# nxlevel® guide *for entrepreneurs*

entrepreneur

Editor

David P. Wold

Primary Authors

David P. Wold

Brandan Kearney

Dennis Sargent

Martha Sargent

On behalf of those involved in developing this program, we at the NxLeveL® Training Network dedicate this guide to entrepreneurs everywhere striving to reach the next level of success....

## Fifth Edition

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NX LEVEL®

*"Helping Entrepreneurs Reach the Next Level of Success..."*

# nxlevel® guide *table of contents*

entrepreneur

## To NxLeveL® Participants, Instructors and Interested Readers:

Thank you for choosing NxLeveL®. We know there are a variety of off-the-shelf entrepreneurial training programs from which to choose, and we appreciate your selection of NxLeveL®. Our goal is to help entrepreneurs like you reach the next level of success, because we understand that a strong small-business sector builds strong communities and a strong nation.

More than 160,000 people have taken NxLeveL® courses in communities located in over 48 states, as well as in Puerto Rico, American Samoa, Canada, Latin America, Europe, and Asia. This is the fifth edition of the *NxLeveL® Guide for Entrepreneurs*. It incorporates recent feedback from NxLeveL® participants and instructors.

While no single text can answer every question or solve every problem, we believe this book will be an invaluable aid in setting and achieving your entrepreneurial goals.

NxLeveL® is thankful for its initial support from the US WEST Foundation. The original 14-state network (comprising US WEST Communications' corporate territory) of organizations and their staff were extremely helpful in providing feedback, identifying writers, and providing sites to test our training materials. Their willingness to share information was invaluable. Without the support of US West, other local contributors, and the agencies implementing NxLeveL® on a statewide basis, NxLeveL® would not be the quality program that it is today.

NxLeveL® moved to Utah in 2002, and is now run by the NxLeveL® Education Association, but our commitment and mission remain the same. Like any customer-oriented business, we need to know what you like about us, and what you don't like. Please contact us with your suggestions, so that we can continue to improve our books and courses in ways that will benefit you and your fellow entrepreneurs.

**Michael Finnerty, President/CEO**
**NxLeveL® Education Association**
63 East 11400 South #322
Sandy, Utah 84070

Phone: 801.446.6162 or 800.873.9378
Fax: 801.446.6972
E-mail: mikef@nxlevel.org
Website: www.nxlevel.org

NX LEVEL®

*"Helping Entrepreneurs Reach the Next Level of Success..."*

## Letter From the Editor

My fellow contributors and I believe that entrepreneurship thrives in the United States primarily because of our legal and social structure, and our diversity. We conceived, researched, and wrote this course of study for students of all professional and educational backgrounds, and every gender, age, and race. The only prerequisites for taking this course are curiosity, and passion for the adventure of entrepreneurship.

This text presents the theories and practice of entrepreneurship through real-life stories about small businesses, because nothing is as inspiring to entrepreneurs as the experiences of successful business owners. Every contributor to this book has either started a business or helped others to do so. The result is a composite of our experiences, which gives you an opportunity to learn from our mistakes as well as our successes.

Every chapter of this new edition reflects the sweeping technological innovations and legislative changes of recent years. We've added new chapters on green business opportunities, saving energy and resources, and project management, and included important new information on social networking media, demand-driven manufacturing, profit-based growth strategies, unconventional financing sources, managing during economic downturns, cloud computing, business continuity planning, and many other current and emerging topics. In particular, our updates on green business and technology have made this book more valuable than ever.

No matter who you are or what you know, entrepreneurship presents many challenges. In the businesses I started, I had a love/hate relationship with the challenges I faced. I can't say that I always enjoyed them, but I knew that the day they ended, I would be out of business. Challenges were proof that my business was covering new ground and growing. Obstacles are part and parcel of managing a business. Our goal is to help you avoid the predictable obstacles, and inspire you to overcome the unpredictable ones.

Entrepreneurship is about freedom. Few things in life are as satisfying as being able to decide what work you'll do, and to choose when, where, how, and with whom you'll do it. With this freedom, inevitably, comes responsibility. Entrepreneurs do not answer to bosses, but we do have responsibilities to lenders, investors, and family, and we are bound by the laws of profitability. Above all, we have responsibilities to ourselves. We must be true to our vision, and design our businesses to reflect the best of what we have to offer.

I believe I speak for all the contributors to this text when I say that entrepreneurship has enriched our lives by allowing us to share remarkable experiences with unique and talented people. When confronting obstacles, it was very often the dedication and humor of the people we worked with that kept us moving onward and upward.

It is this sense of the pioneering spirit and joy of entrepreneurship that we want to pass along to you. We wish you the best of luck and many good times as you set out on your own entrepreneurial adventures!

David Wold
Mill Valley, California

## About the Authors

Preparing the NxLeveL® text books was a challenge, and to meet that challenge in the best possible way, we asked a wide variety of individuals to help us. The authors have a combined 300 years of business experience, making the sharing of their experiences just that much more beneficial. The authors include professional educators and entrepreneurs who have both educational and practical experience. We'd like to recognize them here.

### Primary Authors

**David P. Wold** is an international entrepreneurship consultant, advising start-up and growing businesses on strategy, management, and marketing. He has over 25 years of experience growing businesses in the United States, Latin America, the Middle East, Russia, and Eastern Europe. A graduate of the University of Wisconsin, he has an MBA from the Thunderbird School of Global Management.

**Brandan Kearney** is a freelance writer and editor who has written extensively on environmental regulations and pollution control. He has written manuals on the qualitative analysis of chemicals for HazTech Systems, Inc., a San Francisco-based industrial hygiene company, and has conducted training on safe shipping, handling, and identification of chemicals. He ran a successful small business for 15 years, and has contributed to and edited several textbooks on entrepreneurship and international trade.

**Dennis Sargent** is Director of the Small Business Development Center at Linn-Benton Community College. He is a CPA, and holds an MBA from Oregon State University. Dennis has more than 25 years of experience in business consulting, systems design, teaching, and management.

**Martha Sargent** is an Assistant Professor of Accounting and Director of the Small Business Development Center at Western Oregon State College. She holds an MBA from Oregon Sate University and is a CPA. Martha has more than 20 years of experience in accounting and teaching.

### Contributing Authors

**Helen LeBoeuf-Binninger** holds BBA, MBA and CPA certificates. She has been involved with small businesses as an entrepreneur and consultant. She currently provides business consulting and training services to small businesses near her home in Idaho.

**Virginia Campbell** is the Assistant State Director for the Washington Small Business Development Center. Ms. Campbell has 10 years of human resource experience in the private sector, and nine years of experience as the owner of a small business in the construction industry.

**James Deffenbaugh** is the Executive Director of a nonprofit community planning and loan organization. He is a past administrator of the California Regional Parks System, and has been an administrative partner for a CPA firm. He has many years of counseling and consulting experience with both small and large businesses.

**Dawn Gardner** owned and operated a small business, served as Press/Public Relations Officer to Governor Lamm from 1985 to 1987, developed entrepreneurial training programs in Colorado, and provides workshops on home-based businesses.

**Kris Jon Gorsuch** is a graduate of the University of Iowa College of Law. Kris is an attorney specializing in helping entrepreneurs establish successful businesses. He has written and spoken extensively on business development, and teaches continuing education classes. He holds Martindale Hubble's highest achievement rating.

**Joseph B. Harris** is a Business Development Specialist for the Washington Small Business Development Center in Pullman, Washington. He teaches entrepreneurship and business planning at Washington State University.

**Robert Horn** was the Director of the Colorado Center for Community Development at the University of Colorado at Denver, and founded the NxLeveL® Training Network. He is an educator and professional planner by training. He holds a masters in Urban and Regional Planning, and has been involved in community economic development for the past twenty-five years.

**Dr. Lawrence A. Howard** obtained his PhD in Political Science at the University of Washington. He has held a number of executive positions in international logistics, such as shipping agent, and market research manager for a major global steamship company. He has taught at the California Maritime Academy and Upper Iowa University, and is currently Chair of the Global Business and Transportation Department at State University of New York (SUNY) Maritime.

**Randy Johnson** has developed several entrepreneurial training classes and has spoken on such topics as financing, economic development, home-based business and marketing. He is currently president of the Rocky Mountain Home-Based Business Association.

**Paul Karofsky** started working in his family's business in 1967, and has been involved with small businesses ever since. He is Director of the Northeastern University Center for Family Business, is a lecturer at the University's College of Business Administration, and writes a family business column for several publications.

**Yolanda Collazos Kizer** is the president of Builder's Book Depot and Casa Feniz Merchandizing, Inc. She has an MBA, and serves on several civic organizations throughout Arizona, including the Governor's Strategic Partnership for Economic Development and the City of Phoenix Commission on the Economy.

**Johanna Leestma** is a graduate of Vassar College. She owned a successful backpack design and manufacturing business before earning her MBA from the Thunderbird School of Global Management. She is the founder and president of a successful online business called Loom.

**Craig A. Lorenz** is a practicing CPA in California with over 25 years of experience in business consulting services, accounting, and taxes. He has worked with closely held businesses and start-ups throughout his career, and has had his own business for over fifteen years. He has a BA in Accounting.

**Lorre McKeone** of North Platte, Nebraska, has managed three small businesses and spent 7 years as a loan officer before starting her own business, The Executive Extra. She teaches classes, workshops and provides consulting services for small businesses. Ms. McKeone graduated with honors from Hastings College.

**William Mullane** has over 20 years of experience working with small business. He is a former newspaper publisher and was the communications manager for Schweitzer Mountain Resort. Mr. Mullane helped create the Royal Saudi Air Force Survival Training Center and curriculum. He has an MBA from the Thunderbird School of Global Management, and is currently an entrepreneurship and technology consultant at Boise State University.

**Cameron Wold** co-founded the NxLeveL® Training Network. A former commercial banker, his expertise includes entrepreneurial training, welfare transition, and shared-use commercial kitchens. A graduate of Amherst College, he holds an MBA from the University of Southern California, and a PhD in education from the University of Idaho. He is currently Dean of Graduate School Programs at Colorado Christian College.

**R. L. Wolverton** is a freelance writer and photographer who teaches small business planning. He has owned and published newspapers and magazines, and his writing has appeared in several national magazines. He lives in Wyoming.

**Editor**
**David P. Wold**

**Design and Printing**
**Jeremy Bailey** • Graphic Designer • www.jbinkdesign.com

# Part I
# Understanding Entrepreneurship

## Chapter 1
## THINKING ENTREPRENEURIALLY

*About This Chapter:*
- *The importance of small business*
- *Risks and rewards of entrepreneurship*
- *What makes a good entrepreneur?*
- *Strategies for success*
- *Self-assessment and your business check-up*

### Introduction
The term "entrepreneur" is often applied to small-business owners as a class, in its literal sense of "one who organizes, manages, and assumes the risks of a business." But this really doesn't communicate the special talents that entrepreneurs possess, or the unique nature of the entrepreneurial vision.

Most small businesses have the ability to become entrepreneurial, but their owners choose to keep them small to avoid the risks and complications that come with growth. For instance, the owner may not want to hire, train, and manage the new employees a larger business would require, and so he or she avoids the risks and foregoes the rewards of entrepreneurship.

By contrast, entrepreneurs are never content with the status quo. They're always looking for new markets, new ideas, and new challenges. They are innovative, visionary people with a strong desire to create something new, and take it as far as it will go.

The self-assessment questionnaires at the end of this chapter identify a few of the most valuable qualities an entrepreneur can possess, and encourage you to find and develop these qualities in yourself. After completing the questionnaires, and doing some soul-searching, you can draw upon your insights to create a personal mission statement that will guide your efforts to grow your business.

Our greatest weakness lies in giving up. The most certain way to succeed is to always try just one more time.

—Thomas Edison

### The Importance of Small Business
Small businesses are America's backbone. The Small Business Administration (SBA) reports that America's small businesses (those with less than 500 employees):

- Create 75 percent of the net new jobs added to the economy
- Represent 99.7 percent of all employer firms
- Employ half of all private sector employees
- Pay almost 45 percent of the total private payroll in the United States

Small firms create twice as many innovations per employee as large firms

- Employ 40 percent of the nation's high-tech workers (e.g., scientists, engineers, and computer technicians)
- Comprise 97 percent of all US exporters
- Were awarded $83.3 billion in direct federal prime contracts in 2007
- Produce 13 times more patents per employee than large firms

Studies also show that small firms produce twice as many innovations per employee as large firms. Some attribute this to the adventurous spirit of small business, others to the ability of a small firm to move and change more rapidly than a large, bureaucratic company.

Small businesses also help to lead the country out of economic downturns. Since the mid-1990s, small businesses have created 60 to 80 percent of the net new jobs. In the most recent year with data, firms with fewer than 500 employees created 979,102 net new jobs, or 79 percent of the total. When larger businesses downsize, start-up business is the logical option for displaced workers. These start-ups are often better able to respond to emerging global trends, technology, and opportunities than their large competitors.

Some start-ups are based on exciting new technology. Some offer a faster, cheaper, or more pleasant way of getting things done. And still others are pioneering better ways of doing ordinary and extraordinary things, through green or sustainable business practices.

What all these businesses have in common is innovation. If someone else is doing it, entrepreneurs will find a way to do it better. If no one else is doing it, entrepreneurs will find a way to make it happen.

*Renata Stein had an unusual but rewarding hobby: she designed one-of-a-kind purses using unconventional fabrics and color combinations. Tropical flowers, striped upholstery fabric, oilcloth, straw, plastic fruit and beads all figured into her colorful creations. There was nothing else like them on the market anywhere!*

*The response from customers at small boutiques and craft fairs was enthusiastic, so Renata quit her office job and started a small business called Fiery Angel. She knew her new business would be a lot of work. Her unique bags took plenty of time to design and stitch. More than once, she'd had trouble meeting deadlines for fairs and shows. But, she reasoned, that was back when she had a day job, and worked at her sewing during evenings and weekends. Now, she'd have plenty of time to be creative!*

*Or so she thought.*

## Risks and Rewards of Entrepreneurship

Starting a business can be challenging even in the best economic climate. To succeed, an entrepreneur needs courage, knowledge, foresight, good advice, plenty of determination, and a little bit of luck.

Research shows that less than a third of small businesses survive for seven years or longer. Generally, businesses that stay open for four years have a better chance of survival. Important factors that affect a firm's long-term viability include having adequate capital and employees, as well as the owner's education level, determination, willingness to learn, and reason for starting the firm.

Why would you want to take the risk of starting your own business, when you could work for someone else and have the security of a regular monthly income?

Different individuals have different motivations and ideas of success, but some of the most attractive rewards for entrepreneurs include:

- **Independence.** Entrepreneurs like to follow their own path, instead of taking orders from other people. They enjoy making their own decisions and carrying them out. They're also willing to accept the serious responsibilities that come with this freedom.
- **Money.** The financial rewards of running a successful business can go far beyond what one can expect from a normal job, and provide much greater personal satisfaction.
- **Self-realization.** Entrepreneurs often have a great idea, or a belief in themselves, that they want to fulfill. For these people, the primary reward is the sense of self-worth and accomplishment that comes with overcoming challenges and making good things happen. Many people find this to be one of the most fulfilling parts of running a successful business.
- **Fun.** Most entrepreneurs really enjoy what they do. The entrepreneurial lifestyle presents opportunities for fun, excitement, and creativity that most businesses cannot offer their employees.

Entrepreneurship provides opportunities for fun, excitement, and creativity

Next, let's look at some of the risks and drawbacks that entrepreneurs face.

- **Failure.** Entrepreneurs must assume the emotional burden of failure.
- **Loss of money.** Most start-up entrepreneurs have their own money at risk.
- **Long hours.** Most entrepreneurs report 60-70 hours per week as normal.
- **Family problems.** Because of the strain of operating a business, the entrepreneur's family relationships may suffer.

- **Bad timing.** While people in all stages of life have started successful businesses, certain times are more conducive to taking on a new business venture. Sometimes, it is just not the right time to start a new business. In these situations, it's much better to put off one's venture temporarily than to let overwhelming distractions and difficulties harm one's prospects for success.

## What Makes a Good Entrepreneur?

Every day, millions of people dream of starting a business. Every day, hundreds of entrepreneurs turn their dreams of starting a business into reality. What is the difference between those who dream about it, and those who do it?

Well, entrepreneurs are usually young, old, or somewhere in between. They're either male or female. They're often college-educated, or not. In other words, they come from every imaginable background. No gender, age, or ethnicity bestows a particular advantage in entrepreneurship.

But certain personality types *do* have an advantage. Most observers agree that successful entrepreneurs have certain characteristics in common.

Loving what you do is essential to doing it well!

- **Passion.** When you're really passionate about your work, hard work often leaves you feeling exhilarated rather than exhausted. This is why successful entrepreneurs are able to work harder, more happily, and more productively than other people. Loving what you do is essential to doing it well.
- **Creativity.** It takes creativity to come up with new ideas and solve problems. Entrepreneurs enjoy experimenting with new approaches and strategies, which includes being open to creative suggestions from others.
- **Foresight.** Business success doesn't happen by accident. Every entrepreneur has a vision, but the successful ones plan carefully to turn that vision into reality. They set appropriate, attainable, and affordable goals, and create realistic and flexible plans for achieving them. Successful entrepreneurs may take calculated risks, but they're not gamblers. They make every effort to foresee obstacles and reduce risk.
- **Persistence.** Entrepreneurs are not afraid of challenges. But persistence means more than believing in one's business against all odds. Entrepreneurs must be equally persistent when it comes to the less glamorous side of business. They may have to do boring tasks that they don't enjoy, but they don't allow themselves to get discouraged. The true entrepreneur has enough discipline and commitment to complete these tasks properly and on schedule.
- **Self-confidence.** Entrepreneurs are confident in their ability to make their businesses prosper, even when the people around them aren't. They're optimistic and have faith in their own ideas, but they're also self-confident enough to realize that there's no shame in asking questions or seeking advice.

- **An open mind.** The best entrepreneurs look at situations as they are, not as they want or imagine them to be. They don't let received wisdom, preconceived notions, and political or social prejudices get in the way of adapting to—and making the most of—a changing world.
- **Humility.** Good entrepreneurs know that they're not superhuman. They understand that they can make mistakes, get things wrong, and treat other people badly. Because they're aware of their own biases and blind spots, they're careful to get frequent reality checks, often by seeking help and advice from mentors who have some experience in their industry.
- **Communication skills.** Entrepreneurs need excellent communication skills to inspire lenders and employees, resolve disputes, negotiate fair contracts, and attract and retain customers.
- **Good health and high energy.** Starting a business requires a tremendous amount of effort and time. Without good health and high energy, it's very hard to maintain a successful business. If you wish to be an entrepreneur, take care of your health...you're going to need it!

Note that many of these good traits can become faults if carried to extremes. For instance, there can be a fine line between being persistent and being stubborn, or between being self-confident and being delusional. That's why it's so important to seek good advice, and recognize it when it's offered.

Here are some other problems that entrepreneurs should always watch out for:

- **Arrogance.** Entrepreneurs who think they can do everything singlehandedly may find it difficult to work as part of a team, or to foster teamwork among employees. Others may alienate people by throwing authority around for the fun of it. Remember that no business exists in isolation. Even if you don't have employees, you may still have outside partners, creditors, suppliers, and—most important of all—customers. Recognize the value of the relationships that make your business possible, and don't jeopardize them with arrogant behavior.
- **Overvaluing authority.** If you value your own authority too much, you may not want to give any to other people. The result? A customer walks into your business, finds that no one but you can make what seems to be a simple decision, and goes away mad. Also, people who overvalue their authority are often unable to take advice or criticism, because they see it as a threat. They don't want to be questioned or challenged, even if they're driving the business off a cliff.
- **Greed.** It's important to want to succeed in business. But it's also important to set rational limits, and stick to them. Sacrificing your friendships, your employees, your ethics, or your family for success is ultimately self-destructive. The best entrepreneurs have learned self-control, and are able to focus their desire on a more balanced and realistic idea of success that includes fair play, win-win solutions, and good citizenship.

