Japan because it would get stale. So you enter into a licensing agreement with a Japanese company that allows your licensee to manufacture coffee-flavored popcorn using your special process and to sell it in Japan under your brand name. In exchange, the Japanese licensee would pay you a royalty fee.

Another popular way to expand overseas is to sell franchises. Under an international franchise agreement, a company (the *franchiser*) grants a foreign company (the *franchisee*) the right to use its brand name and to sell its products or services. The franchisee is responsible for all operations but agrees to operate according to a business model established by the franchiser. In turn, the franchiser usually provides advertising, training, and new-product assistance. Franchising is a natural form of global expansion for companies that operate domestically according to a franchise model, including restaurant chains, such as McDonald's and Kentucky Fried Chicken, and hotel chains, such as Holiday Inn and Best Western.

Contract Manufacturing and Outsourcing

Because of high domestic labor costs, many U.S. companies manufacture their products in countries where labor costs are lower. This arrangement is called international contract manufacturing or outsourcing. A U.S. company might contract with a local company in a foreign country to manufacture one of its products. It will, however, retain control of product design and development and put its own label on the finished product. Contract manufacturing is quite common in the U.S. apparel business, with most American brands being made in a number of Asian countries, including China, Vietnam, Indonesia, and India.[9]

Thanks to twenty-first-century information technology, nonmanufacturing functions can also be outsourced to nations with lower labor costs. U.S. companies increasingly draw on a vast supply of relatively inexpensive skilled labor to perform various business services, such as software development, accounting, and claims processing. For years, American insurance companies have processed much of their claims-related paperwork in Ireland. With a large, well-educated population with English language skills, India has become a center for software development and customer-call centers for American companies. In the case of India, as you can see in Table 19.1 "Selected Hourly Wages, United States and India", the attraction is not only a large pool of knowledge workers but also significantly lower wages.

Table 19.1 Selected Hourly Wages, United States and India

Occupation	U.S. Wage per Hour (per year)	Indian Wage per Hour (per year)
Middle-level manager	$29.40 per hour ($60,000 per year)	$6.30 per hour ($13,000 per year)
Information technology specialist	$35.10 per hour ($72,000 per year)	$7.50 per hour ($15,000 per year)
Manual worker	$13.00 per hour ($27,000 per year)	$2.20 per hour ($5,000 per year)

Source: Data obtained from "Huge Wage Gaps for the Same Work Between Countries – June 2011," WageIndicator.com, http://www.wageindicator.org/main/WageIndicatorgazette/wageindicator-news/huge-wage-gaps-for-the-same-work-between-countries-June-2011 (accessed September 20, 2011).

Strategic Alliances and Joint Ventures

What if a company wants to do business in a foreign country but lacks the expertise or resources? Or what if the target nation's government doesn't allow foreign companies to operate within its borders unless it has a local partner? In these cases, a firm might enter into a strategic alliance with a local company or even with the government itself. A strategic alliance is an agreement between two companies (or a company and a nation) to pool resources in order to achieve business goals that benefit both partners. For example, Viacom (a leading global media company) has a strategic alliance with Beijing Television to produce Chinese-language music and entertainment programming.[10]

An alliance can serve a number of purposes:

- Enhancing marketing efforts
- Building sales and market share
- Improving products
- Reducing production and distribution costs
- Sharing technology

Alliances range in scope from informal cooperative agreements to joint ventures—alliances in which the partners fund a separate entity (perhaps a partnership or a corporation) to manage their joint operation. Magazine publisher Hearst, for example, has joint ventures with companies in several countries. So, young women in Israel can read *Cosmo Israel* in Hebrew, and Russian women can pick up a Russian-language version of *Cosmo* that meets their needs. The U.S. edition serves as a starting point to which nationally appropriate material is added in each different nation. This approach allows Hearst to sell the magazine in more than fifty countries.[11][12][13][14]

Foreign Direct Investment and Subsidiaries

Many of the approaches to global expansion that we've discussed so far allow companies to participate in international markets without investing in foreign plants and facilities. As markets expand, however, a firm might decide to enhance its competitive advantage by making a direct investment in operations conducted in another country. Foreign direct investment (FDI) refers to the formal establishment of business operations on foreign soil—the building of factories, sales offices, and distribution networks to serve local markets in a nation other than the company's home country. On the other hand offshoring occurs when the facilities set up in the foreign country replace U.S. manufacturing facilities and are used to produce goods that will be sent back to the United States for sale. Shifting production to low-wage countries is often criticized as it results in the loss of jobs for U.S. workers.[15]

FDI is generally the most expensive commitment that a firm can make to an overseas market, and it's typically driven by the size and attractiveness of the target market. For example, German and Japanese automakers, such as BMW, Mercedes, Toyota, and Honda, have made serious commitments to the U.S. market: most of the cars and trucks that they build in plants in the South and Midwest are destined for sale in the United States.

A common form of FDI is the foreign subsidiary: an independent company owned by a foreign firm (called the *parent*). This approach to going international not only gives the parent company full access to local markets but also exempts it from any laws or regulations that may hamper the activities of foreign firms. The parent company has tight control over the operations of a subsidiary, but while senior managers from the parent company often oversee operations, many managers and employees are citizens of the host country. Not surprisingly, most very large firms have foreign subsidiaries. IBM and Coca-Cola, for example, have both had success in the Japanese market through their foreign subsidiaries (IBM-Japan and Coca-Cola–Japan). FDI goes in the other direction, too, and many companies operating in the United States are in fact subsidiaries of foreign firms. Gerber Products, for example, is a subsidiary of the Swiss company Novartis, while Stop & Shop and Giant Food Stores belong to the Dutch company Royal Ahold.

Where does most FDI capital end up? Figure 19.6 "Where FDI Goes" provides an overview of amounts, destinations (developed or developing countries), and trends.

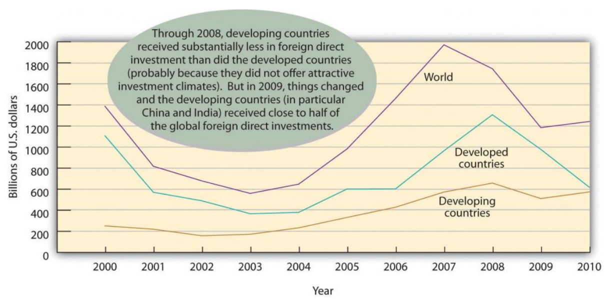


Figure 19.6 Where FDI Goes

All these strategies have been successful in the arena of global business. But success in international business involves more than merely finding the best way to reach international markets. Doing global business is a complex, risky endeavor. As many companies have learned the hard way, people and organizations don't do things the same way abroad as they do at home. What differences make global business so tricky? That's the question that we'll turn to next.

Multinational Corporations

A company that operates in many countries is called a multinational corporation (MNC). *Fortune* magazine's roster of the top five hundred MNCs in the world speaks for the growth of non-U.S. businesses. Only two of the top ten multinational companies are headquartered in the United States: Wal-Mart (number 1) and Exxon (number 3). Four others are in the second tier (tenth through twentieth): Chevron, General Electric, Bank of America, and ConocoPhillips. The remaining fourteen are non-U.S. firms. Interestingly, of the twenty top companies, nine are energy suppliers, and seven are insurance or financial service firms. Figure 19.7 "The World's Twenty Largest MNCs" provides a list of these twenty largest MNC's according to revenues.