Delegating responsibility and authority is one of the toughest but most important things an entrepreneur must do

Having fun is as important to success as hard work!

- **Workaholism.** Some people see their business as the only important activity in life. This can make for unhappy families...and ultimately, unhappy entrepreneurs. Remember: Your investment of time, energy, and financial resources requires family support, and that in turn requires you to meet your family's emotional needs. Living a balanced life—one with plenty of time for family, friends, and relaxation—is better for you than workaholism, and that makes it better for your business, too.

*Right from the start, Fiery Angel demanded roughly 80 hours of work per week. When Renata wasn't designing and sewing purses, she was buying raw materials, balancing her books, checking on orders, juggling consignments, and negotiating bulk wholesale contracts. She was very, very busy!*

*She was also very successful, but that only made matters worse. After she'd sold her designs to a couple of boutiques in Chicago, the Fiery Angel line of purses was picked up by a New York showroom. Suddenly, she had more work than she could handle.*

*Something had to give. Unfortunately, it turned out to be what little remained of her personal life. A month after the orders started coming in from New York, she was working almost 100 hours a week. Before long, the unthinkable had happened: she was remembering her office job fondly!*

## Strategies for Success

Businesses fail for many reasons. They ignore their customers, they disregard market conditions, they miscalculate prices, they don't stick to plans and budgets, or they lack managerial control.

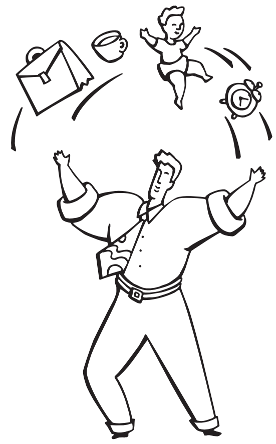
As helpful as it is to learn what not to do by analyzing the reasons a business fails, it's even more helpful to understand what makes a business successful. Business success can be defined in all sorts of ways—including business size, market share, profitability, efficiency, and the ability to innovate—but there are certain qualities that every successful business shares.

Businesses succeed because they:

- Have a clear sense of purpose
- Base their goals on realistic expectations
- Understand their strengths and weaknesses relative to those of their competitors
- Target the right group of customers

- Specialize in solving customer problems, and experiment with new approaches
- Are organized for maximum flexibility
- Create customer loyalty and repeat business by offering a unique value
- Build enduring relationships based on quality, honesty, and responsiveness
- Develop a new product or service that captures a large market share
- Manage cash flow effectively
- Empower employees to be the best they can be
- Keep a close eye on costs, pricing, and profit
- Prepare and use a business plan

In the next few pages, we'll look at some basic steps you can take to increase your chances of success.



Where will you draw the boundaries between work, family, and leisure time?

### Setting Boundaries

Because entrepreneurs have so much flexibility in creating their work environment and schedule, they need to address personal priorities very early in their ventures. Where will the boundaries be drawn between work, family, and leisure time?

For many, the traditional boundaries between private and professional time are blurred. It's easy for entrepreneurs to focus too intently on the rewards they reap from their efforts. Unfortunately, this preoccupation with the business sometimes alienates them from family and friends, and leaves them with no time for community, athletic, or creative pursuits.

From the outset, smart entrepreneurs take the time to evaluate their personal priorities, and plan a schedule that allows them to fulfill these priorities.

### Flexibility

Entrepreneurs should always be ready and willing to adapt as necessary to changing circumstances, but this is especially true in times of economic uncertainty. In all but the very worst situations, there will be new opportunities for growth and improvement.

Here are some tips for staying flexible:

- Stay curious! Attend seminars and night classes, join online discussions, and learn as much as you can about your options.
- Question your assumptions. Don't be a slave to business as usual.
- Ask for suggestions from employees, partners, and customers. They may know things you don't.
- Look realistically at costs. Are you saving on materials, but losing market share? Are you saving time, but alienating customers?
- In an economic downturn, position your business as part of the solution.
- Review your business model at least once a year.

Effective time management leads to effective business management

### Time Management

Starting a new business places unique demands on your time. Entrepreneurs who fail to manage their time often fall into a cycle of inefficiency and poor performance. They're too busy to teach employees how to work effectively, so they end up trying to do too many tasks themselves. They don't have time to weed out mistakes and improve practices. They can't build strong relationships with customers and suppliers, nor can they fully enjoy their leisure time.

Effective time management leads to effective business management. No matter how small your business is, you usually can't singlehandedly do all of the tasks it requires. You must delegate duties, and give people the authority to perform tasks in the most effective ways. After all, you should focus your efforts on the tasks that only you can do: guiding the business by setting goals, and devising strategies that will achieve those goals.

Here are some useful time-management tips:

- List all business activities, and record how much time is spent on each over a one-week period
- Identify wasted time and "gaps" that can be used more efficiently
- Create an agenda of prioritized tasks, and cross them off as they are completed
- Finish tasks in one session
- Create agendas for meeting goals and deadlines
- Keep work areas clear of clutter, and file papers and e-mails immediately
- Schedule the most important work during the time when you're most alert
- Make sure all activities support your stated goals
- Combine tasks that can be done together

### Continuous Learning

One of the most important things you can do is to make an ongoing study of your industry, your competition, and new and emerging trends. Make a point of reading things you don't normally read, even if they're written by people you don't normally agree with. No one's always wrong, and it can be dangerous to listen only to the voices you enjoy hearing.

Do everything you can to stay aware of changes in the economy and your industry, and make sure your business is flexible enough to adapt when it must. Remember: to resist change is very often to resist opportunity!

### Getting Help When You Need It

Obviously, you can't learn to do everything at once. That's why you must recognize your own abilities, and use good judgment in choosing other people to fill the gaps in your knowledge. Resist the temptation to move beyond your core strengths. Instead, delegate responsibility, and learn to rely on advisors and mentors.

| February | | | | | | |
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| 27 | 28 | | | | | |

# Weekly Planner

## February 7-13, 2010

| | | |
|---|---|---|
| Monday 7 | 10:30am - 12:30pm | Meet with Richard Hersey/Textiles Unlimited - discuss supply agreement and schedule |
| | 2:00pm - 3:00pm | Interview Frances Klein for asst. position |
| | 4:00pm - 5:00pm | Aerobics class |
| Tuesday 8 | 9:00am - 10:30pm | Women in Business breakfast |
| | 11:00am - 1:00pm | Review March - June orders |
| | 3:00pm - 4:00pm | Appointment with Flair Boutique |
| Wednesday 9 | 8:30am - 12:30pm | SBDC Conference - “Financing Sources” |
| | 1:00pm - 3:00pm | Lunch with Robin Grant re: design concepts |
| Thursday 10 | 9:00am - 10:00am | Finalize lease with MMC Management Co. |
| | 11:00am - 12:00pm | Contact Hilton gift shop re: July - Dec. orders |
| | 7:30pm | Attend NxLeveL® Going Green class |
| Friday 11 | 9:00am - 10:30am | Meet with accountant - review tax returns |
| | 1:00pm - 2:00pm | Present designs to Shelly’s Shop |
| | 4:00pm - 5:00pm | Yoga class |
| Saturday 12 | 11:30am | Golf with Ann |
| | 8:00pm | Movie with Bill |
| Sunday 13 | 12:00pm | Lunch with Mom and Dad |
| | 7:00pm | Prepare next week’s work plan |

A **mentor** is a person who agrees to guide you, support you, and give you valuable advice—and criticism—in order to help you reach your business goals. The ideal mentor is someone you like and respect, who can make a commitment to spending a few hours every month talking to you clearly and honestly about your business. Your mentor should be a knowledgeable, upbeat person who has managed to climb up to where you want to be, and is now in a position to lower a rope to you.

A mentor can offer an objective take on the strengths and weaknesses of your ideas, and help you to improve them

A mentor shouldn't be someone you run to every time you have a problem. Instead, your mentor should meet with you regularly to assess your progress, offer constructive criticism, and motivate you to excel. A mentor can also offer an objective take on the strengths and weaknesses of your business ideas, and help you to improve them.

How do you get a mentor? Well, if you feel you have a good rapport with someone who's given you valuable business advice in the past, you can simply ask that person to be your mentor.

If you don't know anyone who fits the bill, your local Small Business Development Center (SBDC) may be able to help you find a mentor. Visit **www.sba.gov/sbdc** to find an SBDC near you.

*Why was Renata feeling so overwhelmed? Part of it came with the territory of running a successful business single-handedly. But there were other problems, too.*

*Renata knew she could save money and time by buying materials in bulk, but she felt she didn't have enough cash on hand. Therefore, she had no choice but to buy raw materials every week or two, make her purses as fast as possible, and repeat the process. It was costing her a lot of time and money to scour her city for new and exciting materials week after week. But without those materials, she didn't have a business!*

*It sounds strange, but the very thing that made Fiery Angel so successful—its one-of-a-kind purses made out of unusual materials—was causing it to falter.*

### Bootstrapping

Often, entrepreneurs must use all their creativity to beg, borrow, or find the resources they need to support a new venture. This is called **bootstrapping**. It's the practice of getting by with as few resources as possible, and getting the most out of those you have. This might mean holding down three jobs, borrowing money from family and friends, selling assets, mortgaging a house, or even resorting to credit-card financing.

Bootstrapping is not just a way to finance a new business; it's also a way to keep a successful business lean and flexible. Successful entrepreneurs are always looking for unconventional ways to generate revenue, minimize costs, and maximize profits.

## NxLEVEL® TECH TIP

### BUSINESS RESOURCES AND THE WEB

There are hundreds of Websites devoted to entrepreneurship. Here are a few of the best:

**Entrepreneur** (www.entrepreneur.com). This remarkable Website comprises thousands of pages, with chat rooms, a bookstore, over 300 free downloadable business forms, free membership and e-mail accounts, several years' worth of back issues of *Entrepreneur* and *Small Business Start-ups* magazines, and many links to related sites.

**SmallBusiness.com** (www.smallbusiness.com) is a growing site that offers resources for those seeking information and assistance in starting and running a small business in the United States. Because it uses the collaborative Wiki format, it encourages knowledge-sharing and includes user-generated content from entrepreneurs.

**Startup** (www.startup.wsj.com) is an offshoot of the *Wall Street Journal*, and features lots of news, advice, anecdotes, and ideas for the entrepreneur.

And don't forget the **NxLeveL® Training Network** (www.NxLeveL.org).

Here are some hints for the bootstrapping entrepreneur:

- Cut down on the need for full-time employees by using independent contractors, temp workers, or services from other businesses.
- Use barter arrangements to procure supplies, or trade the expertise you have for expertise you don't. For instance, if you're in the business of Web design, but you lack illustration skills, you might design a site for a local artist in return for the artwork you need.
- Find local sources for free or inexpensive office equipment and supplies through sites like Craigslist (www.craigslist.org) and Freecycle (www.freecycle.com).
- Share a rental space with another business.
- If you need access to specialized equipment or facilities, find an existing business that will let you use it during closing or off-peak hours.
- Form a cooperative or collective with likeminded or complementary businesses.
- Use free or low-cost online faxing, database, and accounting programs.
- Send invoices by e-mail, instead of printing and mailing them.
- Look at **peer-to-peer funding** options based on social networking tools, like Kickstarter (www.kickstarter.com)
- Increase your visibility and reach with blogs, YouTube, Facebook, and other social networking sites.

Increase your visibility and reach with social networking sites

Send marketing materials electronically, instead of printing and mailing them

- Consider joining a **Local Exchange Trading System (LETS)**. This is a local, nonprofit network whose members trade goods and services, usually by means of interest-free local currency. LETS is also known as a **mutual credit system**, and is a popular method of bootstrapping in economically disadvantaged regions.
- Look into policies that will save money while giving you a positive, greener brand image (e.g., send marketing materials and catalogs electronically, instead of printing and mailing them).

## Self-Assessment and Your Business Check-Up

This section contains a series of questionnaires designed to help you assess your business skills and lifestyle preferences. You may find it helpful to solicit feedback from family, co-workers, and friends. Ask them to answer these questions with you in mind, then review their answers with them.

### Your Personal Assessment

People are defined by their actions: how they interact with people, how they make decisions, what their natural talents are, and how they get things done. In general, our personalities are revealed by a unique composite of daily habits that reflect our skills, motivation, and past learning. The following personal assessment will help you to compare your habits to those of successful entrepreneurs, and identify any skills you need to improve.

Read each statement carefully, and enter a score in the right-hand column based on how well the statement agrees with your own feelings. Use a scale of 1 to 4:

1 = strongly disagree
2 = disagree
3 = agree
4 = strongly agree

When you have finished the test, calculate your total by adding all points in the score column. A score of 25 to 62 points in this exercise may mean that starting a business is not the right choice for you. Becoming an entrepreneur is stressful and challenging, and if the ability to focus your energy wholeheartedly on a goal is not among your strengths, you may want to consider a different profession!

That said, a low to mid-range score may simply mean that you have not yet had a chance to develop these skills. With a little training and experience—such as you'd get from partnering with more experienced people, or going to work in a small, entrepreneurial business—you can easily overcome this handicap.

Perhaps your self-confidence is lower than you'd like. You may feel that you're not as creative as you need to be, or that you lack leadership abilities. Chances are, if you look closely at your achievements, you'll find that you possess more good qualities than you think. This book will help you to develop many of the personal qualities entrepreneurs need, including leadership skills, creativity, and a capacity for innovative problem-solving.

If you scored between 63 and 100 points, you are well on your way to having the skills you'll need. You enjoy setting goals and achieving them, and are comfortable with taking some risks. However, since the success of your venture depends on discovering and improving upon your weak areas, we recommend that you consider ways to develop those skills for which your score was below 3.

## Personal Assessment

| Statement | Score |
|---|---|
| I enjoy competition in work and play. | |
| I often set goals for myself. | |
| I often meet the goals I set for myself. | |
| I am happiest when I'm responsible for myself and my own decisions. | |
| I am detail-oriented and organized. | |
| I enjoy taking risks. | |
| In group situations, I usually take a leadership role. | |
| I do things on my own. Nobody has to get me going. | |
| I work best when there are no precedents for what I am doing. | |
| I have an open mind, and consistently challenge my own thinking. | |
| I inspire enthusiasm and commitment in other people. | |
| I am a naturally curious person who enjoys learning new things. | |
| I think I have something valuable to offer the world. | |
| I wake up early, feeling alert. | |
| I am not the type to put things off when they need doing. | |
| I am able to prioritize important tasks. | |
| I find it exciting when circumstances change and I must adapt or expand my abilities. | |
| I often identify new skills I need, and work at acquiring them. | |
| I enjoy seeking out new challenges. | |
| I enjoy speaking in front of groups of people. | |
| If given the choice, I prefer to work with other people on a project. | |
| I have no problem juggling several tasks at once. | |
| I have a strong sense of personal ethics. | |
| I can make up my mind in a hurry if I have to. These decisions usually turn out well. | |
| I tend to see the upside of a bad situation. | |
| I believe in being fair, so I aim for win-win situations whenever I can. | |
| | |
| **Personal Total Points** | |

### Your Business Skills Assessment

Entrepreneurs have limited time and resources, so they must focus on what they do best. It's important to know early on which skills you have, and which you'll have to learn, or find in co-workers.

Many of the skills discussed in this exercise are not difficult to acquire. In fact, it's very possible that you use them often without knowing it. To rate yourself fairly, consider past and present participation in community, church, and family activities; hobbies; and professional organizations. You are likely to find that you possess far more business skills than you realize, and can learn those skills you don't have more easily than you might think.

Read the following statements, scoring yourself on a scale of 1 to 4.

1 = strongly disagree
2 = disagree
3 = agree
4 = strongly agree

If you score between 25 and 62 points, you may wish to find a community college or continuing education program that offers basic accounting, financial management, and marketing classes. Talking with experienced business people is another great way to get real-life knowledge about business skills. Seek out people who work in your targeted field and ask them about the skills they feel have been crucial to their success. Learning new business skills is a never-ending process in today's marketplace.

If you score above 63 points, you already possess basic business knowledge. However, the advice above applies to you, too: Make sure your skills are up-to-date, and never stop looking for new opportunities to learn!

## Business Skills Assessment

| Statement | Score |
|---|---|
| I keep track of my personal finances and balance my checkbook every week. | |
| I create monthly and yearly budgets for myself and follow them. | |
| For any given period of time, I know what I spend on medical costs and living expenses. | |
| I know within $100 how much it cost me to operate my car last year. | |
| Even if I don't prepare my tax return myself, I understand the basic concepts. | |
| I know how to borrow money from a bank. | |
| I have an excellent credit rating. | |
| I enjoy getting out there and selling an idea or product to people I have never met. | |
| Give me five minutes, an audience, and a great product and I can make a sale. | |
| I understand how to calculate profitability and perform break-even analysis. | |
| I understand the difference between fixed and variable costs. | |
| I regularly read business books to improve my skills. | |
| I use a computer to manage my work and personal finances. | |
| I understand the basics of budgeting. | |
| I read a wide variety of business-related magazines and Websites | |
| I'm willing to press customers for full payment up front, or if they refused, negotiate with them for a 50% deposit or unconventional payment terms. | |
| I have work experience in the industry or field in which I am interested. | |
| I have managed people by setting goals and assessing performance. | |
| When negotiating a decision with a friend, co-worker, or salesperson, I am usually happy with the outcome. | |
| I understand the basics of how different products and services are distributed. | |
| I have hired and fired people. | |
| I know how to interview and assess prospective employees. | |
| I understand how cash flow affects business decisions. | |
| I am comfortable giving presentations and know how to create professional, effective presentations. | |
| I know how to use computer software to create effective presentations. | |
| I know how to prepare an invoice. | |
| I understand how to get the most out of the Internet, e-mail, and cellphones. | |
| | |
| **Business Total Points** | |

### Your Lifestyle Assessment

Assessing lifestyle preferences means measuring what you value as a human being. Carefully study your motivations, and the priorities that guide your decisions, to ensure that the demands of your work and your personal life are compatible.

Read the following statements, and score yourself as you did in the previous assessments.

1 = strongly disagree
2 = disagree
3 = agree
4 = strongly agree

Are you flexible enough to take on the challenges and uncertainties of a new business? If you score below 62 points, financial, family, community, or other personal responsibilities may be a considerable source of conflict for you. By looking at the statements for which you scored a 1 or 2, you may be able to draw some conclusions about how time, money, family, health, and other issues will affect your ideal lifestyle. This does not disqualify you from pursuing your venture; it simply reveals some of the realities of your life, and presents the parameters within which you must make business decisions.

The same holds true if you score between 63 and 100 points: this is your starting point for understanding what type of business opportunity is best for you to pursue, and how you can make it fit your lifestyle.

## Lifestyle Assessment

| Statement | Score |
|---|---|
| My friends would describe me as a high-energy person. | |
| My health is generally good. I don't get sick very often. | |
| I can support myself without taking money out of my business for one year. | |
| If I needed to, I could keep my full-time job and run my new business on the side. | |
| I have no problem working 10-12 hours a day, 6 days a week, including holidays. | |
| My family will tolerate my working 60 hours or more a week. | |
| When I wake up in the morning, I feel alert and energetic. | |
| I consider myself a high performer. | |
| I know I can work productively for long hours and meet deadlines, no matter what it takes. | |
| I have very good physical stamina. | |
| No matter how hectic things get, I've always made time for friends and family. | |
| At the expense of professional stability, and perhaps higher income, it is important to me to be able to determine when and where I work. | |
| Foremost among my personal goals is the freedom to pursue my own ideas. | |
| I am prepared to lose my savings. | |
| I have a pretty good fallback plan in case things don't work out. | |
| I am prepared to sacrifice the amount of money and/or time that I am able to commit to community, religious, or charity obligations during the first five years of my business. | |
| I can go a year without a vacation. | |
| I have the enthusiastic support of my family to pursue an entrepreneurial venture. | |
| I am comfortable setting, evaluating, and achieving my own 1-, 3-, and 5-year plans. | |
| I understand that part of my job description in my new business would include sweeping the floor, typing letters, and taking out the trash. | |
| Where other people see threats, I see opportunities. | |
| It is important to me to create my own space in which to work. | |
| I am comfortable working in a gray area where the boundaries between my work and personal life are sometimes hidden. | |
| I have a good sense of humor, and I tend to look on the bright side when things go wrong. | |
| | |
| **Lifestyle Total Points** | |

*There was no question about it: Renata had serious time-management problems! Ten months after she started her business, she realized that it had been three months since she'd been on a date, and two months since she'd visited her parents. She'd skipped her high-school reunion, and missed several other events that she'd wanted to attend.*

*She was too busy to shop or cook, so she usually ordered food to go from local restaurants, often paying as much as five dollars extra to have it delivered by Waiters on Wheels. Since she had no time to jog or go to the gym, she'd gained ten pounds.*

*Her business skills were suffering, too. It seemed like she was always struggling to get orders finished. She never had enough time to balance her books, collect past-due payments, and manage consignments.*

*She knew she needed help. But how could she afford it?*

### Personal Mission Statement

Your mission statement must contain specific goals, and describe how you intend to achieve them

Your personal mission statement describes the values and principles on which you base your life. It can look and sound any way you want it to. The only rule is that it must contain specific goals, and describe in a straightforward manner how you intend to achieve them. Here's an example:

> My family comes first, and I will always make time for them. Nothing will distract me from giving my children the emotional and intellectual support they deserve, or from sharing with my spouse all the joys and sorrows of our life together. By treating others as honestly and fairly as I want them to treat me, I will set standards among my peers for ethical behavior. By listening more than I speak, I will allow myself to learn from other people.

### Business Mission Statement

Just about every business has a mission statement these days, but very few of them are well written and informative. Many mission statements contain nothing more than a few bland and imitative boasts about being a "uniquely efficient world-class business committed to outstanding quality."

Like your personal mission statement, your business mission statement must set forth specific, measurable goals. But since your business mission statement is for public consumption, you must take extra care to ensure that it's clear and concise. Don't fall into the trap of using worn-out buzzwords like "commitment" or "unique." These words mean nothing in themselves, and won't impress anybody. Instead, explain what you are committed *to*, and why this makes you special. Note that a good mission statement provides meaningful information that can be checked and verified by the consumer. Let this example be your guide:

> Olympus Fitness and Rehabilitation uses breakthrough proprietary software to deliver personalized, transformative exercise programs, in strict accordance with the standards of the American College of Sports Medicine.

### Your Business Check-Up

Before you can plan for growth, you need to assess your operations and measure efficiency. This is a chance for you to look into the nooks and crannies of your business, and address any problems you may have been putting off. This check-up will help set your course for the future. As you perform the assessment, look at your business as a prospective buyer would. Some of the issues to consider are:

- What are your business's strengths and weaknesses?
- What could you be doing better?
- Which areas of the business have given you the biggest challenges?
- Which areas of the business have you been ignoring?
- Has your business realized its potential?
- Has it demonstrated profitability?
- Does it consistently deliver quality goods and services?
- Does it benefit your community, your country, or the environment?
- Does it have a rich skill base and distinct expertise?
- Do you have any employee problems?
- Do you have a realistic vision for the future—and the strategies and tactics to realize that future?
- What green policies have you undertaken?

These are the concerns you must address before you take your business to the next level of growth.

*Status of your customers and your market*

Successful businesses begin every self-assessment by evaluating how well they are serving their customers. The needs and tastes of customers change constantly; what is ideal for one group of customers may not satisfy another. Therefore, one of the biggest challenges for a growing business is to have a thorough understanding of its customers and market. Consider the following questions:

How well are you serving your customers?

- What percentage of your business is repeat business?
- How large is your overall market?
- How large is your customer base?
- Have you defined your target customers? Where are they? What's important to them? What makes them unique? How much are they willing to pay?

- How has your market changed since you've been in business?
- Do you periodically gather new information about your market?
- Who are your competitors? How do you differentiate your business from theirs?
- What legal or government regulations affect your business?
- Has your market continued to grow, or is it leveling off or shrinking?

*Your profitability and prices*

Even the most talented entrepreneur cannot grow an unprofitable business

Even the most talented entrepreneur cannot grow an unprofitable business. Before you go any further, you need to assess whether or not you are generating a profit.

- What are your variable costs?
- What are your fixed costs?
- Have you created sales forecasts using different pricing methodologies?
- What is your target profit margin?
- How are you currently pricing your products or services?
- Do your price structure allow you to earn your target profit margin?
- How do your prices compare to those of your competitors?
- How do your prices position you in your customers' eyes?

*Renata called up her friend Alison, who was an accountant, and offered her a custom-made handbag in return for a few hours of consultation. To her relief, Alison agreed.*

*The first thing Alison discovered was that Fiery Angel's biggest clients were, on average, taking a crippling 90 days to pay. No wonder Renata was having cash-flow problems!*

*The second thing she discovered was that Renata had almost five thousand dollars' worth of unsold merchandise gathering dust in fifteen consignment stores, at a time when Renata was struggling to keep up with demand.*

*She also noticed that Renata was spending an average of $680 per month on prepared and delivered food.*

*Renata was astonished. She'd never thought about how her lifestyle was affecting her cash flow! She resolved that things would change. The first thing she did was to pull her unsold purses out of the stores, and use them to fill her outstanding orders.*

*For the first time in what seemed like years, she had a bit of breathing room. She intended to make the most of it.*

*Your time management skills*

Growing businesses place unique demands on your time. Multiple tasks, short deadlines, and new challenges can easily cause quality performance to slip. Are you managing time effectively? Ask yourself these questions:

- Do you routinely budget your time?
- Do you set deadlines for completing projects? Do you meet them?
- Do you regularly take time to evaluate your efforts?
- Are you able to solve problems and move on to new challenges?
- Are you delegating responsibility and authority?
- Are you satisfied with the amount of time it takes you to complete routine tasks?
- Do you routinely use project management tools?

*Your team*

Growing businesses must assess how well employees and outside contractors have performed in the past, and identify areas for improvement.

- How satisfied are you with your team's performance?
- Do your people have the skills they need?
- Are you compensating your team appropriately?
- Is your team happy and having fun?
- Do you set performance goals for your team?
- How do you reward your team?
- Can you use social networking tools to optimize team performance?
- Do you have any problem employees?
- What is your rate of employee turnover?

*Your operations*

How well a business manages its operations determines its ability to tackle new challenges and grow. How does your business measure up?

- How are you managing your raw materials? How are inputs ordered, counted, inspected, and stored?
- How good are your relationships with your suppliers?
- Do you negotiate favorable terms? Extended payment plans?
- Is your equipment up-to-date and well maintained?
- Is your work space conducive to productivity and efficiency?
- How much inventory do you keep on hand?
- Are you able to fill orders reliably?
- Are you satisfied with the overall quality of your operations?
- Do you keep organized, accurate records?
- Are you in a location where customers can easily find you?
- Is your product being distributed in the most efficient and effective way?
- Are you managing energy and resources wisely?

Are you managing time effectively?

- What can you do to make your company more environmentally friendly?
- Are you using the Internet and social networking technology as effectively as you could?

*Your financing*

The growth of your business depends on how well capitalized it is, and how well it manages its resources. Consider the following:

- What are your sources of financing?
- How much does your financing cost?
- Are you adequately capitalized?
- What is the value of your business's assets?
- What is the value of your business's debts?

*While going through old consignment accounts, Alison had discovered $1,500 in past-due receivables, which Renata had been too harried to collect. At Alison's urging, Renata used most of this money to buy bulk materials. She also put an ad on Craigslist, offering to buy fabric scraps and worn-out vintage clothing. This saved her considerable time and money, and brought in material she might not have found otherwise.*

*Alison came up with new payment terms for stores and distributors, which offered a discount for buyers who paid within 30 days. This helped to stabilize Fiery Angel's cash flow.*

*With some of the pressure off, Renata started cooking for herself again. This cut her food costs in half, and allowed her to hire a high-school student to do some sewing, piecework, packing, and mailing. Part of the student's "salary" consisted of sewing lessons, which worked out nicely for both of them. Also, with her younger brother's help, Renata set up an Etsy store, which brought in a small but steady flow of direct income, and also proved to be a valuable marketing tool.*

*Perhaps the most important thing that Renata learned from Alison was how to organize her personal time. These days, she takes a break every day at 4pm, and goes for a run or visits the gym. She meets with friends three nights a week, even if it's just to have a cup of tea at a café. Her most important rule? Absolutely no work after 9pm!*

*Renata is still very, very busy, but she no longer feels overwhelmed. Thanks to effective time management, she's finally able to enjoy the rewards of entrepreneurship. The days when she missed her office job are very far behind her!*

## NxLEVEL® GREEN TIP
ENVIRONMENTAL BUSINESS RESOURCES

Here are some interesting statistics on the economic and environmental impact of green business.

- In 2008, the cleantech industry represented 20 percent of all venture capital assets, and this number continues to grow.
- 59 percent of workers think their company should do more to be environmentally friendly.
- 80 percent of young professionals prefer jobs that have a positive impact on the environment.
- 62 percent of shoppers say that the availability of green product options affects their impulse buying patterns.
- More than 40 percent of Lifestyles of Health and Sustainability (LOHAS) consumers state that they look for proof when a company makes a claim about its green business practices, according to research from the Natural Marketing Institute.
- 45 percent of companies surveyed by Symantec Corp. have implemented green IT initiatives, and budgets for such projects are rising.
- LEED-certified green buildings have saved an amount of energy equivalent to burning 1.3 million tons of coal for electricity.
- US telecommuters reduce gasoline consumption by about 840 million gallons every year, and curb carbon dioxide emissions by nearly 14 million tons.

## Conclusion

What is entrepreneurial thinking? It's keeping one eye on profit and the other on "quality of life" issues. It's finding clever ways to maximize your resources. It's using time wisely, and being guided by one's values and commitments. It's evaluating one's priorities, strengths, interests, and goals, and creating a business that fulfills them. Entrepreneurs are truly successful when they find a comfortable balance between business responsibilities and personal needs.

Because of widespread outsourcing, downsizing, and re-engineering at large corporations, entrepreneurial skills may be the key not only to economic independence, but even to survival in the 21st century. Naturally, there are many risks in entrepreneurship. But for most entrepreneurs, the joy of running a business outweighs the drawbacks!

# Chapter 2
# A CUSTOMER-DRIVEN PHILOSOPHY

*About This Chapter:*
- *Developing a customer orientation*
- *Understanding your customers*
- *Creating a customer-centered business*
- *Mapping, gathering, and measuring customer data*

## Introduction
Businesses can't thrive without loyal customers, and they can't grow without new customers. This is why it's so important to deliver exceptional customer service!

For larger corporations, this often entails trying to simulate the more intimate relationship that a small business has with its customers. Companies that manage to create this illusion are often very successful. But as a small business owner, you don't need to fake it. You have the ability to adapt to customer needs more quickly and creatively than your larger competitors.

This is crucial, because it's increasingly difficult—and unwise—to differentiate one's business solely on the basis of things like quality, technology, and price. Furthermore, the rise of social networking sites means that customers have more ability to affect your business—for better or worse—than ever before.

Friendly, unique, responsive, and flexible customer service is one of the small business's greatest advantages. Those who don't take advantage of it are throwing away a vital competitive tool.

You have the ability to adapt to customer needs more quickly and creatively than your larger competitors

## Developing a Customer Orientation
All across America, small businesses have challenged conventional wisdom by weathering competition from "big box" stores like Wal-Mart and online goliaths like Amazon. There are a number of reasons for this, but one of the most important is that small businesses can offer sincere, down-to-earth, personalized customer service. They can get to know their customers as individuals, and learn to value them as something more than consumers. Eventually, customer service of this type leads to trust, and trust engenders loyalty that can withstand a tremendous amount of competitive pressure.

It's a basic fact of business that loyal customers are more profitable than new ones. This is expressed nicely by the 80/20 Rule: 20 percent of your customers provide 80 percent of your sales volume.

Here are some reasons for this:

- Loyal customers may be less sensitive to price changes
- Loyal customers generate referrals and word of mouth
- Loyal customers are more likely to purchase supplemental products, which often have a higher profit margin
- Loyal customers make it harder for competitors to enter your market
- Loyal customers tend to need less handling, less education, and less selling time
- Loyal customers make your employees' jobs easier and more satisfying, which makes them more able to offer excellent customer service

Loyal customers make it harder for competitors to enter your market

*As a small home theater component subcontractor, Randy Regner knows that his business depends on his ability to deliver perfect components on time to his client.*

*In an effort to enthuse assembly line workers, he made it a policy to reward employees for meeting or exceeding daily production quotas and deadlines, rooting out problems on the line, and coming up with innovations in production. Employees who outdo themselves get surprise lunch parties, or are told to take Friday off.*

*Because their work involves sitting still for long periods of time, Randy negotiated a group membership rate at a nearby gym. On hot days, he sometimes ends work early and organizes a company swimming trip.*

*Policies like these make Randy's employees fiercely loyal, and highly productive. The spirit of camaraderie that Randy has engendered makes workers less prone to absenteeism, which is very important for assembly line work.*

*And by earning employee loyalty, he's earned loyalty from his customers, who have stuck with him through some tough economic times!*

## Understanding Your Customers

Understanding your customers means knowing how they use your product, and why they choose you over your competitors. It means knowing about the customer's life at work, at home, and in between.

Successful businesspeople have a very accurate profile of their customers, and they make it their business to know when that profile changes. This knowledge is reflected in the business plan, and in the firm's marketing and operating plans. Once you understand what the customer needs, you can put processes in place to deliver it. That's the essence of a customer orientation.

### Creating a Value Profile

What do your customer values most? Are they looking for the best price, or the best quality? Do they see you as a friendly local alternative to a larger, more impersonal firm, or did they choose you simply because you were there? How do they feel about green products, or American-made ones?

Once you find the answers to these questions, you must use them to deliver better customer service than any of your competitors.

To begin, ask yourself, "What do I offer?" Think in terms of intangible qualities, such as convenience, creativity, reliability, time savings, or comfort.

Six basic questions can identify your customers' idea of value:

1. What do our customers want?
2. How does our product meet our customers' needs?
3. What aspects of our customers' dealings with us are most important to them?
4. How do our customers feel about our competitors?
5. What can we do to distinguish ourselves from our competitors?
6. How are our customers' needs likely to change, and how are we preparing for these changes?

## Creating a Customer-Centered Business

Your first task in creating value for your customers is to be sure your business has the tools it needs to deliver innovative, reliable service.

### Employees

Your staff is the first line of direct contact your business has with its customers, so every employee should embody your customer service policy. Let them know what you expect of them, and give them the freedom to invent new ways to deliver customer service. Let them contribute to and improve your customer service plan.

The way a business treats its employees mirrors the way it treats its customers. Whether you have three employees or three hundred, your business must be a place where quality people want to work, and where quality service is delivered. This requires openness, trust, and participation at all levels. To achieve this, you should:

- Hire inspired, curious, and committed people.
- Educate all of your employees in customer service. Even workers who have no contact with customers should understand how they add value to the business, and how their work enables frontline personnel to deliver service.
- Post your customer service goals prominently in your office.
- Help employees gain product expertise, and encourage them to share it with customers.

Every employee should embody your customer service policy

- Let your employees know how much you value their extra efforts to serve customers. Thank them often and publicly for good service!
- Create a system of measurement, recognition, and rewards for excellent customer service. Tie rewards to things like minimizing customer complaints, product returns, and customer wait times; or devising new customer service ideas.

### Customer Service Strategies

A clear strategy is essential to providing good customer service, and it can also stimulate ideas for improvement. Here are some important strategies:

- **Pretend the world is watching you.** It used to be that a single dissatisfied customer might tell a few friends to avoid your business. Now, thanks to the explosion of online business review sites like Yelp (www.yelp.com), that single customer has the ability to communicate with everyone in your area. In addition, the ubiquity of cellphones with built-in video cameras, and the popularity of media-sharing sites like YouTube, means that an unpleasant confrontation can very quickly wind up on the Internet.
- **Map your points of contact with customers.** Plot out every point at which customers interact with your company, from calling your receptionist, to viewing your advertisements, to accepting deliveries from your drivers. This will help you to find points that need more attention, and to eliminate redundant or unnecessary points. Mapping also helps employees to understand how their roles interlock.
- **Get input from everyone in the customer service chain.** Different people will have different experiences of your customers. Your goal is to get the fullest possible picture of the customer, so you should take everyone's experiences and insights into account.
- **Keep the customers you get.** Experts estimate that it costs three to five times more to find a new customer than to keep an old one. Repeat customers represent an ongoing revenue stream that is essential to your business. Suppose a woman goes to a deli and pays one dollar for a bagel. If she doesn't return, her business is worth exactly a dollar to the deli. But if she returns three times a week for a year, her business is worth $156.
- **Earn customers' loyalty by being loyal to them.** The secret to having long-term relationships with customers lies in demonstrating your ability to predict their needs, and to meet them in creative ways.
- **Communicate with your customers.** Critical feedback from customers can direct your attention to things that need improvement. Nobody likes bad news, but gathering bad news is often more valuable than collecting pats on the back. Use every contact with your customers to learn to serve them better.

Earn customers' loyalty by being loyal to them

- **Don't be afraid to educate your customer when necessary.** Contrary to the old saying, the customer is *not* always right. But when a customer doesn't understand one of your policies or decisions, the burden is always on you and your employees to satisfy his or her concerns, by explaining your rationale clearly and respectfully. (This is especially true when it comes to green business decisions; you can't expect customers to support them if they don't understand them!)
- **Embrace the concept of Total Quality Service (TQS).** This popular management tool can be as important for small businesses as it is to the larger corporations that pioneered it. Much has been written about TQS and Total Quality Management (TQM). Your local bookstore will have several publications on these topics.

*When Linda Rogers and Gayle Corson decided to open La Femme, a fine lingerie shop in Grosse Pointe, Michigan, they knew they would be in competition with national lingerie chain stores.*

*However, after doing some research, they realized that there was an untapped market for lingerie. Linda and Gayle decided to innovate by reaching out to larger women, petites, and pregnant women—a niche market not served by the larger stores—and emphasizing organic and sustainable brands.*

*Their business supplies fine lingerie to women who have difficulty finding attractive lingerie elsewhere. By offering special touches like complementary refreshments for shoppers, personal shopping services, and a frequent shopper card, the proprietors of La Femme developed a loyal following.*

*La Femme recently launched a Website that features a cutting-edge "Virtual Dressing Room." Customers enter their measurements, which generates an animated figure that can "wear" different styles, and can be rotated 360 degrees and viewed from a variety of angles.*

*Now, they're working on the next step: custom garments based on virtual body-shape modeling. Instead of going into the store for a fitting, customers will create a virtual body, and La Femme will do the rest!*

*There are other companies that offer solutions for hard-to-fit customers, but La Femme's combination of service, sensitivity, green sourcing, and visionary technology puts it far ahead of the competition!*

### Your Customer Service Plan

Every business should have a customer service plan within its marketing plan. This should include:

- Customer service goals
- Customer service benchmarks
- How customer data will be gathered, stored, accessed, and used
- After-sales service practices
- Return, exchange, and customer complaint policies
- Special order or custom service policies
- How different areas of your business deliver service
- Your system of training and rewards for customer service excellence
- Information on your "customer expert," who will deal with customer needs, trends, and complaints; and regularly compile internal customer service history reports
- A formal system by which customers can report their feedback (e.g., questionnaires, report cards, suggestion box, online surveys)

How does customer information come into your business, and what happens to it after that?