Figure 19.7 The World's Twenty Largest MNCs (Fortune, 2011)

Rank	Company	Revenues (in $ millions)	Country–Type of business
1	Wal-Mart Stores	408,214	US-retailer
2	Royal Dutch Shell	285,129	Netherlands-energy
3	Exxon Mobil	284,650	US-energy
4	BP	246,138	Britain-energy
5	Toyota Motor	204,106	Japan-automobile manufacturer

6	Japan Post Holdings	202,196	Japan-mail delivery, banking and insurance
7	Sinopec	187,518	China-energy
8	State Grid	184,496	China-power grid building and operator
9	AXA	175,257	France-insurance
10	China National Petroleum	165,496	China-energy
11	Chevron	163,204	US-energy
12	ING Group	163,204	Netherlands-financial services
13	General Electric	156,779	US-industrial conglomerate
14	Total	155,887	France-energy
15	Bank of America Corp.	150,450	US-financial services
16	Volkswagen	146,205	Germany-automobile manufacturer
17	ConocoPhillips	139,515	US-energy
18	BNP Paribas	130,708	France-financial services
19	Assicurazioni Generali	126,012	Italy-insurance company
20	Allianz	125,999	Germany-financial services

MNCs often adopt the approach encapsulated in the motto "Think globally, act locally." They often adjust their operations, products, marketing, and distribution to mesh with the environments of the countries in which they operate. Because they understand that a "one-size-fits-all" mentality doesn't make good business sense when they're trying to sell products in different markets, they're willing to accommodate cultural and economic differences. Increasingly, MNCs supplement their mainstream product line with products designed for local markets. Coca-Cola, for example, produces coffee and citrus-juice drinks developed specifically for the Japanese market.[16] When such companies as Nokia and Motorola design cell phones, they're often geared to local tastes in color, size, and other features. For example, Nokia introduced a cell phone for the rural Indian consumer that has a dust-resistant keypad, antislip grip, and a built-in flashlight.[17] McDonald's provides a vegetarian menu in India, where religious convictions affect the demand for beef and pork.[18] In Germany, McDonald's caters to local tastes by offering beer in some restaurants.[19] It offers a Maharaja Mac in India, a McItaly Burger in Italy, and a Teriyaki McBurger with Seaweed Shaker Fries in Japan.[20]

Likewise, many MNCs have made themselves more sensitive to local market conditions by decentralizing their decision making. While corporate headquarters still maintain a fair amount of control, home-country managers keep a suitable distance by relying on modern telecommunications. Today, fewer managers are dispatched from headquarters; MNCs depend instead on local talent. Not only does decentralized organization speed up and improve decision making, but it also allows an MNC to project the image of a local company. IBM, for instance, has been quite successful in the Japanese market because local customers and suppliers perceive it as a Japanese company. Crucial to this perception is the fact that the vast majority of IBM's Tokyo employees, including top leadership, are Japanese nationals.[21]

Criticism of MNC Culture

The global reach of MNCs is a source of criticism, as well as praise. Critics argue that they often destroy the livelihoods of home-country workers by moving jobs to developing countries where workers are willing to labor under poor conditions and for less pay. They also contend that traditional lifestyles and values are being weakened, and even destroyed, as global brands foster a global culture of American movies; fast food; and cheap, mass-produced consumer products. Still others claim that the demand of MNCs for constant economic growth and cheaper access to natural resources do irreversible damage to the physical environment. All these negative consequences, critics maintain, stem from the abuses of international trade—from the policy of placing profits above people, on a global scale. These views surfaced in violent street demonstrations in Seattle in 1999 and Genoa, Italy, in 2000, and since then, meetings of the International Monetary Fund and World Bank have regularly been assailed by large crowds of protestors who have succeeded in catching the attention of the worldwide media.

In Defense of MNC Culture

Meanwhile, supporters of MNCs respond that huge corporations deliver better, cheaper products for customers everywhere; create jobs; and raise the standard of living in developing countries. They also argue that globalization increases cross-cultural understanding. Anne O. Kruger, first deputy managing director of the IMF, says the following:

"The impact of the faster growth on living standards has been phenomenal. We have observed the increased well being of a larger percentage of the world's population by a greater increment than ever before in history. Growing incomes give people the ability to spend on things other than basic food and shelter, in particular on things such as education and health. This ability, combined with the sharing among nations of medical and scientific advances, has transformed life in many parts of the developing world. Infant mortality has declined from 180 per 1,000 births in 1950 to 60 per 1,000 births. Literacy rates have risen from an average of 40 percent in the 1950s to over 70 percent today. World poverty has declined, despite still-high population growth in the developing world."[22]

Key Takeaways

- For a company in the United States wishing to expand beyond national borders, there are a variety of ways to get involved in international business.
- **Importing** involves purchasing products from other countries and reselling them in one's own.
- **Exporting** entails selling products to foreign customers.
- Under a **franchise agreement**, a company grants a foreign company the right to use its brand name and sell its products.
- A **licensing agreement** allows a foreign company to sell a company's products or use its intellectual property in exchange for royalty fees.
- Through **international contract manufacturing** or **outsourcing**, a company has its products manufactured or services provided in other countries.
- A **strategic alliance** is an agreement between two companies to pool talent and resources to achieve business goals that benefit both partners.
- A **joint venture** is a specific type of strategic alliance in which a separate entity funded by the participating companies is formed to manage the alliance.
- **Foreign direct investment (FDI)** refers to the formal establishment of business operations on foreign soil.
- **Offshoring** occurs when a company sets up facilities in a foreign country that replaces U.S. manufacturing facilities to produce goods that will be sent back to the United States for sale. Shifting production to low-wage countries is often criticized as it results in the loss of jobs for U.S. workers.
- A common form of FDI is a **foreign subsidiary**, an independent company owned by a foreign firm.
- A company that operates in many countries is called a **multinational corporation (MNC)**.

Exercises

1. There are four common ways for a firm to expand its operations into overseas markets: importing, exporting, licensing, and franchising. First, explain what each approach entails. Then, select the one that you'd use if you were the CEO of a large company. Why was this approach particularly appealing?
2. **(AACSB) Analysis**

The Global Business Environment

Learning Objective

1. Appreciate how cultural, economic, legal, and political differences between countries create challenges to successful business dealings.

In the classic movie *The Wizard of Oz*, a magically misplaced Midwest farm girl takes a moment to survey the bizarre landscape of Oz and then comments to her little dog, "I don't think we're in Kansas anymore, Toto." That sentiment probably echoes the reaction of many businesspeople who find themselves in the midst of international ventures for the first time. The differences between the foreign landscape and the one with which they're familiar are often huge and multifaceted. Some are quite obvious, such as differences in language, currency, and everyday habits (say, using chopsticks instead of silverware). But others are subtle, complex, and sometimes even hidden. Success in international business means understanding a wide range of cultural, economic, legal, and political differences between countries. Let's look at some of the more important of these differences.

The Cultural Environment

Even when two people from the same country communicate, there's always a possibility of misunderstanding. When people from different countries get together, that possibility increases substantially. Differences in communication styles reflect differences in culture: the system of shared beliefs, values, customs, and behaviors that govern the interactions of members of a society. Cultural differences create challenges to successful international business dealings. We explain a few of these challenges in the following sections.

Language

English is the international language of business. The natives of such European countries as France and Spain certainly take pride in their own languages and cultures, but nevertheless English is the business language of the European community. Whereas only a few educated Europeans have studied Italian or Norwegian, most have studied English. Similarly, on the South Asian subcontinent, where hundreds of local languages and dialects are spoken, English is the official language. In most corners of the world, English-only speakers—such as most Americans—have no problem finding competent translators and interpreters. So why is language an issue for English speakers doing business in the global marketplace?

In many countries, only members of the educated classes speak English. The larger population—which is usually the market you want to tap—speaks the local tongue. Advertising messages and sales appeals must take this fact into account. More than one English translation of an advertising slogan has resulted in a humorous (and perhaps serious) blunder. Some classics are listed in Table 19.2 "Lost in Translation".

Table 19.2 Lost in Translation

In Belgium, the translation of the slogan of an American auto-body company, "Body by Fisher," came out as "Corpse by Fisher."
Translated into German, the slogan "Come Alive with Pepsi" became "Come out of the Grave with Pepsi."
A U.S. computer company in Indonesia translated "software" as "underwear."
A German chocolate product called "Zit" didn't sell well in the United States.
An English-speaking car-wash company in Francophone Quebec advertised itself as a "*lavement d'auto*" ("car enema") instead of the correct "*lavage d'auto*."
A proposed new soap called "Dainty" in English came out as "aloof" in Flemish (Belgium), "dimwitted" in Farsi (Iran), and "crazy person" in Korea; the product was shelved.
One false word in a Mexican commercial for an American shirt maker changed "When I used this shirt, I felt good" to "Until I used this shirt, I felt good."
In the 1970s, GM's Chevy Nova didn't get on the road in Puerto Rico, in part because *Nova* in Spanish means "It doesn't go."
A U.S. appliance ad fizzled in the Middle East because it showed a well-stocked refrigerator featuring a large ham, thus offending the sensibilities of Muslim consumers, who don't eat pork.

Furthermore, relying on translators and interpreters puts you as an international businessperson at a disadvantage. You're privy only to *interpretations* of the messages that you're getting, and this handicap can result in a real competitive problem. Maybe you'll misread the subtler intentions of the person with whom you're trying to conduct business. The best way to combat this problem is to study foreign languages. Most people appreciate some effort to communicate in their local language, even on the most basic level. They even appreciate mistakes you make resulting from a desire to demonstrate your genuine interest in the language of your counterparts in foreign countries. The same principle goes doubly when you're introducing yourself to non-English speakers in the United States. Few things work faster to encourage a friendly atmosphere than a native speaker's willingness to greet a foreign guest in the guest's native language.

Time and Sociability

Americans take for granted many of the cultural aspects of our business practices. Most of our meetings, for instance, focus on business issues, and we tend to start and end our meetings on schedule. These habits stem from a broader cultural preference: we don't like to waste time. (It was an American, Benjamin Franklin, who coined the phrase "Time is money.") This preference, however, is by no means universal. The expectation that meetings will start on time and adhere to precise agendas is common in parts of Europe (especially the Germanic countries), as well as in the United States, but elsewhere—say, in Latin America and the Middle East—people are often late to meetings.

High- and Low-Context Cultures

Likewise, don't expect business people from these regions—or businesspeople from most of Mediterranean Europe, for that matter—to "get down to business" as soon as a meeting has started. They'll probably ask about your health and that of your family, inquire whether you're enjoying your visit to their country, suggest local foods, and generally appear to be avoiding serious discussion at all costs. For Americans, such topics are conducive to nothing but idle chitchat, but in certain cultures, getting started this way is a matter of simple politeness and hospitality.

If you ever find yourself in such a situation, the best advice is to go with the flow and be receptive to cultural nuances. In high-context cultures, the numerous interlocking (and often unstated) personal and family connections that hold people together have an effect on almost all interactions. Because people's personal lives overlap with their business lives (and vice versa), it's important to get to know your potential business partners as human beings and individuals.

By contrast, in low-context cultures, such as those of the United States, Germany, Switzerland, and the Scandinavian countries, personal and work relationships are more compartmentalized: you don't necessarily need to know much about the personal context of a person's life to deal with him or her in the business arena.

Intercultural Communication

Different cultures have different communication *styles*—a fact that can take some getting used to. For example, *degrees of animation in expression* can vary from culture to culture. Southern Europeans and Middle Easterners are quite animated, favoring expressive body language along with hand gestures and raised voices. Northern Europeans are far more reserved. The English, for example, are famous for their understated style and the Germans for their formality in most business settings. In addition, the *distance* at which one feels comfortable when talking with someone varies by culture. People from the Middle East like to converse from a distance of a foot or less, while Americans prefer more personal space.

Finally, while people in some cultures prefer to deliver direct, clear messages, others use language that's subtler or more indirect. North Americans and most Northern Europeans fall into the former category and many Asians into the latter. But even within these categories, there are differences. Though typically polite, Chinese and Koreans are extremely direct in expression, while Japanese are indirect: They use vague language and avoid saying "no" even if they do not intend to do what you ask. They worry that turning someone down will result in their "losing face," and so they avoid doing this in public.

This discussion brings up two important points. First, avoid lumping loosely related cultures together. We sometimes talk, for example, about "Asian culture," but such broad categories as "Asian" are usually oversimplifications. Japanese culture is different from Korean, which is different from Chinese. Second, never assume that two people from the same culture will always act in a similar manner. Not all Latin Americans are casual about meeting times, not all Italians use animated body language, and not all Germans are formal.

In summary, learn about a country's culture and use your knowledge to help improve the quality of your business dealings. Learn to value the subtle differences among cultures, but don't allow cultural stereotypes to dictate how you interact with people from *any* culture. Treat each person as an individual and spend time getting to know what he or she is about.

The Economic Environment

If you plan to do business in a foreign country, you need to know its level of economic development. You also should be aware of factors influencing the value of its currency and the impact that changes in that value will have on your profits.

Economic Development

If you don't understand a nation's level of economic development, you'll have trouble answering some basic questions, such as, Will consumers in this country be able to afford the product I want to sell? How many units can I expect to sell? Will it be possible to make a reasonable profit? A country's level of economic development can be evaluated by estimating the annual income earned per citizen. The World Bank, which lends money for improvements in underdeveloped nations, divides countries into four income categories:[23]

- *High income*—$12,276 or higher (United States, Germany, Japan)
- *Upper-middle income*—$3,976 to $12,275 (China, South Africa, Mexico)
- *Lower-middle income*—$1,006 to $3,975 (Vietnam, Philippines, India)
- *Low income*—$1,005 or less (Kenya, Bangladesh, Haiti)

Note that that even though a country has a low annual income per citizen, it can still be an attractive place for doing business. India, for example, is a lower-middle-income country, yet it has a population of a billion, and a segment of that population is well educated—an appealing feature for many business initiatives.

The long-term goal of many countries is to move up the economic development ladder. Some factors conducive to economic growth include a reliable banking system, a strong stock market, and government policies to encourage investment and competition while discouraging corruption. It's also important that a country have a strong *infrastructure*—its systems of communications (telephone, Internet, television, newspapers), transportation (roads, railways, airports), energy (gas and electricity, power plants), and social facilities (schools, hospitals). These basic systems will help countries attract foreign investors, which can be crucial to economic development.