## Mapping, Gathering, and Measuring Customer Data

Many businesses suffer because different types of customer data are scattered across a variety of desks, in a variety of formats. The result is that useful customer information isn't always available when employees need it.

Therefore, after you've mapped the points of contact between your company and your customers, you should map the different paths by which customer information comes into your business, and what happens to it after that.

For example, some of your customers will contact you by e-mail, some will browse your Website, some will call, and some will mail letters or postcards. If you have different employees monitoring these communications, and they don't integrate their knowledge, it limits your company's ability to serve the customer. A good system will centralize and link all these forms of communication, so you can cross-reference and analyze them. The logical solution is a central database.

Here are some of the data you should monitor:

- Response to promotional campaigns
- Questions and suggestions
- Requests for promotional packets, newsletters, and catalogs
- Order placement and fulfillment data
- Demographics and psychographics
- Account information
- Website browsing data
- After-sale praise and complaints

Even mistakes can be informative. If people keep calling to ask whether you offer a particular service, perhaps your Website or ads aren't clear enough about what your business is. Or perhaps you should consider offering the service people are requesting! Customer inquiries can be a good source of ideas, so you might want to have a call log that very briefly describes each call that comes in.

Suppose you run a graphic-design firm called Lightbox, and people keep calling to ask if you sell LED lighting systems; you could then take steps to adjust your advertisements and listings to make it more clear what your business does.

On the other hand, if you sell lighting fixtures, you might consider whether adding this new product could be profitable. But either way, if your receptionist simply says "No, sorry," and forgets all about the call, you get no information.

## NxLEVEL® TECH TIP

BUSINESS RESOURCES AND THE WEB

**Salesforce.com** is an on-demand customer relationship management (CRM) tool that allows you to manage and integrate customer contacts and communications. It's different from traditional software-based CRM systems, in that the application and the data are stored on the vendor's system, instead of your computers.

You and your employees access your data over the Internet, through a standard Web browser. This eliminates the need for multiple software licenses and upgrades.

The system is scalable to businesses of different sizes, and its features are customizable by the end user. In April of 2009, Salesforce.com launched a mobile version of their application, for use with Blackberry, iPhone, and Windows mobile devices.

You can learn more about on-demand CRM, and view demos and screenshots, by visiting **www.salesforce.com**.

### Monitoring Customer Satisfaction

Since your employees deal with customers every day, they're your best resource for information-gathering. Encourage them to report on customer attitudes, positive and negative. If possible, have them fill out a brief report after customer interactions, or enter data into the "comments" field of your customer database.

Your employees are your best resource for gathering data on customer satisfaction

One solution might be to have employees who deal with phone-in customers ask every fifth caller a couple of simple, conversational questions like "How long were you on hold? Did you find that wait unreasonably long?" Have them ask questions like these once a week, or once a month, and mark the results on a tally sheet. You could also call customers who recently received goods, and ask about the condition the goods arrived in and whether the shipping speed was acceptable.

One benefit of doing this—in addition to the informational benefit—is that it discourages tunnel vision among your employees. Workers have a tendency to go on automatic pilot, and to do familiar jobs without thinking. But when asked to write a brief summary of customer interactions, they may start noticing small but important details they'd overlooked in the past.

Train your employees to gather data on a daily basis

Many businesses ask customers to fill out survey cards or questionnaires, or participate in online surveys. These are good ideas, but it's even more important to train your employees to gather data on a daily basis, and devise a reliable way of storing and sharing it.

*Online business reviews*

As we mentioned above, there are many Websites that allow customers to rate businesses and products. In theory, this is a positive development; not only does it provide a way to monitor customer satisfaction, but it can amplify good word of mouth, and bring you a steady stream of new customers. Studies show that consumers are far more likely to trust, and act on, customer reviews than traditional advertisements.

In practice, however, problems abound. Many sites allow users to be anonymous, which means that you never know who is rating your business. It could be a disgruntled employee, or even a competitor! In most cases, you'll have no recourse; the best policy is to try to benefit from any constructive criticism you hear, and ignore the rest of it.

One thing you should definitely *not* do is write positive or defensive reviews under a false identity. Even if your true identity doesn't come out—and the odds are pretty good that it will—savvy users have a way of recognizing this behavior.

In cases of serious misrepresentation, you may feel a need to respond. If that happens, be careful to wait until you're no longer feeling angry, and then answer the criticism calmly, factually, and honestly. Threats, insults, or any sort of drama are likely to make the situation much worse.

If the site is part of your community—e.g., it belongs to the local newspaper—you may be able to get truly offensive or slanderous comments removed. But again, this should be a last resort, and you should never undertake this course of action while you're still angry.

Above all, try to keep a sense of perspective. If you've made a serious commitment to quality and service, it's very likely that positive comments will balance or even directly contradict the negative ones.

One more point. Some sites, like Yelp (www.yelp.com), allow you to e-mail reviewers directly, which allows business owners to ask for more details about the reviewer's dissatisfaction, and to offer to make amends. Handled carefully, this can turn people who are skeptical about your business into true believers.

If you decide to go this route, we recommend coming up with a polite form letter in advance, and sticking to it. Introduce your business, reference the negative review, and ask what you can do to resolve the problem. As the conversation progresses, remain calm and respectful, and learn whatever you can, with an eye towards preventing the problem from happening again. Unless the reviewer is extremely rude and unreasonable, you should always offer him or her some sort of reward for taking the time to answer your questions.

*Without a reliable source of water, it doesn't take long for crops to wither in the hot Arizona sun. For farmers in Arizona, the only thing better than an efficient irrigation system is a skilled person to ensure that it runs reliably and smoothly.*

*Jack Knetsch began H20 Repairs in 2008, after working for ten years at a large irrigation management firm in Glendale. He'd worked with nearly every type of irrigation system around, and he also knew all of the major customers in western Arizona. With his lean business (himself and two partners), Jack was able to offer faster service and lower prices than his larger competitors.*

*Jack makes a point of monitoring, documenting, and analyzing his dealings with customers. After each repair, he asks customers to fill out a report card to rate his service, speed, professionalism, and expertise. He calls again at three months, six months, and one year to make sure that everything is still working smoothly. He also keeps detailed records on the type of system each customer has, the type of crops they plant, the local geology, and every other pertinent detail. He even has pictures of former worksites on file, for future reference!*

*When his customers call, they're often amazed at how well he remembers their individual situations. He doesn't bother telling them that he set up a customer-management system to do just that!*

## NxLEVEL® GREEN TIP
ENVIRONMENTAL BUSINESS RESOURCES

It's important to know where your target customers stand on environmental issues, because different customer attitudes call for different strategies, offerings, and price points.

**The LOHAS Consumer Trends Database**™ (www.nmisolutions.com/lohasd.html) offers qualitative and quantitative research on green consumer behavior, and "helps companies understand the interconnection of consumer values and purchase patterns across product categories and the values that drive consumer purchase beyond the point of consumption. Understanding these values will allow you to communicate with consumers in a much more meaningful manner and develop long-term relationships."

### Managing Customer Experience

One idea that has becoming popular in recent years is managing customer experience. This requires a holistic approach to customer service that optimizes every interaction with the customer, and creates emotionally invested customers who are not just loyal, but serve as advocates for your brand, often by means of social networking tools that the business itself provides (e.g., a Facebook page). In some cases, managing customer experience can involve having customers assist in product development and delivery.

To a certain extent, the goal of customer experience is to make large companies seem like small, friendly ones. For instance, if you call a sales line one day, and a shipping department the next, the shipping person you talk to will immediately know who you are and what you ordered. Businesses accomplish this level of information-sharing through advanced technology and the integration of business functions.

As the owner of a small business, you have an advantage in managing customer experience

As the owner of a small business, you may have an advantage in managing customer experience, in that you yourself may be the sales and shipping department. In that case, you may find it easier to maintain excellent, personalized service as you grow than to try to create it out of thin air, as larger companies often do.

On the other hand, managing experience during a growth phase requires integration between all business functions, all employees, and all forms of communication from phone to e-mail to your company blog. This is likely to require an investment in technology and training that may be too ambitious for most small businesses.

Even if you can't manage cutting-edge experience management at this stage, it provides a good framework for action, and a good ideal to embrace. Here are some of the qualities that experience-oriented companies share:

- **They learn everything they can about their customers.** They understand who they are, where they live, how they spend, what they believe, what they expect, and what annoys them. They build every aspect of their business around this knowledge, and make adaptations as necessary, both to adjust to changing demands and also to exceed customer expectations.
- **They understand the larger business network into which their business fits.** All their employees, suppliers, and partners have an impact on customer satisfaction, so all of them have to be integrated as much as possible in order to deliver the best results.
- **They go above and beyond what's expected.** Where another company might cut corners to improve the bottom line, they believe that spending a little extra to earn a loyal client is a good trade-off.
- **They're reliable.** No matter who you deal with, or when you deal with them, the company's values, competence, and service standards are apparent. Their name is a promise of quality, and they keep that promise every time they do business.

- **They give customers a chance to design their own experience.** Some companies ask customers to create ad campaigns, contribute to a Website, or vote on product features. In all cases, the goal is to give users more direct control of products and services.
- **All the parts of the business communicate with each other.** As we noted above, managing experience requires serious integration between marketing, sales, supply chain, customer service, and all other departments. Not only must this integration take place across business functions, but also across communication channels. In other words, whether a customer communicates with the business by phone, fax, e-mail, mail, or a blog, that communication is integrated with, and understood in terms of, all previous communications. To put it more simply, if you call the sales department today, send an e-mail to the technical department tomorrow, and send a text message to the shipping department three days later, everyone involved knows what you're talking about, and can answer any questions you might have. You've undoubtedly spoken to companies where you had to explain your situation to three or four people in a row. Avoiding that sort of frustration and wasted effort is one of the main goals of customer experience management.

Give customers a chance to design their own experience

These customer service practices should be a starting point for your own experience management strategies:

- When customers enter your place of business, greet them immediately and pleasantly.
- Don't make customers repeat themselves, if you can help it. If one of your employees needs to be filled in, tell him or her yourself.
- When a mistake occurs, quickly and professionally accept responsibility and fix it.
- Always make an extra effort to help customers find what they need.
- Follow up on all customer contacts: always record the customer's name, phone number, and order type. After customers call for product information or service assistance, follow up within two days to check on satisfaction.
- Make sure employees look professional and tidy when they deal with customers.
- Thank your customers every chance you get.
- Thank your employees for delivering excellent service.
- Always answer the phone within three rings.
- Don't "dump" customers on hold. If you must, ask if you can put them on hold or call them back within five minutes.
- Have someone call your business and pretend to be a customer, in order to gauge service quality.
- Periodically survey customer satisfaction.

## Conclusion

Your customers are a valuable source of information for your business. If you listen, they will tell you what they want. If you plan your strategy carefully, you can deliver what your customers want faster and better than any of your competitors.

This will enable you to create lasting business relationships, generate enthusiastic referrals, and create new product and service opportunities. Finding new ways of looking at your customers will keep you focused, excited, and competitive.

# Chapter 3
# MANUFACTURING, SERVICE, AND RETAIL BUSINESSES

*About This Chapter:*
- *The world of manufacturing*
- *The world of service business*
- *The world of retail*

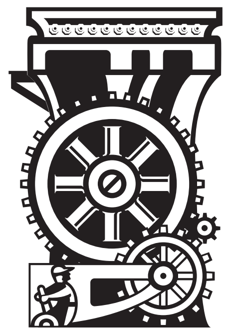
## Introduction

Economists typically break economies down into three sectors. The **primary sector** extracts raw materials, like coal, wood, and grain. The **secondary sector** consists of manufacturers. And the **tertiary sector** provides services, such as accounting, legal help, healthcare, information management, retailing, and so forth.

According to this theory, countries usually progress from an emphasis on extractive industries like farms and mines, to manufacturing industries like textiles and automobiles, and finally to a service-based economy in which the manufacturing sector shrinks considerably.

While it's easy to see a shift away from manufacturing in America, this doesn't mean that there are no longer any opportunities in the manufacturing sector, especially for small business. Domestic and global niche markets still abound for American-made goods, and the rise of green technology has led to a renewed focus on manufacturing opportunities.

This chapter isn't designed to be a comprehensive guide to beginning a manufacturing, service, or retail business; there are many books dedicated to these subjects, which you can and should consult. What this chapter *does* offer is a basic understanding of trends, organizational challenges, and the skills needed to excel in each of these businesses, so that you can make an informed decision about the industry that's right for you.



Economies of scale: The more goods are produced with the same machinery and overhead, the lower the per-unit costs and the higher the profits

## The World of Manufacturing

Huge conveyor belts whirring along, heavy machinery stamping out parts, sparks flying—this is what springs to mind when most people think of manufacturing. But manufacturing isn't limited to such large-scale operations. Small bakeries, weavers, and microbreweries are also manufacturers.

Manufacturing has traditionally been defined as the mass production of components and finished products. Mass production is based on the concept of **economies of scale**: the more goods can be produced with the same machinery and overhead, the lower the per-unit costs and the higher the profitability.

US manufacturing remains a vitally important driver of economic growth and technological innovation

Manufacturing often requires greater technical expertise and financial resources than either retailing or service businesses.  Also, the timeframe for completing business transactions tends to be longer.

Today, many opportunities exist for small, highly specialized manufacturers to provide inputs to larger manufacturers, especially in green business ventures. These **business-to-business (B2B)** operations often require less capital investment at start-up. For instance, a small manufacturer may need to invest in only one or two pieces of equipment.

### Trends in Manufacturing

Manufacturing today is very different than it was 20 years ago. Increased international competition, new regulations, advances in product and process design, energy concerns, and skyrocketing nonproduction costs are revolutionizing the way the world builds things. In recent years, the US manufacturing sector has seen its output and total employment decline dramatically. However, it remains a vitally important driver of economic growth and technological innovation.

*Competitive challenges*

For larger manufacturers, competition is tougher than ever, largely because globalization has made it easy for foreign manufacturers to enter the US market, and vice versa.

The nature of international competition varies. Some of it comes from low-wage areas with very few regulations protecting workers and the environment. And some of it comes from technologically sophisticated countries with stringent regulatory policies, whose governments have made a huge investment in their manufacturing sector at a time when the United States has seen a trend towards what some observers call "deindustrialization."

In the face of these pressures, many US manufacturers are seeking greater flexibility and speed in manufacturing practices, while reducing energy usage and environmental impacts. The innovative redesign of products and processes has become an important way of achieving a competitive edge. The United States also remains at the head of the line in technologically oriented products; more new patents are produced in the United States than in any other country.

*Meeting global standards*

The European Union (EU) is now a bigger market than the United States, and the trend towards globalization means that many US businesses are trying to gain market share by meeting EU standards, or complying with sourcing and packaging requirements.

*Green technology and industry*

The increasing demand for greener products and processes presents opportunities and threats for American manufacturing. On the one hand, stricter regulation of industrial emissions will almost certainly place a heavier burden on certain manufacturers. On the other hand, it is already spurring investment in cleaner and greener technologies, which will present lucrative opportunities for businesses that are ready and able to meet or exceed 21st-century environmental standards.

Although some observers believe that stricter regulation will lead to the virtual collapse of US manufacturing, it's more likely that there will be a shift in the balance of power from backward-looking to forward-thinking manufacturers, in which larger, more inflexible American businesses that have enjoyed relatively relaxed oversight will lose a certain amount of ground to smaller American and foreign businesses that have evolved to meet or anticipate changing standards.

One example of the latter trend is the Spanish wind-turbine firm Gamesa, which is building multiple manufacturing facilities in Pennsylvania. The future of American manufacturing may hinge to some extent on how well it can compete on green technologies. Currently, the United States ranks fifth in the world manufacture of solar panels, and imports more than half of its wind turbines from other countries.

Some experts have predicted that one out of four Americans will be working in the renewable energy or energy efficiency industries by 2030; approximately 75 percent of these new jobs are projected to be in the manufacturing sector. While these figures may be exaggerated, most experts have little doubt that the green technology trend will create important new opportunities in the manufacturing sector.

### *Energy efficiency*

Since most manufacturing activity is energy-intensive, managing energy costs is increasingly important to every manufacturer's bottom line. If a carbon tax is imposed, increasing efficiency will be an economic necessity for many manufacturers.

Global competition being what it is, passing higher energy costs on to consumers may reduce competitiveness. Fortunately, investing in energy-efficient processes (e.g., solar or geothermal) may reduce costs over the long haul, while increasing the willingness of consumers to pay a higher price (because they perceive you as trying to clean up the environment, or reduce America's dependence on foreign oil). In many cases, simple product and process redesign may allow you to reduce energy inputs considerably.

Simple product and process redesign may allow you to reduce energy inputs considerably

Before you can identify the best ways of reducing energy use, you should get an energy audit. The US Department of Energy offers free audits through its Industrial Assessment Centers (IAC); they claim that IAC recommendations can lead to an average of $55,000 in annual savings per manufacturer. You can learn more by visiting **www.oit.doe.gov/iac**.

### *Change management*

Established manufacturers have often been slow to adapt to changing market conditions. The combination of expensive investment in machinery, and highly specialized employee skill sets, makes it difficult for manufacturers to shift gears.

Change management means responding swiftly and positively to changes in legislation, social and political opinion, competitor behavior, economic forces, and the like. Good change management policies focus on anticipative and adaptive behavior, as opposed to reactive behavior; they require you to give up old habits and wishful thinking, in favor of an engaged and realistic view of your business's internal and external environment.

Change management is important in every kind of business, but nowhere more so than in manufacturing. Today, the best manufacturing operations make a point of being flexible. Their machinery and processes can be redesigned or expanded easily, and their personnel are able to anticipate and adapt to change. This trend is very likely to continue and intensify for the foreseeable future.

Demand-driven manufacturing aligns the supply chain to evolving customer needs

### *Demand-driven manufacturing*

The recent economic downturn has increased the trend towards **demand-driven manufacturing**, which can improve cash flow by speeding up production times, reducing inventory, and shortening payment cycles. Very simply put, the goals of demand-driven manufacturing are *alignment* of the supply chain to customer needs, *agility* in responding to demand, and *adaptability* to evolving conditions.

Instead of letting sales forecasts guide production, manufacturers and their supply chain partners actually respond to consumer demand in real time. This approach requires a highly integrated supply chain, as well as software that can provide precise control of inputs, production scheduling, inventory, and order fulfillment. In some cases, it may even be necessary to give customers input into product design and specifications. This requires a serious emphasis on tracking and managing customer relationships.

A very simple example of demand-driven manufacturing is digital books; instead of printing thousands of books and hoping consumers will buy them, a publisher can make an e-book available on demand for download onto a computer or a handheld reader.

This is comparatively easy, because what's being sold is information. Things get much more complicated when you're selling a tangible good with production inputs from multiple suppliers (e.g., metal, rubber, screws, paint, labels, and packing materials). Still, the necessity of shortening production times, reducing inventory, and being more responsive to customer needs makes demand-driven manufacturing very appealing to many businesses. In all likelihood, this practice will not only continue, but also become more affordable for small businesses to implement.

### *Outsourcing and offshoring*

As a result of the emphasis on high-speed production, things that used to be considered central to manufacturing (development, design, assembly, and logistics) are often performed by other businesses through outsourcing agreements, strategic alliances, and partnerships. In fact, some American "manufacturers" no longer manufacture any part of their product; they simply assemble it out of components bought from partners who may not operate in the same state, or even the same country. These businesses manufacture their products only in the sense that they control the trademark, patent, design, branding, supply chain, and after-sales service.