Currency Valuations and Exchange Rates

If every nation used the same currency, international trade and travel would be a lot easier. Unfortunately, this is not the case. There are about 175 currencies in the world: Some you've heard of, such as the British pound; others are likely unknown to you, such as the *manat*, the official currency of Azerbaijan, a small nation in Southwest Asia. Let's pretend you suddenly find yourself in Azerbaijan and all you have with you is a credit card (which none of the restaurants or hotels will take) and U.S. dollars (which no one wants either). How can you get some Azerbaijani manats so you can buy a good meal and check into a hotel? If it's during the day, you're in luck. Head to the closest bank and ask someone there who speaks English to exchange your dollars for Azerbaijan manats. If you give the bank clerk $300 (all of your travel money), don't expect to get back 300 manats; the two currencies are not equal. To determine how much Azerbaijan money you'll get in exchange for your $300, the bank clerk will look up the day's foreign exchange rate—which tells you how much one currency is worth *relative to another currency*. If today were August 23, 2011, the clerk would find an exchange rate of 1 U.S. dollar equals .79 manats (which means that you get 79 manats for every dollar you give to the bank clerk). In other words, when you hand the clerk your $300 you'll get back only 235 manats (.79 × $300). Most likely, the deal does not sound good to you, but you have no choice—that's what the exchange rate is. Plus, you're lucky that it's during the day and the banks are open: sleeping outside in Azerbaijan with an empty stomach doesn't sound like fun, although it would give you time to wonder what would happen if an Azerbaijani traveled to the United States. When the traveler goes to exchange manats for U.S. dollars, he or she will get back $1.27 for each manat. Exchanging 300 manats for U.S. dollars yields $381 in U.S. dollars (1.27097 × $300). Well, this doesn't sound fair. Why did you receive fewer manats for your U.S. dollars while the Azerbaijan traveler received more dollars for his or her manats? It is because the U.S. dollar is weak relative to the Azerbaijan manat. There are many reasons for the weakness of the U.S. dollar, but one possible culprit is the huge $14 trillion debt (and rising) carried by the United States. And if you are looking for things to get upset about, your share of this huge U.S. debt is about $47,000 (and rising).[24]

Now, we'll look at two business examples. First, let's say that your business is importing watches from Switzerland. Because the watchmaker will want to be paid in Swiss francs, you have to figure out how many U.S. dollars you'll need to buy the francs with which to pay the watchmaker. You'd start by finding out the exchange rate between the Swiss franc and the U.S. dollar.

Figure 19.8 Currency. Understanding currency values and exchange rates is important to understanding how global business functions. epSos.de – Exchange Money Conversion to Foreign Currency – CC BY 2.0.

You could simply look in a newspaper or go to any number of Web sites—say, http://www.oanda.com to get the current exchange rate. To keep things simple, let's assume that the exchange rate is 1 Swiss franc = US$1.27 (i.e., 1 Swiss franc is worth $1.27). Let's also assume that you owe the Swiss watchmaker 1,000 francs. Doing some quick math, you figure that it will take $1,270 to buy 1,000 francs (1,000 francs × the exchange rate of 1.27 = $1,270).

Now let's say that you don't have the cash flow to pay the watchmaker for two weeks. When you check the exchange rate two weeks later, you find that it has gone up to 1 Swiss franc = $1.37. Are you better off or worse off? It's easy to check: 1,000 francs × the new exchange rate of 1.37 = $1,370. You've just learned the hard way that when the value of the franc relative to the dollar goes up, it costs you more to buy something from Switzerland. You probably can't help but wonder what would have happened if the value of the franc relative to the dollar had gone *down*—say, to $1.17 per franc. At this rate, you'd need only $1,170 to pay the 1,000 francs (1,000 × 1.17). In other words, when the value of the franc relative to the dollar drops, it costs less to buy goods from Switzerland. In sum you've learned the following:

- If a foreign currency goes *up* relative to the U.S. dollar, Americans must pay *more* for goods and services purchased from sellers in the country issuing the currency (foreign products are more expensive). This is bad for exporters who have to pay more for the foreign-made goods they buy to bring back to the United States to sell.
- If a foreign currency goes *down* relative to the U.S. dollar, Americans pay *less* for products from the country issuing the currency (foreign products are cheaper).

In the interest of being thorough, let's look at this phenomenon from the perspective of an American seller and a Swiss buyer. First, we need to know the exchange rate for the U.S. dollar relative to the franc, which happens to be .79 francs = US$1. This means that if you want to sell something—let's say your latest painting—for $1,000 U.S. to an art lover in Switzerland, the Swiss buyer will need only 790 francs to get the $1,000 needed to pay you. If the exchange rate went up to .89 francs = US$1, the cost of the painting would be $890. If the exchange rate went down to .69 francs = US$1, the cost of the painting would be $690. So now you also know the following:

- If the U.S. dollar goes *up* relative to a foreign currency, foreign buyers must pay *more* for American goods and services (they become more expensive).
- If the U.S. dollar goes *down* relative to a foreign currency, foreign buyers pay *less* for American products (they become cheaper). This is good for importers as their "cheaper" goods are more attractive to customers in the foreign country.

The Legal and Regulatory Environment

One of the more difficult aspects of doing business globally is dealing with vast differences in legal and regulatory environments. The United States, for example, has an established set of laws and regulations that provide direction to businesses operating within its borders. But because there is no global legal system, key areas of business law—for example, contract provisions and copyright protection—can be treated in different ways in different countries. Companies doing international business often face many inconsistent laws and regulations. To navigate this sea of confusion, American businesspeople must know and follow both U.S. laws and regulations and those of nations in which they operate.

Business history is filled with stories about American companies that have stumbled in trying to comply with foreign laws and regulations. Coca-Cola, for example, ran afoul of Italian law when it printed its ingredients list on the bottle cap rather than on the bottle itself. Italian courts ruled that the labeling was inadequate because most people throw the cap away. In another case, 3M applied to the Japanese government to create a joint venture with the Sumitomo Industrial Group to make and distribute magnetic tape products in Japan. 3M spent four years trying to satisfy Japan's complex regulations, but by the time it got approval, domestic competitors, including Sony, had captured the market. By delaying 3M, Japanese regulators managed, in effect, to stifle foreign competition.[25]

One approach to dealing with local laws and regulations is hiring lawyers from the host country who can provide advice on legal issues. Another is working with local business people who have experience in complying with regulations and overcoming bureaucratic obstacles.

Foreign Corrupt Practices Act

One U.S. law that creates unique challenges for American firms operating overseas is the Foreign Corrupt Practices Act, which prohibits the distribution of bribes and other favors in the conduct of business. Unfortunately, though they're illegal in this country, such tactics as kickbacks and bribes are business-as-usual in many nations. According to some experts, American businesspeople are at a competitive disadvantage if they're prohibited from giving bribes or undercover payments to foreign officials or businesspeople who expect them; it's like asking for good service in a restaurant when the waiter knows you won't be giving a tip. In theory, because the Foreign Corrupt Practices Act warns foreigners that Americans can't give bribes, they'll eventually stop expecting them.

Where are American businesspeople most likely and least likely to encounter bribe requests and related forms of corruption? Transparency International, an independent German-based organization, annually rates nations according to "perceived corruption," which it defines as "the abuse of public office for private gain." Table 19.3 "Corruptibility Around the World, 2010" reports a sampling of the 2010 rankings.

Table 19.3 Corruptibility Around the World, 2010

Rank	Country	CPI Score*
1	Denmark	9.3
1	New Zealand	9.3
1	Singapore	9.3
4	Finland	9.2
4	Sweden	9.2
6	Canada	8.9
15	Germany	7.9
17	Japan	7.8
20	United Kingdom	7.6
22	United States	7.1
98	Mexico	3.1
175	Iraq	1.6
176	Afghanistan	1.4
178	Somalia	1.1
*A score of 10 means that a country is squeaky clean. Anything under 3 means that corruption is rampant.		

Source: [26]

Key Takeaways

- Success in international business means understanding an assortment of cultural, economic, and legal differences between countries.
- Cultural challenges stem from differences in language, concepts of time and sociability, and communication styles.

- If you do business in a foreign country, you need to know the country's level of economic development.
- In dealing with countries whose currency is different from yours, you have to be aware of the impact that fluctuations in exchange rates will have on your profits.
- Finally, in doing business globally, you must deal with the challenges that come from the vast differences in legal and regulatory environments.

Exercises

1. **(AACSB) Communication**
    - Executiveplanet.com (http://www.executiveplanet.com/index.php?title=Brazil)
    - Kwintessential (http://www.kwintessential.co.uk/resources/global-etiquette/brazil-country-profile.html)

    Write a brief report to summarize what you learned about cultural differences between U.S. and Brazilian businesspeople.
2. **(AACSB) Ethics**
3. **(AACSB) Ethics**
    1. Why have some multinationals decided to help control AIDS in their workforces?
    2. Why have others failed to help?
    3. From a humanitarian perspective, what's the right thing to do? From a business perspective?
    4. What would you do if you conducted operations in a nation whose government was unwilling or unable to control the spread of AIDS?

Trade Controls

Learning Objective

1. Describe the ways in which governments and international bodies promote and regulate global trade.

The debate about the extent to which countries should control the flow of foreign goods and investments across their borders is as old as international trade itself. Governments continue to control trade. To better understand how and why, let's examine a hypothetical case. Suppose you're in charge of a small country in which people do two things—grow food and make clothes. Because the quality of both products is high and the prices are reasonable, your consumers are happy to buy locally made food and clothes. But one day, a farmer from a nearby country crosses your border with several wagonloads of wheat to sell. On the same day, a foreign clothes maker arrives with a large shipment of clothes. These two entrepreneurs want to sell food and clothes in your country at prices below those that local consumers now pay for domestically made food and clothes. At first, this seems like a good deal for your consumers: they won't have to pay as much for food and clothes. But then you remember all the people in your country who grow food and make clothes. If no one buys their goods (because the imported goods are cheaper), what will happen to their livelihoods? Will everybody be out of work? And if everyone's unemployed, what will happen to your national economy?

That's when you decide to protect your farmers and clothes makers by setting up trade rules. Maybe you'll increase the prices of imported goods by adding a tax to them; you might even make the tax so high that they're more expensive than your homemade goods. Or perhaps you'll help your farmers grow food more cheaply by giving them financial help to defray their costs. The government payments that you give to the farmers to help offset some of their costs of production are called subsidies. These subsidies will allow the farmers to lower the price of their goods to a point below that of imported competitors' goods. What's even better is that the lower costs will allow the farmers to export their own goods at attractive, competitive prices.

The United States has a long history of subsidizing farmers. Subsidy programs guarantee farmers (including large corporate farms) a certain price for their crops, regardless of the market price. This guarantee ensures stable income in the farming community but can have a negative impact on the world economy. How? Critics argue that in allowing American farmers to export crops at artificially low prices, U.S. agricultural subsidies permit them to compete unfairly with farmers in developing countries. A reverse situation occurs in the steel industry, in which a number of countries—China, Japan, Russia, Germany, and Brazil—subsidize domestic producers. U.S. trade unions charge that this practice gives an unfair advantage to foreign producers and hurts the American steel industry, which can't compete on price with subsidized imports.

Whether they push up the price of imports or push down the price of local goods, such initiatives will help locally produced goods compete more favorably with foreign goods. Both strategies are forms of trade controls—policies that restrict free trade. Because they protect domestic industries by reducing foreign competition, the use of such controls is often called protectionism. Though there's considerable debate over the pros and cons of this practice, all countries engage in it to some extent. Before debating the issue, however, let's learn about the more common types of trade restrictions: tariffs, quotas, and, embargoes.

Tariffs

Tariffs are taxes on imports. Because they raise the price of the foreign-made goods, they make them less competitive. The United States, for example, protects domestic makers of synthetic knitted shirts by imposing a stiff tariff of 32.5 percent on imports.[27] Tariffs are also used to raise revenue for a government. Shoe imports are worth $2 billion annually to the federal government[28]

Quotas

A quota imposes limits on the quantity of a good that can be imported over a period of time. Quotas are used to protect specific industries, usually new industries or those facing strong competitive pressure from foreign firms. U.S. import quotas take two forms. An *absolute quota* fixes an upper limit on the amount of a good that can be imported during the given period. A *tariff-rate quota* permits the import of a specified quantity and then adds a high import tax once the limit is reached.

Sometimes quotas protect one group at the expense of another. To protect sugar beet and sugar cane growers, for instance, the United States imposes a tariff-rate quota on the importation of sugar—a policy that has driven up the cost of sugar to two to three times world prices.[29] These artificially high prices push up costs for American candy makers, some of whom have moved their operations elsewhere, taking high-paying manufacturing jobs with them. Life Savers, for example, were made in the United States for ninety years but are now produced in Canada, where the company saves $10 million annually on the cost of sugar.[30]

An extreme form of quota is the embargo, which, for economic or political reasons, bans the import or export of certain goods to or from a specific country. The United States, for example, bans nearly every commodity originating in Cuba.

Dumping

A common political rationale for establishing tariffs and quotas is the need to combat dumping: the practice of selling exported goods below the price that producers would normally charge in their home markets (and often below the cost of producing the goods). Usually, nations resort to this practice to gain entry and market share in foreign markets, but it can also be used to sell off surplus or obsolete goods. Dumping creates unfair competition for domestic industries, and governments are justifiably concerned when they suspect foreign countries of dumping products on their markets. They often retaliate by imposing punitive tariffs that drive up the price of the imported goods.

The Pros and Cons of Trade Controls

Opinions vary on government involvement in international trade. Some experts believe that governments should support free trade and refrain from imposing regulations that restrict the free flow of goods and services between nations. Others argue that governments should impose some level of trade regulations on imported goods and services.

Proponents of controls contend that there are a number of legitimate reasons why countries engage in protectionism. Sometimes they restrict trade to protect specific industries and their workers from foreign competition—agriculture, for example, or steel making. At other times, they restrict imports to give new or struggling industries a chance to get established. Finally, some countries use protectionism to shield industries that are vital to their national defense, such as shipbuilding and military hardware.