The trend towards **offshoring** means that small manufacturers who don't have access to cheap offshore labor may find themselves at a pricing disadvantage compared to larger counterparts. However, there's a simultaneous trend away from competing solely on the basis of price. This makes careful market segmentation, targeting of niche markets, and branding more important for manufacturers than ever before.

*In 1992, Bill Beckford, Matt Lewis, and Charles Maturin graduated from their small high school in upstate New York and started working at the Val-Pine furniture plant, just as their fathers had done before them.*

*In 2006, Val-Pine outsourced its manufacturing jobs to China, and closed its plant. It hit the local economy hard. Some workers got jobs in nearby cities, and ended up commuting for over an hour. Others left town in search of greener pastures. And a few—like Bill, Matt, and Charles—decided to start their own businesses.*

*All three men came from woodworking families, and they wanted to continue that tradition. So in 2007, they started a small company called Ausable Woodworking, after writing up a business plan describing their goals as a manufacturer of high-quality, handcrafted "green" furniture.*

***Virtual organization***

The trend towards outsourcing and strategic alliances has led many manufacturers towards "virtual" organization, as opposed to the traditional "vertical" organization. **Virtual businesses** are defined by the number of tasks that they pay other businesses or individuals to perform. **Vertical businesses** are defined by the number of functions (sourcing, shipping and warehousing goods, and distribution) they perform themselves. A vertical integration strategy implies that a business controls the supply of all or many of its own inputs, and performs its own value-generating activities.

The virtual business model spells opportunity for start-ups and small firms

**Benefits of Vertical vs. Virtual Organization**

***Vertical benefits***

- Cost savings and economies of scale
- Employment security
- Control of strategic information or proprietary technology
- Ensured supply of inputs
- Ability to sell excess capacity for additional revenue

***Virtual benefits***

- Buying components at lowest total cost, considering service, quality, and impact on lead times
- Lower overhead and quicker break-even point
- Business can do more tasks with fewer people
- Ensured supply of inputs
- Supplier consolidation reduces administrative costs and variation in quality, while increasing control and cooperation

The virtual business model spells opportunity for even the smallest and newest manufacturers

The virtual business model spells opportunity for even the smallest and newest manufacturers. These businesses can step in to perform specific functions for larger manufacturing companies at competitive prices.

*Matt wondered how they'd compete with companies like Val-Pine, which had rock-bottom production costs thanks to their use of offshore workers and their enormous economies of scale.*

*Bill decided the way to compete was* not *to compete. Where Val-Pine's line was mass-produced, Ausable's would be handcrafted. Where Val-Pine's wood was from clearcut forests, Ausable's would be sustainably harvested, reclaimed, or recycled. Where Val-Pine targeted price-sensitive customers, Ausable would target institutions, businesses, and high-end retailers that made a point of buying sustainable products.*

*They didn't know much about these practices, but they knew that they had to find a niche market, and that this was a viable one.*

*They researched nontoxic stains and varnishes, underwater logging, and certification from the Forest Stewardship Council. They also looked into institutions and businesses they could target on the basis of their buying practices, and researched early Colonial woodworking techniques.*

*All of this information went into their business plan, but what they planned for and what happened turned out to be very different!*

### Operational and Managerial Issues

In a manufacturing business, organizational structures and processes tend to be focused on reducing lead times and inventories, speeding machine set-up, lowering costs, improving quality and efficiency, and accelerating product delivery times.

The foremost strategic planning issues are:

- Virtual vs. vertical organization
- Improving energy efficiency and reducing waste
- How to use innovative technology in products or processes
- Competitive positioning: Will you lead on price? Quality? Service?
- Which geographic markets to serve
- Identifying target customer segments
- What channels of distribution to use
- After-sales service and technical support
- Ensuring maximum customer satisfaction through minimum defects

*Customers*
In manufacturing, supplier and customer relationships more closely resemble partnerships than those in service and retail businesses.

Defining characteristics of customer relationships in manufacturing include:

- Varied customer bases that may cross international borders
- Designing and producing products tailored to a specific customer
- Quick delivery
- Close communication via computer and phone
- Extensive technical support and follow-up service
- Cooperative sharing of information and production needs

Since they often buy inputs from a variety of competitors, business customers may require that manufacturers conform to international standards for quality, performance, and size.

*Suppliers*
The most common aspects of supplier relationships include:

- Shared turnaround time
- Shared quality standards
- Close proximity by geography and/or communication
- Flexible, collaborative problem-solving
- Joint production scheduling
- Use of backup suppliers
- Tough price competition among suppliers

*Employees*
Manufacturers increasingly consider good employees to be assets of even greater value than their equipment. They often draw on the creative energies of employees to find innovative solutions to problems. The more skilled employees are, the better they are at performing multiple functions, and troubleshooting machinery. Manufacturers tend to invest considerable time and money in training and updating the technical skills of their employees, and they place a great deal of emphasis on reducing employee turnover.

People are one of the things that give a manufacturing firm its competitive edge. A competitor may imitate your product, but it can't imitate a creative, empowered team that feels a sense of pride and ownership in your firm's success. Good people are the key to adaptation and forward thinking; they're worth what it takes to keep them.

Good people are the key to adaptation and forward thinking!

*Quality*
Manufacturers must ensure that their processes consistently result in high-quality products, which means inspecting the product as it moves through every stage of production. Ideally, the manufacturer must maximize the number and accuracy of quality inspections, while minimizing the time and cost required to do so. This is why they need

high-performance, multiskilled employees who are adept at detecting and correcting manufacturing defects.

Making these goals a central part of organizational culture is the goal of **Total Quality Management (TQM)**. Ideally, TQM leads to quality control at every level of an organization, so that defects are eliminated before reaching the consumer.

In order to communicate this commitment to quality to customers and partners, many firms seek an external verification of their quality standards through **ISO 9000** or **Six Sigma** certification. Other firms make their environmental practices conform to **ISO 14000**. Certification of this type is a lot of work, but it can provide a considerable competitive advantage, particularly in foreign markets.

*Start-up costs*
Unless you intend to build a retail store with gold fixtures and marble floors, starting a manufacturing business requires more financial investment than a retailing or service business. Plant, machinery, and equipment often call for a heavy up-front investment. Once the business is set up, the manufacturer's major financial issues are controlling costs for inputs and materials, and counting and valuing inventory.

### Are You a Manufacturer at Heart?

Most successful manufacturers have educational and professional backgrounds in production or engineering. People who perform well in manufacturing generally:

- Are gifted at identifying and managing new production processes
- Can talk and think like an engineer
- Enjoy working with assembly lines, production schedules, and machines
- Are interested in lifelong learning and continuous improvement
- Have found or invented a unique product or process
- Have long-range conceptualization and planning skills

## The World of Service Business

The service sector comprises more small businesses and one-person providers than retailing or manufacturing. Hospitals, telecommunications providers, shipping companies, house painters, cleaning services, content providers, and babysitters all fall under the heading of service businesses.

The service sector is comparatively flexible and inexpensive to enter

The business of delivering services is comparatively flexible and inexpensive to enter. Service businesses tend to have:

- Closer relationships with customers
- Lower overhead
- Easier market entry and exit
- A smaller management team (often just one person)

On the other hand, service providers often find it difficult to differentiate themselves, because they provide intangible goods for which there may be no objective standards and no guarantee of quality. If you're a CPA, for instance, how would you convince prospective clients that you're better than all the other CPAs out there, especially when you consider that the client may not have enough expertise to make an informed judgment? For this reason, service providers usually need to be experts at presenting themselves as something special, developing relationships, and earning loyalty.

Service providers need to be experts at developing relationships and earning loyalty

## NxLEVEL® TECH TIP
### BUSINESS RESOURCES AND THE WEB

Many companies now offer **software as a service** (SaaS) to subscribers or renters, at a fraction of the cost of buying the programs.  Currently available programs run the gamut from single functions such as payroll, e-mail, and direct marketing; to multifunctional programs such as **Enterprise Resource Planning (ERP)**, which includes personnel, accounting, order processing, manufacturing management, and inventory; and **Customer Relationship Management (CRM)**, which administers sales force automation, marketing, and customer service.  These programs provide entrepreneurs with the computer capabilities of much larger companies at an affordable price, while allowing them to focus on their core competencies.

For more information, you can visit **SaaS Showplace** (www.saas-showplace.com), which bills itself as "the largest vendor-independent, online directory of SaaS solutions with over 1100 company listings."

*In its first six months, Ausable did reasonably well selling furniture to individual customers. But they had bigger ideas; a lot of their friends were out of work, and Ausable wanted to grow enough to hire them and rejuvenate the local economy. They realized that this would be hard to do while they were selling a couple of dining-room sets a month.*

*Then, one day, a member of the County Historical Trust approached Matt, and asked him for a donation to help restore a Revolution-era mansion on the outskirts of town. After a brief conversation, Matt found that part of the restoration involved using early woodworking techniques to repair banisters, mantelpieces, and the like. Matt explained Ausable's techniques and materials, and asked for information on bidding for the job.*

*Two weeks later, five members of the County Historical Trust toured Ausable's workspace. They were impressed with Ausable's quality and skill, their use of water-based stains, and their old-fashioned approach. They also appreciated the fact that they were trying to help the local economy. After a couple of weeks of negotiation, Ausable won the bid.*

Time pressures have led to new opportunities for providing home and office services

### Trends in Service Business

The most important trends affecting service businesses are:

- **Downsizing.** Large corporations have reduced their number of full-time employees and begun relying on a growing number of independent contractors to perform non-core functions.
- **Repairing and reusing existing products.** Consumers are buying more expensive, higher quality durables, which they repair and upgrade rather than replace.
- **Time pressures.** As more members of households go to work, fewer people are left at home to do basic household chores. This has led to new opportunities for providing home and office services.
- **Obtaining and processing information.** Because of advances in information technology, there's more information to be organized and processed.
- **Bringing order to chaos.** Specialized businesses provide order and create time savings for other businesses and individuals.
- **Targeting niche markets.** Businesses of all types have benefited from dividing larger customers into niche markets. The smaller the market, the more focused a business's marketing efforts can be.
- **Collaboration.** Service providers are increasingly partnering with complementary businesses in order to add value. For instance, a mechanic might partner with a car detailer to offer a package deal of a tune-up and full-service cleaning.
- **Higher expectations for service.** Individuals and businesses expect better service, increasing opportunities for new competitors.

#### *Competitive challenges*

Many service businesses are now feeling the international competitive pressures with which manufacturers have been contending for years. Computer experts and graphic designers, for instance, have found that the larger firms for which they used to work are hiring workers in countries like India.

Of course, the flip side is that US service businesses are increasingly able to compete in international markets, particularly given the trend towards online delivery of services.

### Operational and Managerial Issues

Major operational challenges for service businesses include:

- Deciding to what degree they will customize or standardize their services
- Differentiating themselves from competitors
- Managing brand identity
- Ensuring the professionalism of employees
- Creating print, video, and voice media that communicate the nature of the service
- Accurately measuring costs and pricing services
- Ensuring consistency and quality

*Customers*

Unlike manufacturing and retailing businesses, service businesses have a great deal of flexibility as to how, where, and when to deliver their service. They can serve customers face-to-face—as gardeners or doctors do—or indirectly via mail, phone, or the Internet.

Another unique feature of many service businesses is that they have an ongoing relationship with customers, and can involve them in the design and delivery of their services.

Service businesses need to make sure that their customers understand the intangible benefits of their service. Tax-preparation consultants might point out the tax savings they offer, while employee trainers might focus on the higher productivity and long-term savings their seminars provide. References are often very important to service businesses.

Truly competitive service businesses maximize opportunities to improve customer satisfaction and loyalty. Some service providers ask their customers to take part in hiring customer service agents. A more widespread practice is the use of customer satisfaction surveys; hotels, car rental companies, and even mail-order companies use these surveys to gauge their performance and better understand customer preferences.

Employees can make or break a service business

*Employees*

How service businesses train and manage their employees depends on the industry in which they operate and the level of service they provide. As more expertise is required, compensation demands rise, as does the need for other types of rewards.

Service business owners know that the employees who interact with customers make or break their businesses. Employees often have to assess customer needs, tailor their service accordingly, and control quality.

This is a lot to ask, which is why service businesses tend to hire people who are capable of performing multiple tasks, train them to work in teams, and give them greater flexibility in how they perform their specific tasks.

Service businesses must constantly update their expertise and improve their service

*Quality*
Characteristics of excellence in service business include:

- A quantitative approach to measuring customer needs
- Continual measurement of performance against that of competitors
- Focusing on service and communication improvements
- Minimizing the time taken to meet customer needs
- A commitment to continuous learning and self-improvement
- Using information technology and social networking to improve dialogue with customers
- Offering security and confidentiality, especially online

*It took a while for the County Historical Trust to get enough donations, as well as the grant it had applied for. That was just as well, because the mansion was a big job; Ausable had to hire four more workers, and do a lot of studying.*

*They also had to work closely with an expert on 18th-century architecture, who was extremely picky about wood. Sometimes, it took an hour or more to find a single piece that the expert deemed appropriate for a missing stair or a door panel!*

*Though Ausable did a beautiful job, they made a number of mistakes in billing labor and materials. In the end, Bill estimated that they'd lost almost $2,500 through billing errors.*

*On the other hand, they'd made over $200,000 for a little more than four months' work. And they'd garnered a lot of prestige and goodwill; the plaque on the mansion even said "Restored by Ausable Woodworking"!*

*Start-up costs*
Fixed costs generally make up the majority of service providers' costs. For example, a tree trimmer can trim an additional tree using his existing set of tools; therefore, his cost for pruning one additional tree is minimal.

On the other hand, if he wants to trim trees for an entire neighborhood, he'll have to hire an assistant and get more equipment. Having done this, he's able to trim more trees, until he hits his new maximum capacity.

This is the concept of **incremental capacity gains**: service providers have relatively low costs for serving small numbers of additional customers, but must increase capacity to meet greater demands.

### Are You a Service Provider at Heart?

Service businesses are successful because they know their customers well, and often customize the services they provide to each customer. Communication and follow-up with customers are especially important. For these reasons, people who excel in service businesses tend to be:

- Good at interpersonal communication
- Creative and adaptable
- Self-disciplined, confident, personable, and independent
- Experts in a specific field, with a strong interest in continuous learning

## The World of Retail

Retail businesses are among the most popular entrepreneurial ventures. Many of these establishments are owner-operated, and have fewer than five employees.

Small retail ventures are comparatively easy to launch in many cities and towns, due to the relative ease of securing retail rental space, and the low initial capital requirements. Unfortunately, small retail businesses have a very high failure rate. Customer knowledge, customer service, and creativity are the keys to success in retailing.

Customer knowledge, customer service, and creativity are the keys to success in retailing

Today, about one-third of all new businesses are retail stores that buy merchandise from wholesalers or manufacturers and resell these goods directly to consumers. Other retail strategies include e-commerce, mail order, and automatic merchandising.

### Trends in Retailing

Retailing has gone through a profound shift in the past 15 years. More large-scale retailers have emerged, and shopping malls are cropping up to house scores of national chains. In many towns, outlying malls have replaced downtown business districts.

The ability of e-retailers to target niche markets around the world is arguably the most important development in retail sales, and most of the existing retail giants have moved swiftly to dominate online markets. That said, even businesses that don't sell online need to have an attractive and engaging online presence, because consumers often use the Internet to research retail options in their area and elsewhere.

These trends notwithstanding, many retail businesses are still run by a single owner with expertise in a particular type of product. These retailers may lack sophisticated purchasing, planning, cost control, and merchandising expertise. But they have been remarkably resilient in the face of heavy competition from retailing giants like Wal-Mart and Amazon, because they offer consumers personal service and a pleasant atmosphere.

Furthermore, large retail chains usually won't carry product lines that have slow stockturn, are difficult to procure from suppliers, or appeal to a limited market. This is where a small retailer can be very competitive, so it's a good idea to identify products you can offer that larger competitors can't or won't.

Related to this trend is the ongoing appeal of green, healthy, sustainable, American-made, and local products. At a time when consumers are worried about money, buying green or sustainable products can be seen as a way to make spending feel more positive. Especially when it comes to luxury purchases, consumers may be less interested in what a product is or does, than in what it says about their values or concerns.

Since healthcare is a perennial worry, products that promise to improve health, ward off illness, or aid in self-improvement are likely to remain popular.

Online and offline retailers need to focus on the quality of consumer experience

Last, more selective consumer spending means that online and offline retailers need to focus on the quality of consumer experience. Retail outlets should be geared towards browsing and entertainment, and less oriented on making the sale at all costs. Consumers who are wary about buying are more likely to explore a wider range of options, weigh quality against price, and so forth. A relaxing, low-pressure atmosphere may be the best way to attract and keep customers of this type.

### Operational and Managerial Issues

Whether a retail business is run by a single owner or a team of employees, it must perform the same core functions: buying and selling merchandise, providing customer service, and managing finances. Unlike manufacturing businesses, only the largest retail businesses organize themselves into product departments; most smaller retailers simply have a salesperson or two who assist customers and sell merchandise. An employee or the owner may also order and price merchandise.

*Customers*

Most small retailers can't compete with the low prices, high-traffic locations, and huge promotional budgets of national and regional retailers. Instead, they usually compete on the basis of customer service. For small businesses, an effort to deliver unique customer service can cost very little, and create long-term customer loyalty.

Franchises and mass marketers generally offer standard products at standard prices. However, small businesses that target niche markets have a more intimate personal relationship with customers, and can differentiate themselves through heavily individualized service.

At a minimum, shoppers expect the following:

- Courteous, professional attention
- Convenient store hours
- A clean, enjoyable shopping environment
- Prompt service
- Knowledge about the product
- A fair return policy
- Speedy and sincere resolution of complaints

You may also want to offer:

- Free delivery
- Special discounts and promotions (e.g., a frequent buyer card)
- Holiday events and birthday specials
- Gift certificates and gift wrapping
- Refreshments
- Play area and toys for children

**Retail Promotional Techniques**

- Incentive programs for repeat purchases at point of sale
- Phone calls to follow sales
- Customer promotions based on past purchasing activity
- Special events for special customers
- Customer notification of sale events

*Suppliers*

In general, retailers enjoy a very different relationship with their suppliers than manufacturers do. Rather than a close, collaborative partnership, retailers and suppliers tend to have more limited, traditionally structured relationships. (One exception is the relationship of franchisees with their parent organization, the franchisor. This is discussed in Chapter 6 *Franchising*.)

Most small retailers buy merchandise from wholesalers. However, some retailers may be able to bypass wholesalers (and their markups) entirely, and purchase directly from manufacturers. Retailers who order large quantities can engage in **specification buying**. This means asking the manufacturer to change the packaging or features of the product to fit merchandising needs.

In the smaller, boutique segment of retailing, the number of specialized sales representatives is growing. These people act as liaisons between retailers and manufacturers, and tend to carry a full line of varied but complementary products. One example of this is clothing and jewelry representatives.

Smart retailers cultivate strong relationships with their suppliers, so that they can rely on getting the products they need at the best possible prices. Sources of prospective suppliers include Business-to-Business Yellow Pages, trade publications, trade associations, libraries, merchants that carry the same product line, trade shows, and the Internet. Retailers often create a standard form to use when dealing with suppliers. Many computer programs are available for this purpose.

Smart retailers cultivate strong relationships with their suppliers

*The restoration project was a turning point for Ausable. Other buildings needed restoration all through the county, for starters, and Ausable was in a great position to win more bids. Sales of furniture had gone up, too, thanks to the publicity they'd gotten; in fact, they had a waiting list!*

*Perhaps the most beneficial aspect of the restoration job was that it increased Ausable's knowledge about and access to sources of growth capital. Within a year, their revised business plan brought in a bank loan, and a community grant. This enabled them to buy more equipment and materials, and keep their four extra workers on the payroll.*

*One of their first projects was to make a more affordable product line, preferably using a fast-growing renewable wood like bamboo. They still wanted to attract institutional buyers, but their furniture designs were really too old-fashioned and expensive to use in schools and libraries.*

*It seemed like they were having to rethink their business plan every other month!*

Employees should project the image of the business and communicate the features and benefits of products

***Employees***

Like manufacturers, successful retailers know that trained employees are one of their best assets. Training strategies commonly used in retail businesses include:

- Assigned readings
- College courses
- Job rotation
- Management training
- Customer profile training
- Successful selling practices
- Product specification and performance training

Many successful retailers compensate their employees with hourly wages and enhance their earnings with discounts on store merchandise, bonuses during peak sales periods, and commissions on sales. By encouraging employees to purchase store merchandise at discounted rates, retailers can create enthusiastic, real-life advertisers for their products.

***Location***

How do brick-and-mortar retailers choose a location? First, they need to know where their target customers live, work, and shop. Second, they must consider the type of merchandise they sell. Retailers who carry convenience goods (coffee, fast food, photocopying services) tend to locate themselves in convenient spots, while retailers who offer specialty products might not be as choosy about a central location, since customers will be willing to travel further to find their product.

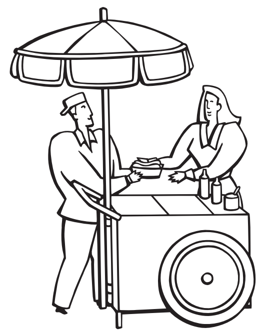
When evaluating a city in which you wish to locate, consider the following:

- Concentration of target customers
- Growth or decline in population
- Income and spending patterns
- Competition
- Government incentives for business relocation or start-up
- Health of the local economy

When evaluating an area within that city, consider:

- Types of customers and businesses in downtown, suburban, and residential areas
- Access routes
- Public transportation routes
- New construction or development
- Appearance of the area
- Demographic and psychographic characteristics of the area
- Local bankruptcies or closures

When narrowing the selection to a specific site, consider:



- Existing anchor tenant or other tenants (look at their lease terms)
- Corners (they have higher visibility and more traffic)
- Parking
- The image of the block or neighborhood
- The image of the building and retail space
- The location and number of competitors
- Zoning restrictions
- Traffic flow
- Nearby landmarks, industries, and tourist attractions
- Nearby businesses with complementary or attractive products or services (e.g., a popular restaurant or coffee shop, or some other high-traffic business)
- Opportunity for expansion
- Internet and networking capabilities (e.g., availability of DSL or cable connection)
- Costs, lease, rent, and tenant improvements
- Pedestrian traffic patterns
- Security for customers and employees
- Former tenant's type of business and reason for closure

*Store design*

Every element of your store design affects your customers both physically and psychologically, so you must create an environment that encourages your customers to visit, buy, and return regularly. The primary components of a store include:

- **The overhead or exterior sign.** This must be well maintained, and easy to see, read, and understand. It should also complement your business concept.
- **Show window(s).** This is where you must present the most compelling reasons for customers to come in and buy. Window displays should be kept clean and current. Get help from a professional designer or a creative friend to create colorful and enticing displays.
- **Store entrance.** Make sure your doorway is clean, inviting, and wide enough that customers can easily enter and leave the store. It is important to keep the area immediately in front of your store well swept, and clear of debris, ice, and snow.
- **Selling area.** The selling area is dedicated to merchandise displays and the interaction between customers and employees. Try to anticipate customer traffic flow, keeping in mind that customers usually shop from right to left. Also, remember that employees need at least 30 inches of clearance space for easy movement behind counters.
- **Non-selling area.** This includes checkout, dressing rooms, return desk, storage area, promotions, and back office. These areas should be kept clean, well organized, and secure. Make them easy to survey and access, so you can quickly serve customers and restock shelves.
- **Flooring.** Flooring should be composed of a durable material that is safe (especially in wet weather) and aesthetically appealing.
- **Ceilings.** Lowering or raising the ceiling can make a store more intimate and cozy, or more formal.
- **Lighting** showcases merchandise and creates your desired atmosphere.
- **Decor or theme.** Paint, wallpaper, photos, pictures, and murals can all create the right selling environment for your business. If possible, have an interior designer help select colors and textures, and develop a theme.
- **Fixtures** include carts, shelves, countertops, display cases, floor stands, peg boards, racks, stocking bins, desks, and islands. Start-up retailers can purchase fixtures at discounted prices from other businesses or retail equipment dealers. Bear in mind that a store cluttered with fixtures often deters shopping.

Don't overlook customers with special needs when designing your retail space!

When choosing these components, think carefully about the needs of your target customers. Parents with very young children will need room to manoeuvre strollers, and would probably appreciate rest rooms with a changing table. Customers with disabilities may need special features like wheelchair ramps and handrails. Older customers may need a place to sit and rest, while young children may need a play area to distract them while their parents shop. Don't overlook customers with special needs when designing your retail space!

***Delivering a unique retail experience***

Today's retailer must create a unique shopping experience that satisfies the demands of today's shopper. One of the key issues is determining how to identify, understand, and satisfy your best customers. Here are some methods that have proved helpful:

- Tracking purchasing records via loyalty programs
- Analysis of incentive programs
- Use of formal surveys
- Studying returns, complaints, and disputes

The goal is to determine what your best clients like and dislike, and emphasize those elements that make shopping at your store a pleasurable experience for them. In other words, accentuate the positive, and eliminate those things that irritate or distract your customers.

The key word here is "experience." Today's shopper is looking for a total sensory experience and highly personalized customer service, delivered in a memorable way that highlights your merchandise, your space, and your personality. Some experts urge retailers to think of the customer as a ticket holder at a staged experience: all the props must be in the right place, and all the roles must be performed perfectly. In a world where sameness increasingly defines the everyday shopping experience, creativity and innovation matter more than ever in creating a successful retail store.

***Start-up costs***

Retailing start-up costs vary widely depending on your target market, your retail space, your merchandise, and the decor and image you want.

One of the major cost elements of retailing is inventory management, which includes all planning and stocking activities. Effective managers project their sales figures to plan for their inventory needs; this ensures the fastest possible turnover of merchandise. Limiting the amount of inventory held can also reduce storage, stocking, and maintenance costs.

Good inventory management means knowing which items are hot sellers and which are slow movers, and pricing them accordingly. Too many small retailers simply buy what they like without considering customer desires. The science of ordering appropriate merchandise, and pricing and displaying it to sell, is called **merchandising**.

Good inventory management means knowing which items are hot sellers and which are slow movers

*Early in 2008, a young designer named Carol Peake happened to stop by Ausable's workshop. She'd seen and loved their work at the restored mansion, and was interested in seeing their furniture.*

*While talking to Charles and Matt, she explained her idea for a set of standardized wooden components that would fit together in a variety of ways to form end tables, dining tables, chairs,* *desks, and day beds. She'd gotten the idea from watching her nephew playing with Tinkertoys, and was looking for an eco-friendly company to make the parts under her supervision.*

*Matt saw instantly that if her design really worked, it would be ideal both for institutional and consumer use. If you didn't want a chair anymore, you could pull it apart and make a table! There was no glue, and no nails or screws. It was an amazing idea!*

*In time, Ausable negotiated a licensing deal with Carol, updated its business plan, and started producing the interlocking pieces according to her design. Today, they produce a limited amount of handmade furniture for the high-end market, and hundreds of building blocks for Carol Peake's popular modular furniture (the local elementary school loves it). They now have eight full-time employees, and three part-timers. They're still dreaming of building a factory that'll employ a hundred workers or more. And with their skill, their luck, and their ability to adapt quickly to new opportunities, they stand a very good chance of doing just that!*

### Are You a Retailer at Heart?

Successful retailers have an eye for detail, a flare for color and design, and an understanding of human temperament

Are you people-oriented? Service-oriented? These are the two most important traits for retailers. Successful retailers create a unique brand identity for their store, in which all elements complement each other: the store sign, display windows, Website, store layout and design, and the appearance and service of employees. Successful retailers have an eye for detail, a flare for color and design, and an understanding of human temperament.

In determining your fitness for retail business ownership, consider the following:

- **Customers.** You must enjoy contact with people to be a successful retailer. Also, customer buying habits change frequently, so you must adapt to be successful.
- **Products.** Expert product knowledge is essential in a small retail environment.
- **Suppliers.** Are you a firm, assertive negotiator? You'll need to negotiate the best price and ensure that deliveries are timely.
- **Hours.** The best times for customers to shop are when they're not working, so you should expect to work late hours and weekends. Does this schedule suit you? Is your family life compatible with long hours?
- **Employees.** Unless you own a very small establishment, you'll need to hire employees. Can you give clear directions, delegate responsibility, and evaluate performance fairly?
- **Recordkeeping.** Can you develop and maintain excellent recordkeeping systems and controls? If not, are you willing to learn? In most states, you must pay sales taxes and are subject to unannounced audits of your sales transactions.
- **Security.** Shoplifting, employee theft, and robberies are inherent risks of the retail business. Creating controls and safeguards is essential.

**NxLEVEL® GREEN TIP**

ENVIRONMENTAL BUSINESS RESOURCES

In an interesting example of current trends in manufacturing and service business, IBM is spearheading a new environmental quality standard called Green Sigma™, which "applies Lean Six Sigma principles and practices to energy, water, waste and greenhouse-gas emissions throughout a company's operations." In support of this solution, IBM has launched a consulting business that will assist other firms in meeting this standard, as well as a Green Sigma™ Coalition comprising businesses like Honeywell Building Solutions, Cisco, Siemens Building Technologies Division, and Schneider Electric.

IBM claims that its own conservation efforts "have saved 4.6 billion kWh of electricity and $310 million in costs, and avoided over three million metric tons of CO2 emissions since 1990." The tools it created to solve these problems, and the experience it gained, are the basis for its new Green Sigma™ consultancy, which is a perfect example of how adopting green practices can lead to new business opportunities.

## Conclusion

Manufacturing, service, and retail operations all present unique challenges and rewards. Manufacturing tends to attract technologically proficient people who are not intimidated by production schedules, machinery, and large capital investments. People who start service ventures are usually good at interpersonal communication, have expertise in a particular field, and adapt to trends quickly and easily. Retailers generally love to help people and are very service-oriented.

Your interests and passions will determine what type of business is best for you, but whichever you choose, start-up costs, the competitive environment, relationships with suppliers and customers, and emerging technologies will all play vital roles in determining your success.

# PART II
# ENTRY AND GROWTH STRATEGIES

## Chapter 4
## ENTRY STRATEGIES

*About This Chapter:*
- *Starting a new business*
- *Buying an existing business*
- *Buying a franchise*
- *Alternative entry strategies*

### Introduction
Any entrepreneur can have a good idea. The ones who succeed understand that no matter how good their idea is, it's still necessary for them to research their market, know their customers, and choose the right entry strategy.

The entry strategy that's appropriate for your business may depend on any number of variables. But at a minimum, it has to be affordable, appropriate, and attainable. In other words, the start-up costs have to be within reason, the type of business model has to make sense for your product and customer, and you have to be personally capable of starting and sustaining it. In the following pages, we'll consider some of the different ways of getting into business, and the pros and cons of each.

Your entry strategy must be affordable, appropriate, and attainable

### Starting a New Business
First, let's look at some of the most common things that inspire people to create a new business.

#### Inventing a New Product
Many people believe that inventing a new product is the best path to a successful business. In reality, this path can be long and difficult.

Most inventors don't realize how much time and money it takes to bring a new product to market. If you intend to start a business based on an invention, you must carefully research and fully understand the marketplace.

You must also determine how you'll finance your endeavor, understand the limitations of a business built on one product, and be prepared to spend a lot of time and energy getting your product in front of prospective customers.

Remember: an inventor may be a genius, and yet lack the aptitude for running a business.

### Discovering a Spin-off Business

Suppose you're a buyer for a landscaping contractor. In the course of your work, you realize that no one has a good stock of seedless cherry or plum trees. With a little research, you locate a supply of seedlings, find an area where you can grow them, and discover a source for the capital you need. This is an example of a simple spin-off business. There are many opportunities to develop such businesses, and because they're often grounded in the owner's expertise and existing business relationships, they're often successful.

### Turning a Hobby into a Business

Have a hobby? Turn it into a business!

If you're going to start a business, why not do something you love? You may have a better chance of success if you develop a business from a hobby you're passionate about, although this of course depends on variables like how big the market is, how many competitors you have, what prices you can charge, and your business model. Contrary to what some people believe, loving what you do is not always a recipe for success.

Also, when you turn a hobby into a business, you must recognize that your product has an economic value, and that you need to make a profit. You're running a business, not pursuing a hobby. And as the business develops, you may not have time to enjoy your hobby the way you did in the past.

*Annie Parsons had been working for three years in a beauty shop in Brooklyn, New York, where she specialized in manicures and pedicures.*

*Her clients loved her cheerful, bright attitude. She was very different from workers in other nail salons, who simply tried to get customers in and out as quickly as possible. And because she read all the magazines and knew all the latest products and styles, customers often came to her for advice on what to wear to job interviews, or how to dress for a big date.*

*That's what gave Annie the idea of opening a combination nail salon and fashion consultancy. She'd offer the usual manicure services, but she'd do it at a leisurely, luxurious pace, and she'd also offer fashion consultations to mothers and young women who wanted advice on how to look their best. Competition was fierce, and many salons were offering lower prices and faster turnaround, even if they had to break labor laws or use illegal chemicals to do it. Annie decided to go the opposite route: she'd see a few less people and charge more money.*

*The more she thought about it, the better it sounded. She knew about fashion and she had a warm personality. Better yet, she had lots of regular customers at the beauty parlor, and she was pretty sure they'd keep coming to her if she left and started her own business.*

### Knowledge of an Existing Customer Base

The greatest risk you face when starting a business is that you'll have too few customers. Therefore, you enjoy a great advantage if you already know of customers who are ready and willing to buy enough to sustain a business.

Some entrepreneurs have had customers who were so eager to purchase a given product that they were willing to provide financing, or to place an initial order that was large enough to establish the business. The number of major companies needing new products, services, or parts is almost unlimited. If you can find fully qualified buyers who are capable of meeting their commitments, you may be able to establish your company with limited risk. In order to position your company for growth, however, you must understand the long-term wants and needs of your customers.

### Knowledge of Unmet Needs

Many successful businesses have been launched by entrepreneurs who recognized an unmet consumer need, and worked hard to deliver a product that would meet it. That being the case, you might think that all you have to do is find an unfulfilled need and leap into production before anyone else.

Unfortunately, it's not that simple. People sometimes deceive themselves into thinking that they've found such a need where it doesn't really exist. Friends may tell you that your idea is great and that your product is sure to sell like hotcakes, but their opinions may be clouded by friendship.

Even if you do have an exciting, unique specialty product, the market may be too small to sustain your business for any meaningful length of time. That's why you must carefully determine how large your market is, and what percentage of that market will provide you with sufficient sales to grow your business.

### Expanding a Part-time Activity

One way to develop a full-time business is to expand on a part-time activity. By keeping your full-time income and starting slowly, you can reduce the risks inherent in business start-ups. Internet businesses, such as eBay Stores, can be a good way of starting out slowly and gauging customer response to your offerings. Doing freelance work for various companies is another good method of becoming self-employed.

Turn part-time work into a full-time business!

There are definite advantages to starting a business in this manner: you have the opportunity to observe market demand; to grow with your interests and capabilities; and to develop your client base to the point where it can sustain a full-time business.

### Professional or Technical Expertise

You may have a specific technical education, or have acquired various skills through prior business experience. These skills can be useful in building a business. For instance, if you're a nurse and want to move from hospital-based work to consulting for an HMO on healthcare costs, your schooling and work experience will obviously be major factors in your business's success.

It's important to remember that you need more than professional expertise to run a successful business. In addition to delivering a technical service, you must also handle bookkeeping, marketing and selling, and financial management. Therefore, you may need to combine your skills with those of people who can do things you can't.

### Desperation

Although desperation isn't the ideal way to discover your entrepreneurial creativity, it does provide an impetus for many people. You may be the victim of downsizing, outsourcing, offshoring, merge and purge, or any of the other methods corporate America has found to slash its workforce. Once you lose your job, you may find that no one in your area needs your skills. Any number of reasons can cause you to decide that your best, or only, option for earning a living is to work for yourself. Often, tough times bring out the fighting spirit that an entrepreneur needs!

## NxLEVEL® GREEN TIP

ENVIRONMENTAL BUSINESS RESOURCES

The explosion in green and sustainable business has led to all sorts of innovative new business ideas. Many entrepreneurs are improving existing products by making them more eco-friendly, others are overhauling existing products and process, and still others are coming up with brand-new ideas for products and services.

Here are several sites that can help you to stay abreast of the explosion in green design, and may even inspire you to come up with a breakthrough idea of your own.

- **Metaefficient** (www.metaefficient.com) reviews new green products, and rates their efficiency. In addition to providing an overview of trends in green design, Metaefficient may give you ideas for improving efficiency at your business.
- **Inhabitat** (www.inhabitat.com) is a blog devoted to the future of design, which tracks the innovations in technology, practices, and materials that are pushing architecture and home design towards a more sustainable future.
- **CleanTechnica** (cleantechnica.com) reports on the latest trends in clean tech, from renewable energy sources, to less toxic materials, to more efficient IT.
- **AfriGadget** (www.afrigadget.com) is a blog that discusses the often ingenious solutions that ordinary Africans devise for everyday problems. In addition to being fascinating, it encourages you to think about alternatives uses for existing products and waste materials.

## Buying an Existing Business

Many entrepreneurs will buy an existing business to complement their products or services. For instance, a local marketing firm might purchase a direct-mail fulfillment house in order to expand its business. Likewise, if you've always wanted to own your own bookstore and your favorite local store is for sale, you might consider buying the store in order to jumpstart your dream. If the business is thriving, you can avoid much of the uncertainty of a start-up operation.

Although buying a business may not offer the same opportunity for creativity as starting one from scratch, there will still be many ways to express yourself, such as improving the business's image, expanding the customer base, and streamlining operations. For more information, see Chapter 5 *Valuing and Buying a Business*.

## Buying a Franchise

Franchising is a method of business expansion whereby a business owner or manager allows others to market products or services under his or her name and trademark, in strict adherence to a prescribed system. In return, the franchisee pays a fee and, usually, an ongoing royalty. Moreover, the franchisee pays all of the costs of getting into the franchise.

In effect, a franchisee is able to launch a new business with less risk and fewer growing pains. Someone else has already developed an operating system that works. It's like a cook using a recipe created and tested by a master chef; he or she can be pretty sure of getting good results on the first attempt.

Franchises may offer less risk and fewer growing pains

However, not every franchise is viable. Many small, less expensive franchises are underfunded, lack a good training program, or fail to provide necessary support. Many of the large, well-known franchises are too costly for beginning entrepreneurs. Still, the support and proven business successes of some franchises make them an attractive starting point for the entrepreneur. For more information, see Chapter 6 *Franchising*.