Despite valid arguments made by supporters of trade controls, most experts believe that such restrictions as tariffs and quotas—as well as practices that don't promote level playing fields, such as subsidies and dumping—are detrimental to the world economy. Without impediments to trade, countries can compete freely. Each nation can focus on what it does best and bring its goods to a fair and open world market. When this happens, the world will prosper. Or so the argument goes. International trade hasn't achieved global prosperity, but it's certainly heading in the direction of unrestricted markets.

Key Takeaways

- Because they protect domestic industries by reducing foreign competition, the use of controls to restrict free trade is often called **protectionism**.
- Though there's considerable debate over protectionism, all countries engage in it to some extent.
- **Tariffs** are taxes on imports. Because they raise the price of the foreign-made goods, they make them less competitive.
- **Quotas** are restrictions on imports that impose a limit on the quantity of a good that can be imported over a period of time. They're used to protect specific industries, usually new industries or those facing strong competitive pressure from foreign

firms.

- An **embargo** is a quota that, for economic or political reasons, bans the import or export of certain goods to or from a specific country.
- A common rationale for tariffs and quotas is the need to combat **dumping**—the practice of selling exported goods below the price that producers would normally charge in their home markets (and often below the costs of producing the goods).
- Some experts believe that governments should support free trade and refrain from imposing regulations that restrict the free flow of products between nations.
- Others argue that governments should impose some level of trade regulations on imported goods and services.

Exercise

(AACSB) Analysis

Because the United States has placed quotas on textile and apparel imports for the last thirty years, certain countries, such as China and India, have been able to export to the United States only as much clothing as their respective quotas permit. One effect of this policy was spreading textile and apparel manufacture around the world and preventing any single nation from dominating the world market. As a result, many developing countries, such as Vietnam, Cambodia, and Honduras, were able to enter the market and provide much-needed jobs for local workers. The rules, however, have changed: as of January 1, 2005, quotas on U.S. textile imports were eliminated, permitting U.S. companies to import textile supplies from any country they choose. In your opinion, what effect will the new U.S. policy have on each of the following groups:

1. Firms that outsource the manufacture of their apparel

2. Textile manufacturers and workers in the following countries:

- China
- Indonesia
- Mexico
- United States

3. American consumers

Reducing International Trade Barriers

Learning Objective

1. Discuss the various initiatives designed to reduce international trade barriers and promote free trade.

A number of organizations work to ease barriers to trade, and more countries are joining together to promote trade and mutual economic benefits. Let's look at some of these important initiatives.

Trade Agreements and Organizations

Free trade is encouraged by a number of agreements and organizations set up to monitor trade policies. The two most important are the General Agreement on Tariffs and Trade and the World Trade Organization.

General Agreement on Tariffs and Trade

After the Great Depression and World War II, most countries focused on protecting home industries, so international trade was hindered by rigid trade restrictions. To rectify this situation, twenty-three nations joined together in 1947 and signed the General Agreement on Tariffs and Trade (GATT), which encouraged free trade by regulating and reducing tariffs and by providing a forum for resolving trade disputes. The highly successful initiative achieved substantial reductions in tariffs and quotas, and in 1995 its members founded the World Trade Organization to continue the work of GATT in overseeing global trade.

World Trade Organization

Based in Geneva, Switzerland, with nearly 150 members, the World Trade Organization (WTO) encourages global commerce and lower trade barriers, enforces international rules of trade, and provides a forum for resolving disputes. It is empowered, for instance, to determine whether a member nation's trade policies have violated the organization's rules, and it can direct "guilty" countries to remove disputed barriers (though it has no legal power to force any country to do anything it doesn't want to do). If the guilty party refuses to comply, the WTO may authorize the plaintiff nation to erect trade barriers of its own, generally in the form of tariffs.

Affected members aren't always happy with WTO actions. In 2002, for example, the Bush administration imposed a three-year tariff on imported steel. In ruling against this tariff, the WTO allowed the aggrieved nations to impose counter-tariffs on some politically sensitive American products, such as Florida oranges, Texas grapefruits and computers, and Wisconsin cheese. Reluctantly, the administration lifted its tariff on steel.[31][32]

Financial Support for Troubled Economies

The key to helping developing countries become active participants in the global marketplace is providing financial assistance. Offering monetary assistance to some of the poorest nations in the world is the shared goal of two organizations: the International Monetary Fund and the World Bank. These organizations, to which most countries belong, were established in 1944 to accomplish different but complementary purposes.

The International Monetary Fund

The International Monetary Fund (IMF) loans money to countries with troubled economies, such as Mexico in the 1980s and mid-1990s and Russia and Argentina in the late 1990s. There are, however, strings attached to IMF loans: in exchange for relief in times of financial crisis, borrower countries must institute sometimes painful financial and economic reforms. In the 1980s, for example, Mexico received financial relief from the IMF on the condition that it privatize and deregulate certain industries and liberalize trade policies. The government was also required to cut back expenditures for such services as education, health care, and workers' benefits.[33]

The World Bank

The World Bank is an important source of economic assistance for poor and developing countries. With backing from wealthy donor countries (such as the United States, Japan, Germany, and United Kingdom), the World Bank has committed almost $73 billion in loans, grants, and guarantees to some of the world's poorest nations.[34] Loans are made to help countries improve the lives of the poor through community-support programs designed to provide health, nutrition, education, infrastructure, and other social services.

Criticism of the IMF and the World Bank

In recent years, the International Monetary Fund and the World Bank have faced mounting criticism, though both have their supporters. Some analysts, for example, think that the IMF is often too harsh in its demands for economic reform; others argue that troubled economies can be turned around only with harsh economic measures. Some observers assert that too many World Bank loans go to environmentally harmful projects, such as the construction of roads through fragile rain forests. Others point to the World Bank's efforts to direct funding away from big construction projects and toward initiatives designed to better the lot of the world's poor—educating children, fighting AIDS, and improving nutrition and health standards.[35]

Trading Blocs

So far, our discussion has suggested that global trade would be strengthened if there were no restrictions on it—if countries didn't put up barriers to trade or perform special favors for domestic industries. The complete absence of barriers is an ideal state of affairs that we haven't yet attained. In the meantime, economists and policymakers tend to focus on a more practical question: Can we achieve the goal of free trade on the *regional* level? To an extent, the answer is yes. In certain parts of the world, groups of countries have joined together to allow goods and services to flow without restrictions across their mutual borders. Such groups are called trading blocs. Let's examine two of the most powerful trading blocks—NAFTA and the European Union.

North American Free Trade Association

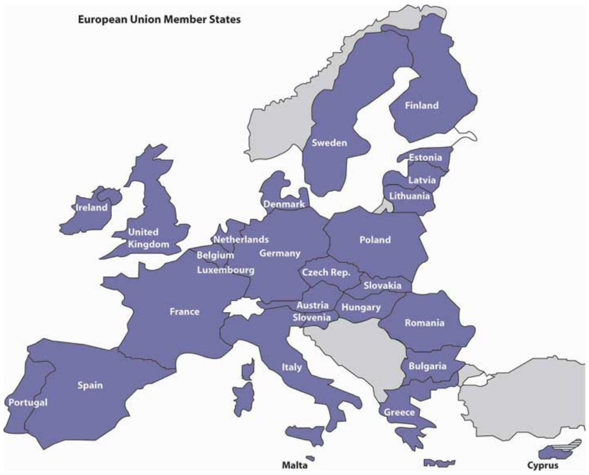
The North American Free Trade Association (NAFTA) is an agreement among the governments of the United States, Canada, and Mexico to open their borders to unrestricted trade. The effect of this agreement is that three very different economies are combined into one economic zone with almost no trade barriers. From the northern tip of Canada to the southern tip of Mexico, each country benefits from the comparative advantages of its partners: each nation is free to produce what it does best and to trade its goods and services without restrictions.