*Near Atlantic Avenue, there was an old barbershop that had been there for most of Annie's life. Now, it was closing down. The owner had announced his plans to retire. Annie talked to him and found that he was more than willing to lease her the shop.*

*The shop was old-fashioned in a good way, with chrome and porcelain fixtures from the days when barber shops were expected to be elegant. The chairs were perfect for manicures, and the front windows faced a couple of beautiful old sycamores across the street.*

*Annie felt strongly that the time had come to stop daydreaming. She didn't have any business experience, so she started taking some introductory business courses at the nearby community college. She soon found that she got the most out of her classes by talking one-on-one to her instructors afterwards. One of her most helpful instructors was Dana Morris.*

*She took Dana her out for coffee, and talked about her business idea. Dana was able to give her advice on everything from setting up a sole proprietorship, to conducting market research, to dealing with the environmental laws and health codes that apply to nail salons. Most important, she gave Annie an outline of a business plan, and explained how the information would fit into it. Annie studied it until she knew it backwards and forwards, and began researching and writing her first business plan.*

## Alternative Entry Strategies

In this section, we will explore some of the non-traditional methods that people have used to enter the world of self-employment.

### Test Marketing Online

Many entrepreneurs use sites like eBay and Etsy to test-market their products. This is a good strategy for niche businesses that wish to reach a select audience. The start-up cost is extremely low, market research is comparatively easy, and you have access to a wide variety of motivated buyers. Some businesses find that these sites generate adequate income, while others use them as a stepping-stone to bigger and better things.

Understand and stay abreast of online scams!

On the downside, you run various risks when you sell online. For one thing, many of these sites are geared towards reassuring customers with return and refund policies that make it easier for dishonest buyers to get goods for free. Also, if you're successful, you may find that other sellers or sites are copying your product, pretending to represent your business, and so forth. While Internet sales can be a great way to launch a new business, it's essential that you understand and stay abreast of the ever-evolving pitfalls and scams that endanger buyers and sellers online.

### Technology Transfer

Technology transfer is a less common business entry method, in which procedures and products developed by state and federal agencies are made available for commercial use.

There are many technology transfer options. In several universities and colleges, products are developed and offered for commercial development. NASA and other governmental scientific agencies are also good sources for technology transfer ideas.

### Purchasing a Business in a Different Locale

Most people who consider purchasing a business limit their search to businesses in the immediate area, and thus miss many excellent opportunities. If you buy a business in another town, you get all the advantages of buying an existing business, but are not dependent on your local market for support.

Consider looking at communities where small manufacturing, publishing, catalog, or food-processing companies might be available.

### Licensing

Under a licensing agreement, you give another party the right to produce or market your product. In return, you receive a percentage of income from its sale.

Licensing is also beneficial if you want to manufacture or distribute a product that's trademarked or copyrighted by someone else. You might manufacture toys based on a popular children's film through a license with the film company, or produce software for a small, independent software development company. In both instances, you're using your manufacturing expertise and creating a highly recognizable product.

Licensing arrangements are common in industries such as electronics, apparel, and software. Obviously, some products are more suitable for licensing than others. Licensing is not risk-free, as many people are in the business of producing "knock-off" products. If you license another party to produce and distribute your product, you should first take every precaution to protect the intellectual property rights associated with your product (such as trademarks, copyright, or a patent), and make sure that your licensee takes steps to protect your trademark as well. See Chapter 18 *Intellectual Property Rights* for more information.

Last, make sure your license agreement contains measurable performance standards.

### Buying a Good Idea

Sometimes people are willing to sell an idea because they don't have the desire, time, or money to start a business of their own.

As with any start-up or expanding business, you must research the market to determine if there's enough demand to support the business. In addition, it helps to choose a product and market with which you're already familiar.

To find inventors who are looking to sell their ideas, you can consult a local business broker or inventor's club. You can find the inventor's club nearest you by visiting **www.inventorsdigest.com**.

### Copy an Idea from Somewhere Else

The basic concept of fast-food hamburger restaurants is not exclusively a McDonald's idea. Long before there was McDonald's, there were Dairy Queen restaurants. Many fast-food restaurants patterned their operations on successful chains.

Take someone else's idea, and make it better!

If you're going to pattern an operation on a successful business, use the essence of the approach to operations. Don't copy names, duplicate products, or infringe on the protected rights of businesses. If you choose to copy someone, do it within the framework of the law. In fact, you may find that the owner of the business you wish to emulate may be willing to be a mentor to you if you don't plan to infringe on his or her market.

Make sure that your joint-venture agreement clearly states the rights and responsibilities of each partner

### Joint Venture

If you have an idea you believe in, but you don't have the capital or knowledge to exploit it, consider finding a partner who possesses the skills or resources you lack.

Often, large companies will consider a joint venture with you if you can add value to the venture. The corporation may be able to provide funding and guidance to make your idea a success. However, you must make sure that your joint-venture agreement clearly states the rights and responsibilities of each partner. Be prepared for a protracted negotiation process, as big businesses will not enter into joint ventures without thorough due diligence.

### Buy Into an Existing Operation

This can sometimes be less troublesome than starting a company from scratch. You may be able to find opportunities with:

- Companies in the developmental stage
- Small manufacturing companies
- Specialty companies

Make sure the company is financially sound, and that you can work with the current owners. Ask for a copy of their business plan and study it. Make sure they answer all your questions, and that you're completely comfortable with the arrangement.

*After making a list of her main expenses (tools and materials, nail dryers, an airbrush, foot spas, a computer, a sound system, window decoration and painting, signage, some interior paneling, and business licensing fees), Annie added them up, put them in her business plan, and took them to Dana. After suggesting some changes to the plan, Dana got Annie an appointment with a "social capitalist" microfinancing firm that had an interest in protecting Brooklyn's architectural heritage, as well as helping low-income entrepreneurs.*

*They were impressed with Annie's business plan, her high energy, and her determination. What they weren't sure about was whether her relaxed, very personalized service would really be enough to make her stand out from the competition, and justify her higher prices. After doing some research, they suggested that she avoid acrylic nails and the chemicals associated with them, and switch to safer materials. They explained the benefits:*

- *None of her competitors were using nontoxic products, which would give her a large competitive advantage, especially because asthma rates were on the rise in her neighborhood.*
- *Using less toxic materials would reduce her regulatory issues.*
- *The lack of strong odors and toxic dusts would enhance the salon's soothing atmosphere.*
- *Avoiding strong chemicals would lower her insurance rates and protect her health.*
- *The use of a premium product would help to justify a premium price for her services.*

*Annie happily agreed to this. She revised her business plan, taking the cost of alternative nail-care products into account, and resubmitted it. This time, the loan was approved right away!*

*Today, Annie provides high-end, nontoxic manicure services, and recommends appropriate colors, fabrics and styles to her customers. She's built up a loyal following, and word of mouth is starting to pay off.*

## NxLEVEL® TECH TIP

BUSINESS RESOURCES AND THE WEB

The Internet is the perfect place to learn about new and emerging products and technologies. Here are a couple of sites that compile news on entrepreneurial inventions and innovations.

- **Springwise** (springwise.com) calls itself "your daily fix of entrepreneurial ideas." It relies on its network of 8,000 spotters to "scan the globe for smart new business ideas, delivering instant inspiration to entrepreneurial minds."
- **CoolBusinessIdeas.com** (www.coolbusinessideas.com) "is dedicated to the gathering of brand new promising business ideas and opportunities from around the world and informing our newsletter subscribers of emerging trends in the business world so that our worldwide subscribers can gain an edge over the relentless competition."

## Conclusion

The ideal entry strategy is one that's affordable, appropriate, and attainable. It has to be within your means, it has to fit your product and customers, and it has to be manageable given your schedule, your degree of stamina, and your other responsibilities. In short, it must be realistic.

Deciding whether to start or acquire a business is rarely easy. However, you can simplify the process by establishing firm criteria for evaluating your options, based on your goals, your available capital, and your abilities. This can be time-consuming, but it's well worth the effort!

# Chapter 5
# VALUING AND BUYING A BUSINESS

*About This Chapter:*
- *Pros and cons of buying a business*
- *Finding a business to buy*
- *Analyzing a business before you buy*
- *Valuing a business*
- *Using cash flow to value a business*
- *Getting what you want from negotiations*

## Introduction
This chapter will help you to understand the advantages of buying a business rather than starting from scratch. Of course, these advantages only apply if you find the right business!

That's why it's so important to analyze the business before you buy. Profitability is essential, of course. So are location, customer base, and many other details. But it's also important to find a business you enjoy, one which will fulfill you personally and professionally. That's why this chapter encourages you to examine your own motives for buying, as well as the business owner's motives for selling.

## Pros and Cons of Buying a Business
It's hard to say whether one method of getting into business is better than another. Each person has his or her own personality, criteria, and set of circumstances. However, exploring the advantages and disadvantages of purchasing a business may make it easier to decide whether this method is best for you.

### Advantages
The biggest advantage of buying an existing business is that someone else has already gotten things started. If you are eager to get into business, buying a business is by far the quickest way.

Buying a business is the quickest way to be your own boss

Here are some other advantages:

- **Lower cost.** It's often less expensive to buy a business than to start one. However, be careful about price. If the price looks too good to be true, it probably is.
- **Existing market share.** You already have an established market share, and won't have to create a presence in the market.

Buying a business in an ideal location can be a real advantage

- **Clear capital needs.** Although the cost of buying a business may or may not be less than starting from scratch, at least you know the dollar amount. You will get fewer surprises than you would if you tried to estimate start-up costs.
- **Location.** Buying a business in an ideal location can be a real advantage, especially if all the other good locations are taken.
- **Personnel.** You may not have to search for employees with the right skills and training. (Of course, once you become boss, you'll have to determine if you have the best people in the right spots.)
- **Inventory.** The seller should already have inventory on hand and be aware of what customers want. This reduces the risk of ordering unnecessary types and quantities of inventory.
- **Customers.** An existing business has an established customer base, so you don't have to go through the process of creating brand awareness. The customer list can be a particularly valuable asset.
- **Contracts and licenses.** An established business should have all the licenses that it needs to operate in its city and state. It may also have contracts with vendors, landlords, and so forth.
- **Control systems.** An established business should already have accounting, insurance, inventory, personnel, and other control systems in place.
- **Image.** One of the biggest jobs a business has is to create the right image in the minds of its customers. If the business has already done this successfully, it can be a huge advantage to the purchaser.
- **Credit.** Going concerns already have relationships with vendors and suppliers. Also, it may be advantageous to establish your banking relationship with a banker that already knows this business.

### Disadvantages

Each of the above advantages can also be a disadvantage. For example, customers may have a negative image of the business, contracts may be restrictive, or the business may have bad relations with creditors. Other possible disadvantages:

- **Misrepresentation.** Although you don't want to assume that a person is dishonest, some sellers will definitely misrepresent the condition of their businesses. These problems can be difficult to spot until after the purchase.
- **Unexpected changes.** Has a major change occurred that will affect the business? Has a new competitor moved into the area? Is the market shifting away from these types of products? Has a new government regulation been enacted? If you are unfamiliar with the industry in general, you may not find out about these problems until it's too late.

*In the spring of 2008, Dan Schreber started thinking about buying the local health food store in his hometown of Prairie Du Chien, Wisconsin. He was ready for a change, for one thing. He'd been working for eleven years as a county building inspector, and he was pretty sick of it. He knew Sue Flechsig, the store's present owner, and she seemed to be doing very well for herself. She had a nice house, and it seemed like she bought a new car every year!*

*Dan's wife, Sabine, had just inherited $50,000. Dan figured he could use that as a down payment on Sue's $175,000 asking price. He'd have seven years to pay off the remaining $125,000.*

*Dan didn't really know anything about health food, but how hard could it be to stock it and sell it? He'd read newspaper articles about how organic farming was the only growing sector of American agriculture, it seemed like everyone he knew was taking vitamins and herbal remedies, he'd heard about the importance of niche marketing to entrepreneurs, and there were no serious competitors within 75 miles.*

*Besides, he loved food, and he loved to cook. It was ideal, really!*

## Finding a Business to Buy

This section assumes that you have decided to purchase an existing business, and are now beginning your search for the perfect candidate.

First, you need to decide what kind of business to pursue. Consider these questions:

What kind of business do you want to be in?

- What do you want to get out of the business?
- How much capital can you put into the business?
- Do you have the right skills and experience?
- What skills do you lack?
- Do you believe in the business?
- What is the reputation of the business, locally and online?
- How much risk are you willing to take?
- Is this company the right size for you?
- How many employees will you need?
- How many competitors does it have? (Remember to consider online competition!)
- Can you meet whatever social and environmental standards and expectations apply to the business?

### Where to Find Businesses for Sale

Sources of information about businesses for sale generally fall into the following categories:

*Public sources:*

- Small Business Administration
- Newspaper advertisements
- Business associations
- Trade journals
- Chamber of Commerce
- Small business blogs
- Internet (e.g., Craigslist)
- Governmental counselors
- Business magazines

*Private sources:*

- Personal referrals
- Acquaintances
- Attorneys
- Accountants
- Bankers
- Suppliers
- Stockholders
- Real estate and business brokers
- Venture capitalists

The best strategy is to network among the private sources listed above. Let your banker, attorney, and accountant know that you're interested in purchasing a business, and ask them to keep their eyes open for likely prospects. Don't expect instant results—be patient and wait for the right opportunity.

## Analyzing a Business Before You Buy

Once you've found a few businesses that fit your criteria, do a complete analysis of each to decide which of them are worthy of further consideration. This can be a daunting task! Having a team of experts to help you will make a tremendous difference.

### Business Analysis Checklist

Prepare a checklist before purchasing a business!

Below are questions that you should ask when assessing the health of the business. (Of course, not every question will apply to your situation, but most questions are pertinent to most businesses.)

- ❑ Why does the owner want to sell?
- ❑ What is the physical condition of the business?
    - ❑ Equipment
    - ❑ Inventory
    - ❑ Building
- ❑ Does the company own or lease its facilities? If it's leasing, what are the current terms? Does the landlord plan to renew?
- ❑ What is the financial condition of the business?
- ❑ Who are the existing and prospective customers?
- ❑ What is the competitive environment?
- ❑ What legal aspects should be considered?
- ❑ What is the history of the business?

- ❑ Who owns the company, and is it publicly or privately held?
- ❑ How is the company legally organized?
- ❑ How many employees does the company have? How long have they worked there?
- ❑ How are personnel managed?
- ❑ What kind of accounting system is in place?
- ❑ What budgeting and expense controls are in place?
- ❑ What do the company's balance sheets, income statements, and cash flow statements reveal over a period of five years?
- ❑ How does the company manage its short-term and long-term cash and investments?
- ❑ How much debt does the company have?
- ❑ Does the company have any unpaid taxes and/or lawsuits pending?
- ❑ What type of insurance coverage does the company have, and how much?
- ❑ How solid are the company's supplier and vendor relationships?
- ❑ What kind of marketing and promotional activities is the company currently engaged in? What are the plans for future innovations or promotions?
- ❑ Is the company meeting all applicable legal requirements?
- ❑ How tight is the market for the company's products, and how much market share does the company control?
- ❑ How does the company's current pricing structure match that of its competitors?
- ❑ Does the company offer deep discounts to large-scale customers?
- ❑ What is the company's sales history during the past five years?
- ❑ Does the company have an established distribution network and sales force?
- ❑ Where is the business located? Near transportation and shipping lines (if manufacturing)? In a busy suburban mall (if retail)?
- ❑ What sort of online presence does the business have? What percentage of its revenue comes from the Internet?
- ❑ How strong is the company's manufacturing base?
- ❑ How old is its manufacturing equipment?
- ❑ Does the company own or lease its equipment?
- ❑ What environmental laws and standards apply? What is it doing to meet them (e.g., employee training, pollution prevention)?

### Narrowing Your Choices

Answering the questions above should give you a clear picture of the business you are considering. Now, you can use that information to define your best prospect. The following questionnaire will make the process easier.

Be honest with yourself when assessing a business!

Circle the number that best corresponds to your understanding of the prospective business. Be honest with yourself in answering these questions!

| | Strongly Agree | | | | Strongly Disagree |
|---|---|---|---|---|---|
| 1. I could never start a company this good. | 5 | 4 | 3 | 2 | 1 |
| 2. This business offers me the kind of lifestyle I want. | 5 | 4 | 3 | 2 | 1 |
| 3. I have the skills I need to succeed in this business. | 5 | 4 | 3 | 2 | 1 |
| 4. I have a good relationship with a lender who would be willing to help finance this business. | 5 | 4 | 3 | 2 | 1 |
| 5. I've been very thorough in gathering information about the business. I have answered all the questions in the previous section. | 5 | 4 | 3 | 2 | 1 |
| 6. The current owner has answered all my questions. | 5 | 4 | 3 | 2 | 1 |
| 7. I've done a thorough job of gathering the information I need to make an accurate cash flow projection. | 5 | 4 | 3 | 2 | 1 |
| 8. I've calculated an accurate price ceiling and applied my required rate of return (see next section). | 5 | 4 | 3 | 2 | 1 |
| 9. I've been objective in my evaluation, and looked for reasons *not* to buy the business. | 5 | 4 | 3 | 2 | 1 |
| 10. I've done a good job of assessing the strengths and weaknesses of the company's present employees. | 5 | 4 | 3 | 2 | 1 |

Add up your score for each business. The highest score indicates the business to which you should give the most consideration.

*Sabine was hesitant, but Dan was sure that the opportunity was a sound one. The store had been a success at its present location for seven years, and Sue said she'd built considerable customer loyalty and goodwill. That's just what she would say, of course—Dan knew that—but he also knew that it was important to get out of his dead-end job and do something for himself. He was 49, he'd been dreaming of going into business for years, and a great opportunity had dropped into his lap just when he and his wife happened to have an extra $50,000 lying around. No wonder he was so enthusiastic!*

*Sabine knew Dan was more than ready for a change, and she liked the thought of him quitting his job. They'd talked about starting a business many times, and she couldn't deny that everything seemed to be falling into place. Still, $50,000 was a lot of money.*

*Sabine knew that entrepreneurs are supposed to be enthusiastic, but she also knew that they have to be realistic. It looked like she'd have to be realistic enough for both of them.*

*The first thing she wanted to know was why Sue was getting out of the business. Dan said, "She wants to move back to Minnesota."*

*"Why now?" Sabine wondered.*

*She decided it was time to have a little heart-to-heart conversation with Sue. And her accountant.*

## NxLEVEL® TECH TIP
BUSINESS RESOURCES AND THE WEB

There are many business valuation and risk-optimization programs available.

At the basic end, there's Excel's **Solver** function, which uses single numbers for all variables to come up with a simple result. A more elaborate (and expensive) option is Palisade's **RiskOptimizer** (www.palisade.com/RISKoptimizer), which allows you to factor in probability data, resulting in an assessment of the most likely outcomes.

One of the most popular business valuation programs is **BallPark Business Valuation**, an inexpensive program that can be bought on CD-ROM or downloaded online. As the name implies, this program provides a roughly estimated valuation, and should not be used when an official valuation is needed, but it can be a very helpful planning tool.
Visit **www.bulletproofbizplans.com/BallPark** to learn more.

## Valuing a Business

Once you've decided to buy a business, the next question is, "How much is this business worth?" The answer is always the same: "The business is worth whatever the buyer and seller mutually agree that it's worth."

A business is worth whatever the buyer and seller agree it's worth

The buyer and seller have different incentives for placing a price on a business. The seller probably started the business from scratch, or watched it grow from his or her efforts. This is why sellers often have an inflated estimate of their business's worth. The buyer probably has limited resources, which will be used not only for the purchase price, but also to make any necessary changes. Therefore, the buyer wants to pay the lowest possible price. There is always a middle ground between these two positions.

### Valuation Methods

There are numerous methods for valuing a company. And just to make things even more complicated, different terms are often used to describe the same method! (Note: For a fee, a valuation firm will take on this task for you.)

Understanding the pros and cons of the following three methods will make you a stronger negotiator when the time comes to discuss price.