When the agreement was ratified in 1994, it had no shortage of skeptics. Many people feared, for example, that without tariffs on Mexican goods, more U.S. manufacturing jobs would be lost to Mexico, where labor is cheaper. Almost two decades later, most such fears have not been realized, and, by and large, NAFTA has been a success. Since it went into effect, the value of trade between the United States and Mexico has grown substantially, and Canada and Mexico are now the United States' top trading partners.

The European Union

The forty-plus countries of Europe have long shown an interest in integrating their economies. The first organized effort to integrate a segment of Europe's economic entities began in the late 1950s, when six countries joined together to form the *European Economic Community* (EEC). Over the next four decades, membership grew, and in the late 1990s, the EEC became the European Union. Today, the European Union (EU) is a group of twenty-seven countries that have eliminated trade barriers among themselves (see the map in Figure 19.9 "The Nations of the European Union").

Figure 19.9 The Nations of the European Union



At first glance, the EU looks similar to NAFTA. Both, for instance, allow unrestricted trade among member nations. But the provisions of the EU go beyond those of NAFTA in several important ways. Most importantly, the EU is more than a trading organization: it also enhances political and social cooperation and binds its members into a single entity with authority to require them to follow common rules and regulations. It is much like a federation of states with a weak central government, with the effect not only of eliminating internal barriers but also of enforcing common tariffs on trade from outside the EU. In addition, while NAFTA allows goods and services as well as capital to pass between borders, the EU also allows *people* to come and go freely: if you possess an EU passport, you can work in any EU nation.

The Euro

A key step toward unification occurred in 1999, when most (but not all) EU members agreed to abandon their own currencies and adopt a joint currency. The actual conversion occurred in 2002, when a common currency called the *euro* replaced the separate currencies of participating EU countries. The common currency facilitates trade and finance because exchange-rate differences no longer complicate transactions.[36]

Its proponents argued that the EU would not only unite economically and politically distinct countries but also create an economic power that could compete against the dominant players in the global marketplace. Individually, each European country has limited economic power, but as a group, they could be an economic superpower.[37] But, over time, the value of the euro has been questioned. Just as is true with the United States today, many of the "euro" countries (Spain, Italy, Greece, Portugal, and Ireland in particular) have been financially irresponsible, piling up huge debts and experiencing high unemployment and problems in the housing market. But because these troubled countries share a common currency with the other "euro" countries, they are less able to correct their economic woes.[38] Many economists fear that the financial crisis precipitated by these financially irresponsible countries threaten the very survival of the euro.[39]

Other Trading Blocs

Other countries have also opted for economic integration. Four historical rivals in South America—Argentina, Brazil, Paraguay, and Uruguay—have established MERCOSUR (for *Mercado Commun del Sur*) to eliminate trade barriers. A number of Asian countries, including Indonesia, Malaysia, the Philippines, Singapore, and Thailand, are cooperating to reduce mutual barriers through ASEAN (the *Association of Southeast Asian Nations*).

Only time will tell whether the trend toward regional trade agreements is good for the world economy. Clearly, they're beneficial to their respective participants; for one thing, they get preferential treatment from other members. But certain questions still need to be answered more fully. Are regional agreements, for example, moving the world closer to free trade on a *global* scale—toward a marketplace in which goods and services can be traded anywhere without barriers?

Key Takeaways

- Free trade is encouraged by a number of agreements and organizations set up to monitor trade policies.
- The **General Agreement on Tariffs and Trade (GATT)** encourages free trade by regulating and reducing tariffs and by providing a forum for resolving disputes.
- This highly successful initiative achieved substantial reductions in tariffs and quotas, and in 1995, its members founded the **World Trade Organization (WTO)**, which encourages global commerce and lower trade barriers, enforces international rules of trade, and provides a forum for resolving disputes.
- Providing monetary assistance to some of the poorest nations in the world is the shared goal of two organizations: the International Monetary Fund (IMF) and the World Bank. Several initiatives have successfully promoted free trade on a regional level. In certain parts of the world, groups of countries have joined together to allow goods and services to flow without restrictions across their mutual borders. Such groups are called **trading blocs**.
- The **North American Free Trade Association (NAFTA)** is an agreement among the governments of the United States, Canada, and Mexico to open their borders to unrestricted trade.
- The effect of this agreement is that three very different economies are combined into one economic zone with almost no trade barriers.
- The **European Union (EU)** is a group of twenty-seven countries that have eliminated trade barriers among themselves.

Exercises

1. What is NAFTA? Why was it formed? What has it accomplished?
2. What is the European Union? Why was it formed? What has it accomplished? What challenges has it faced?

Preparing for a Career in International Business

Learning Objective

1. Understand how to prepare for a career in international business.

No matter where your career takes you, you won't be able to avoid the reality and reach of international business. We're all involved in it. Some readers may want to venture more seriously into this exciting arena. The career opportunities are exciting and challenging, but taking the best advantage of them requires some early planning. Here are some hints.

Plan Your Undergraduate Education

Many colleges and universities offer strong majors in international business, and this course of study can be good preparation for a global career. In planning your education, remember the following:

- *Develop real expertise in one of the basic areas of business*. Most companies will hire you as much for your skill and knowledge in accounting, finance, information systems, marketing, or management as for your background in the study of international business. Take courses in both areas.
- *Develop your knowledge of international politics, economics, and culture*. Take liberal arts courses that focus on parts of the world that especially interest you. Courses in history, government, and the social sciences offer a wealth of knowledge about other nations and cultures that's relevant to success in international business.
- *Develop foreign-language skills*. If you studied a language in high school, keep up with it. Improve your reading or conversational skills. Or start a new language in college. Recall that your competition in the global marketplace is not just other

Americans, but also individuals from countries, such as Belgium, where everyone's fluent in at least two (and usually three) languages. Lack of foreign-language skills often proves to be a disadvantage for many Americans in international business.

Get Some Direct Experience

Take advantage of study-abroad opportunities, whether offered on your campus or by another college. There are literally hundreds of such opportunities, and your interest in international business will be received much more seriously if you've spent some time abroad. (As a bonus, you'll probably find it an enjoyable, horizon-expanding experience, as well.)

Interact with People from Other Cultures

Finally, whenever you can, learn about the habits and traits of other cultures, and practice interacting with the people to whom they belong. Go to the trouble to meet international students on your campus and get to know them. Learn about their cultures and values, and tell them about yours. You may initially be uncomfortable or confused in such intercultural exchanges, but you'll find them great learning experiences. By picking up on the details, you'll avoid embarrassing mistakes later and even earn the approval of acquaintances from abroad.

Whether you're committed to a career in global business, curious about the international scene, or simply a consumer of worldwide products and services, you can't avoid the effects of globalization. Granted, the experience can be frustrating, maybe even troubling at times. More often, however, it's likely to be stimulating and full of opportunities.

Key Takeaway

- To prepare for a global career, you might want to consider doing some of the following while a student:
  1. Major in international business.
  2. Develop your knowledge of international politics, economics, and culture.
  3. Study a foreign language.
  4. Take advantage of study-abroad opportunities.
  5. Interact with fellow students from other cultures.

Exercise

(AACSB) Analysis

If you had an opportunity to spend a summer working as an intern in a foreign country, which country would you select? Why? In what ways would the internship be valuable to your future career in business? How would you prepare for the internship?

Cases and Problems

Learning on the Web (AACSB)

Keeping Current About Currency

On a day-to-day basis, you probably don't think about what the U.S. dollar (US$) is worth relative to other currencies. But there will likely be times when ups and downs in exchange rates will seem extremely important to you in your business career. The following are some hypothetical scenarios that illustrate what these times may be. (*Note*: To respond to the questions raised in each scenario, search Google for a currency converter.)

Scenario 1: Your Swiss Vacation

Your family came from Switzerland, and you and your parents visited relatives there back in 2007. Now that you're in college, you want to make the trip on your own during spring break. While you're there, you also plan to travel around and see a little more of the country. You remember that in 2007, US$1 bought 1.22 Swiss francs (Frs). You estimate that, at this rate, you can finance your trip (excluding airfare) with the $1,200 that you earned this summer. You've heard, however, that the exchange rate has changed. Given the current exchange rate, about how much do you think your trip would cost you? As a U.S. traveler going abroad, how are you helped by a shift in exchange rates? How are you hurt?

Scenario 2: Your British Friends

A few years ago, you met some British students who were visiting the United States. This year, you're encouraging them to visit again so that you can show them around New York City. When you and your friends first talked about the cost of the trip back in 2007, the British pound (£) could be converted into US$1.90. You estimated that each of your British friends would need to save up about £600 to make the trip (again, excluding plane fare). Given today's exchange rate, how much will each person need to make the trip? Have your plans been helped or hindered by the change in exchange rates? Was the shift a plus for the U.S. travel industry? What sort of exchange-rate shift hurts the industry?

Scenario 3: Your German Soccer Boots

Your father rarely throws anything away, and while cleaning out the attic a few years ago, he came across a pair of vintage Adidas soccer boots made in 1955. Realizing that they'd be extremely valuable to collectors in Adidas's home country of Germany, he hoped to sell them for US $5,000 and, to account for the exchange rate at the time, planned to price them at $7,200 in euros. Somehow, he never got around to selling the boots and has asked if you could sell them for him on eBay. If he still wants to end up with US $5,000, what price in euros will you now have to set? Would an American company that exports goods to the European Union view the current rate more favorably or less favorably than it did back in 2007?

Career Opportunities (AACSB)

Broadening Your Business Horizons

At some point in your life, you'll probably meet and work with people from various countries and cultures. Participating in a college study-abroad program can help you prepare to work in the global business environment, and now is as good a time as any to start exploring this option. Here's one way to go about it:

- Select a study-abroad program that interests you. To do this, you need to decide what country you want to study in and your academic field of interest. Unless you speak the language of your preferred country, you should pick a program offered in English.
  - If your school offers study-abroad programs, choose one that has been approved by your institution.
  - If your school doesn't offer study-abroad programs, locate one through a Web search.
- Describe the program, the school that's offering it, and the country to which it will take you.
- Indicate why you've selected this particular program, and explain how it will help you prepare for your future business career.

Ethics Angle (AACSB)

The Right, Wrong, and Wisdom of Dumping and Subsidizing

When companies sell exported goods below the price they'd charge in their home markets (and often below the cost of producing the goods), they're engaging in *dumping*. When governments guarantee farmers certain prices for crops regardless of market prices, the beneficiaries are being *subsidized*. What do you think about these practices? Is dumping an unfair business practice? Why, or why not? Does subsidizing farmers make economic sense for the United States? What are the effects of farm subsidies on the world economy? Are the ethical issues raised by the two practices comparable? Why, or why not?

Team-Building Skills (AACSB)

Three Little Words: The China Price

According to business journalists Pete Engardio and Dexter Roberts, the scariest three words that a U.S. manufacturer can hear these days are *the China price*. To understand why, go to the *Business Week* Web site (http://www.businessweek.com/magazine/content/04_49/b3911401.htm) and read its article "The China Price," which discusses the benefits and costs of China's business expansion for U.S. companies, workers, and consumers. Once you've read the article, each member of the team should be able to explain the paradoxical effect of U.S.–Chinese business relationships—namely, that they can hurt American companies and workers while helping American companies and consumers.

Next, your team should get together and draw up two lists: a list of the top five positive outcomes and a list of the top five negative outcomes of recent Chinese business expansion for U.S. businesses, workers, and consumers. Then, the team should debate the pros and cons of China's emergence as a global business competitor and, finally, write a group report that answers the following questions:

1. Considered on balance, has China's business expansion helped or harmed U.S. companies, workers, and consumers? Justify your answers.
2. What will happen to U.S. companies, workers, and consumers in the future if China continues to grow as a global business competitor?
3. How should U.S. companies respond to the threats posed by Chinese competitors in their markets?

4. What can you do as a student to prepare yourself to compete in an ever-changing global business environment?

When you hand in your report, be sure to attach all the following items:

- Members' individually prepared lists of ways in which business relationships with China both hurt and help U.S. businesses, workers, and consumers
- Your group-prepared list of the top five positive and negative effects of Chinese business expansion on U.S. businesses, workers, and consumers

The Global View (AACSB)

Go East, Young Job Seeker

How brave are you when it comes to employment? Are you bold enough to go halfway around the world to find work? Instead of complaining about U.S. jobs going overseas, you could take the bull by the horns and grab one job back. It's not that tough to do, and it could be a life-changing experience. U.S. college graduates with business or technical backgrounds are highly sought after by companies that operate in India. If you qualify (and if you're willing to relocate), you could find yourself working in Bangalore or New Delhi for some multinational company like Intel, Citibank, or GlaxoSmithKline (a pharmaceutical company). In addition, learning how to live and work in a foreign country can build self-confidence and make you more attractive to future employers. To get a glimpse of what it would be like to live and work in India, go to the Web sites of *American Way* magazine (http://www.americanwaymag.com/jeffrey-vanderwerf-high-tech-outsourcing-boom-bangalore-leela-palace) and CNN and Money (http://money.cnn.com/2004/03/09/pf/workers_to_india), and check out the posted articles: "Passage to India," and "Needs Job, Moves to India." Then, go to the Monster Work Abroad Web site (http://jobsearch.monsterindia.com/return2origin/index.html) and find a job in India that you'd like to have, either right after graduation or about five years into your career. (When selecting the job, ignore its actual location and proceed as if it's in Bangalore.) After you've pondered the possibility of living and working in India, answer the following questions:

1. What would your job entail?
2. What would living and working in Bangalore be like? What aspects would you enjoy? Which would you dislike?
3. What challenges would you face as an expatriate (a person who lives outside his or her native country)? What opportunities would you have?
4. How would the experience of working in India help your future career?
5. Would you be willing to take a job in India for a year or two? Why, or why not?

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