- **Asset valuation** places a value on the assets of the company (building, property, machinery, inventory, and so forth) and uses this value to price the business. Since this method tends to give lower values, it's typically used by buyers. Common methods include book value (known as the balance sheet method); tangible book value; adjusted tangible book value; replacement value; liquidation value; and excess earnings.
- **Stream of earnings** derives the company's value from its profits, earnings, or cash flow (or their multiples or present values). It usually gives a higher value, and so is typically used by the seller. Common methods include multiple of earnings, price/earnings ratio (if the company has listed stock), discounted future earnings (also known as discounted cash flow), and return on investment (ROI).
- **Estimates** are based on what the business owner thinks the price should be, according to the selling price of other businesses (or, just as often, a hunch). Common methods include fixed price and market value. They're usually arbitrary, so you should avoid them if possible.

You're probably asking yourself, "Which of these methods should I use to establish a beginning price for negotiations? What do I really need to know to make an informed decision? How do I establish what the company should be worth to me?" This next section offers some practical answers to these questions.

### Look At Other Investments

Which investment will give you the best return?

As you search for a business to buy, you should also be looking at other things to do with your money, such as investing in the stock market, a money market fund, T-bills, a savings account, or other investment instruments. By thinking of the purchase of a business as an investment, you can evaluate all investment possibilities on the same terms, and decide which investment offers the best return on your money.

Investment choices can be passive or active. A **passive investment** is one in which you are not actively involved in generating money (e.g., a savings account or the stock market). An **active investment** is one in which you are actively involved in generating money (e.g., owning and working in your own business).

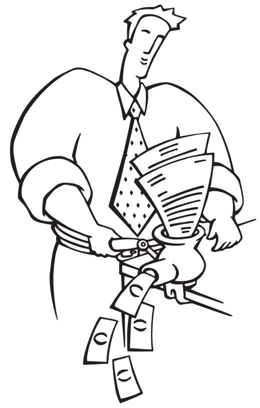
If you can make a 10% return on a passive investment (with little or no time required on your part), does it make sense to buy a business that gives you less than a 10% return, and requires your full-time attention? You must determine if the business you want to buy is a better investment than the other investing options open to you.

### Cash Generation

A company's assets, both tangible and intangible, are good for only two things: They can be sold for cash (liquidated), or used to generate cash.

Obviously, tangible assets—such as equipment, inventory, buildings, and so forth—can be sold for cash. And even though they are more difficult to value, intangible assets—such as goodwill, customer lists, or the value of a patent—can also be sold.

These assets can also be used to generate cash. To illustrate this point, let's look at Better Plastics, Inc., a manufacturer of eco-friendly auto parts. Their assets, including special machinery, were valued at $100,000. The company is currently up for sale.



How much cash can your assets generate?

> **Scenario 1:** Their records show that they had a negative cash flow of $1,000 for each of the past three years. How much would you pay for the company?
> **Scenario 2**: Their records show that they had a positive cash flow of $50,000 for each of the past three years. How much would you pay for the company?

In Scenario 1, you probably asked yourself, "Why would I pay $100,000 for the privilege of losing $1,000 a year?" Perhaps you could sell the equipment for $100,000, but then you haven't really gained anything. However, if this equipment could generate $50,000 in positive cash flow each year, as it does in Scenario 2, it would be better to keep the equipment and use it as a cash generator. The emphasis of the valuation, then, should not be solely on how much the assets themselves are worth, but on how much cash they can generate.

*Sabine got together with Sue, and looked closely at revenues and expenses for the previous years. She took these financial data to her accountant, and together they considered the trends in the health food market generally, as well as the specific issues of location, recognition, credit relationships, county services, taxes, insurance costs, neighborhood security, signage, and stock.*

*One of the things her accountant noticed was a downward trend of almost nine percent over the previous year (ever since a vitamin chain opened a new store at the mall, in fact). She noticed, too, that Sue's credit relationship with the biggest wholesaler in organic pharmaceuticals and beauty products had been teetering on a knife-edge. Among other things, Sue was no longer getting discounts for payment within thirty days.*

*This was definitely food for thought. And there was more to come. For instance, Sabine asked Sue in passing if she'd gotten a good deal on her new Lexus, and Sue said, "Oh, I always lease." Sabine was beginning to have serious doubts about this "successful" business.*

*She wasn't too impressed with the store, either. It was small and cramped, with the aisles packed too closely together. The available parking was not bad for a small store. However, the place next door had become a biker bar. There was a lot of broken glass and debris lying around. On the other side was a drab little restaurant with grease-spattered windows.*

*The location looked pretty bad, overall. But oddly enough, that's precisely what made her decide she was going to turn it into the nicest, cleanest, most pleasant store in town!*

## Using Cash Flow to Value a Business

Cash flow is the movement of money through a business

As we have seen, **cash flow** is the best way to evaluate a business as an investment, and to place a dollar value on it. Cash flow is simply the movement of money through the business; cash comes in through sales, and goes out to pay the bills. **Net cash flow** is the difference between what comes in and what goes out. A positive cash flow means that at the end of a given time period, more cash has come in than has gone out of the business.

How can you use cash flow to evaluate the business as an investment, and to place a value on it? To answer this question, you must examine the company's past cash flows, and estimate its potential future cash flows. The results determine the price you should pay.

### Step 1: Historical Cash Flows

Obtain historical cash flows for as many previous years as possible. It's best to get records for at least the past three years. If the company is less than three years old, get as much of the company's financial information as you can.

Some small businesses will not have a cash flow statement available for inspection. However, most businesses do prepare a **balance sheet**, which shows the company's assets and liabilities; and an **income statement**, which shows the company's profit (or loss) after expenses are subtracted from revenue.

If no cash flow statement is available, one can be created from the income statement and the last two ending-period balance sheets. To take accrual-based financial statements and create a financial picture based on cash accounting requires accounting expertise. An accountant's help in this area is vital.

To get a true picture of cash flow, you must further consider the income statement given to you by the seller. Most business owners try to make the income statement show as little profit as possible; the smaller the profit, the fewer taxes the business has to pay. Conversely, when selling a business, many business owners try to make the company look more profitable by not recording expenses, or by understating them.

An important area in which owners juggle profits and losses is **cost of goods sold**; overstating or understating inventory significantly changes the apparent profit or loss. Therefore, you should insist on an independent inventory count to verify the owner's estimate.

As the prospective owner, you need to know how profitable the company really is. Many accountants use a technique called "recasting" or "reconstructing" to get a true picture of profitability; they modify the cash flow to reflect the business's probable profits had it been run by the prospective buyer. For instance, in the case of an owner who tries to minimize profits, deductions for such unnecessary items as first-class travel would be removed, or the cost of professional management might be substituted for the owner's inflated salary. In the case of an owner who tries to inflate profits, the accountant makes sure that the amounts listed for wages, taxes, legal and accounting fees, supplies, insurance, and all other operating expenses are reasonable. If there is little or no amount in these areas, adjustments must be made.

### Step 2: Projecting Future Cash Flows

Projecting future cash flows simply means making an educated guess, with an emphasis on the word "educated." This is where doing your homework pays off in terms of finding a business that is selling for a bargain price, or has great potential for future profits.

The information in Table 1 is an example of how to prepare a cash flow projection. You can use a blank form to enter information about the future cash flows of the business you are evaluating.

The best approach is to work with an accountant you trust—someone who can help you gather the information, and cast accurate cash flow projections as if you were the owner. Proper discounting of these future cash flows can then be used to calculate your acceptable purchase price range and the return on your investment.

Work with an accountant you trust!

### Step 3: Use Historical and Projected Cash Flows to Place a Value on the Business

The problem with projecting cash flows is that due to the loss of purchasing power, dollars earned in the future are worth less than dollars earned today. However, future cash flows can be "discounted" to today's dollar value. By using a discount rate (interest rate adjusted for risk), you can calculate a **net present value** that determines the dollar value of the business today, even though you are looking at annual cash flows for as many as five years ahead.

There are four steps to calculating net present value:

*1. Estimate future cash flows*

We've already discussed the process of estimating cash flow, but part of our negotiating technique requires us to calculate two different types of cash flow:

a. **Historical cash flow.** Use historical cash flow to calculate the present growth rate, then use this growth rate to project a conservative future cash flow. If past cash flow has grown at 10 percent per year, your estimate is that future cash flow will grow 10 percent or less per year. If the company has not grown in the past three years, or growth has been erratic, this becomes a negotiating tool for lowering the price. This estimate gives you the minimum you should pay.

b. **Your confidential cash flow.** Next, calculate a "best case" cash flow, but for your information only. This gives you an idea of the upside potential for the business, and the maximum you should be willing to pay. This max-min review is extremely useful when it's time to negotiate a price with a seller.

*2. Determine an appropriate discount rate*

It's impossible to buy a sure thing!

The **discount rate** is a risk-adjusted interest rate you would expect from a comparable investment. The risk adjustment is to compensate you for taking the risk of buying this business, since it's impossible to buy a sure thing.

For example, if you could invest in a government-guaranteed security, such as T-bills, and earn 7% interest, and a relatively low-risk business opportunity seems to justify a small 2% premium, then the discount rate for valuing that business would be nine percent.

If the business seems risky, a risk premium of 10 percent could be assigned, resulting in a 17% discount rate. Most small businesses are assigned risk premiums between 5 and 10 percent. As a result, discount rates for most small business valuations range between 12 and 22 percent, but it's not uncommon to find discount rates as high as 35 percent.

In the negotiation process, it's important to understand the procedure of setting the discount rate. If you feel the business is high-risk, you should assign a higher discount rate. If you and the present business owner disagree on the risk involved, you can use this as a negotiating point to lower the price of the business.

*3. Determine a reasonable life expectancy for the business*

Most experts agree that future cash flows should be estimated for three to five years. Estimates beyond five years are not reliable.

*4. Determine the net present value*

The value of the business is determined by calculating the net present value of the projected cash flows, using the discount rate you have chosen. Using the data from the example on the facing page, a value can be calculated for the ABC Company. A growth rate of 10 percent per year is assumed for the data in the table.

Review the table, and then calculate ABC's value by applying the four steps we just discussed.

*1. Estimate future cash flows*

You have determined that the revenues and expenses for the next five years will be those in Table 1. Your evaluation of ABC Company's historical cash flows shows that they have been growing by 10 percent every year. Accordingly, the cash flows in Table 1 show an increase in revenues of 10 percent per year. These are the cash flows you will use:

Year 1 - $ 8,050
Year 2 - $ 9,675
Year 3 - $11,972
Year 4 - $14,967
Year 5 - $18,796

## Table 1. ABC Company Cash Flow

| | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|
| **Revenue** | | | | | |
| Product 1 | 100,000 | 110,000 | 121,000 | 133,100 | 146,410 |
| Product 2 | 100,000 | 110,000 | 121,000 | 133,100 | 146,410 |
| **Total Revenue** | **200,000** | **220,000** | **242,000** | **266,200** | **292,820** |
| **Expenses** | | | | | |
| Cost of Product 1 | 50,000 | 55,000 | 60,500 | 66,550 | 73,205 |
| Cost of Product 2 | 50,000 | 55,000 | 60,500 | 66,550 | 73,205 |
| Wages | 25,000 | 27,500 | 30,250 | 33,275 | 36,603 |
| Outside Services | 250 | 275 | 303 | 333 | 366 |
| Office Supplies | 500 | 550 | 605 | 666 | 732 |
| Repairs & Maintenance | 500 | 550 | 605 | 666 | 732 |
| Advertising | 5,000 | 5,500 | 6,050 | 6,665 | 7,321 |
| Car, Delivery, and Travel | 500 | 550 | 605 | 666 | 732 |
| Accounting and Legal | 1,000 | 1,100 | 1,210 | 1,331 | 1,464 |
| Rent | 6,000 | 6,000 | 6,000 | 6,000 | 6,000 |
| Telephone | 2,000 | 2,000 | 2,000 | 2,000 | 2,000 |
| Utilities | 1,200 | 1,200 | 1,200 | 1,200 | 1,200 |
| Insurance | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 |
| Taxes | 1,000 | 1,100 | 1,200 | 1,331 | 1,464 |
| Loan Repayment | 12,000 | 12,000 | 12,000 | 12,000 | 12,000 |
| Miscellaneous Expenses | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 |
| Owner's Withdrawal | 35,000 | 40,000 | 45,000 | 50,000 | 55,000 |
| **Total Expenses** | 191,950 | 210,325 | 230,028 | 251,233 | 274,024 |
| **Net Cash Flow** | **8,050** | **9,675** | **11,972** | **14,967** | **18,796** |

*2. Determine an appropriate discount rate*
Let's assume you could invest in the stock market and make a return of 10 percent, and that this is your best alternative investment. We'll also assume that you believe the ABC Company is not very risky, so you assign a risk premium of five percent. The total discount rate is the sum of the best alternative investment rate and the risk premium, or 15 percent. Therefore, you want a 15% return on your investment.

*3. Determine a reasonable life expectancy for the business*
In this case, we'll use five years of projected cash flows.

*4. Determine the net present value*
Using present value tables from a financial handbook, a financial calculator, or a computer spreadsheet, use the present value factors for 15 percent (the discount rate). Multiply the present value factor by the cash flows for each year. The total of the discounted cash flows is the value of the business.

| | A | B | C | D |
|---|---|---|---|---|
| 1 | **Year** | **Net Cash Flow** | **Present Value Factor** | **Today's Value** |
| 2 | 1 | $8,050 | 0.8695 | $6,999 |
| 3 | 2 | $9,675 | 0.7561 | $7,315 |
| 4 | 3 | $11,972 | 0.6575 | $7,872 |
| 5 | 4 | $14,967 | 0.5717 | $8,557 |
| 6 | 5 | $18,796 | 0.4972 | $9,345 |
| 7 | **Totals** | **$63,460** | | **$40,089** |

The following example shows how to calculate net present value using Excel, a popular spreadsheet offered by Microsoft.

| | A | B |
|---|---|---|
| 1 | **Year** | **Cash Flow** |
| 2 | 1 | $8,050 |
| 3 | 2 | $9,675 |
| 4 | 3 | $11,972 |
| 5 | 4 | $14,967 |
| 6 | 5 | $18,796 |
| 7 | **NPV** | **$40,089** |

Enter the cash flows for years 1-5 in cells B2 through B6. Then, type the following formula in cell B7: **=NPV(15%,B2:B6)**

Note that the discount rate of 15 percent is already entered in this formula. You can change the discount rate and cash flows to fit your situation.

The calculated value of ABC Company is $40,089. This means that if you buy the ABC Company today for $40,089, and the projected cash flow is accurate, you would realize a 15% annual rate of return on your investment over the next five years.

### What We've Learned

Earlier in this chapter, we said that this method of calculating a business's value would allow you to answer two questions. Now, let's look at the answers to those questions.

- **How does this investment compare with other investments available to me?** At a price of $40,089, given all the assumptions made, your investment in this business will give you a 15% return. You can now compare that return with alternative investments.
- **How can I tell how much a business is worth?** You have calculated that the business is worth $40,089. You now have a starting place for price negotiations.

### Setting a Price Ceiling

Before you make an offer, it is essential that you establish your **price ceiling**—the top price you are willing to pay. This gives you considerable power in the negotiations.

You must remember one principle in price negotiations: The more you pay, the lower your rate of return. For example, if the price for ABC Company was $46,204, the rate of return would only be 10 percent.

The higher the price, the lower your rate of return

In order to set a price ceiling for negotiations, choose your lowest acceptable rate of return and recalculate the net present values at that rate. The resulting number represents your highest acceptable price. You should be prepared to walk away from negotiations if the seller will not accept it.

As stated earlier, you should also prepare a confidential cash flow that reflects revenue-increasing improvements you will be able to make to the company. Using the net present value of the higher cash flows, recalculate the value of the company. This gives the company a higher value, meaning you may be willing to pay more than the historical cash flows justify. This can be risky, so weigh the evidence carefully before using this method.

*Dan was amazed at how determined Sabine suddenly became. Since Sue didn't own the building, Sabine talked to the landlord about the bar next door. She told him she was interested—very interested—in leasing the space, but that she wanted an open wall of plants extending out between the two businesses. The landlord was more than willing, because the bar's lease was coming due and he'd already had complaints from other neighborhood businesses.*

*Next, Sabine considered the view from the highway and the way the neon Philly Cheese Steak sign hanging over the door of the restaurant on the other side seemed to intrude on the health food store, and confuse the identities of the two businesses. She noted the gray-and-white window lettering that didn't stand out at all, and the once off-white but now merely off-putting interior. She noticed the skylight that had been painted over from the outside, and the strong smell of mice in the storeroom.*

*She made a list of all of these problems, and started researching how much it would cost to get them fixed. She called a sign company to get a quote on a sign that would be higher than the overhang, and blot out the cheese steak sign. Dan called a painter and got a bid on the interior, and investigated flooring, shelving, and lighting.*

*Once Dan had gotten a reasonable estimate for all these renovations, they took it to the landlord and said, "This is what it's going to cost to get ourselves settled in." Then, they met with Sue, and told her that they were ready to buy, and the only remaining sticking point was the overall price.*

*Sabine pointed out that they'd be starting in a hole that Sue dug with respect to her credit, and that they had competition from the vitamin store, but added that she was sure something fair could be worked out.*

*A couple more meetings with the landlord resulted in a $25,000 price reduction, and a three-year extension on the lease. The landlord was happy with this deal, as the improvements would increase the appeal and value of his building.*

## Getting What You Want From Negotiations

A win-win outcome creates goodwill on both sides

The objective of the negotiation process should be for both sides to walk away feeling reasonably satisfied. A win-win situation creates goodwill on both sides. Without that goodwill, situations may develop that could affect your business (such as the previous owner telling all his or her old customers that you are unreasonable). If it's not possible to make both sides happy during the negotiations, perhaps you should look for another business to buy.

### Price

It seems to be a rule that when the first asking price is accepted, sellers wonder if they could have gotten more out of the deal. Likewise, if the first counteroffer is accepted, buyers always wonder if they could have gotten the business for an even lower price. To help avoid "buyer/seller remorse," you should generally not offer the full asking price.

What if the asking price is significantly below your price ceiling? You should still make a counteroffer, but by a smaller amount.

How much below the asking price should your offer be? Any counteroffer you make should be justifiable. If your assessment of the company shows that the cash flows will not support a certain price, this is ample justification for a lower price. In addition, your investigation of the company should have made you aware of other factors that justify a lower price, such as old inventory, an unproductive family member on the payroll, or repairs that must be made to the building or equipment. Be on the lookout for these bargaining chips.

If the asking price is significantly above your price ceiling, what should you do? The first step is to counter with a price that can be supported by the cash flow, which is your price ceiling or lower. If that doesn't leave you with enough negotiating room, you must decide whether to walk away or accept a higher price with more favorable terms.

### Terms

What's more important to your particular deal: the price, or the terms of the agreement? If the seller's price is firm, you should dictate the terms to your advantage. If terms are most important to the seller, you should dictate price.

Should you pay a higher price if you can dictate the terms? Always evaluate the deal in terms of the rate of return on your investment. Suppose your ceiling price for a plastics company is $100,000, which will give you the 15% return you require. The seller refuses to go lower than $150,000, but is willing to carry the contract for 25 years, with payments of

$6,000 per year. Your original offer assumed you would need a $100,000 loan for 5 years at 10% interest, with payments of $25,488 per year. These new terms mean an increase in cash flows of more than $19,000 per year, which more than provides your 15% return. Should you pay more than your ceiling price? In this case, the answer is emphatically yes!

*Today, Dan and Sabine are doing quite well. In fact, they're doing better than Dan ever dreamed! He'd never expected to get into a growth business. He'd assumed that the health food store would have a steady and loyal clientele, but not much growth potential.*

*But he hadn't counted on Sabine. She'd recognized right away that part of Sue's problem had been her focus on vitamins and herbal remedies. That had been a good strategy when Sue started out, but since then a lot of competition had sprung up. In 2008, even the local chain drug store sold herbal remedies. Obviously, Sue couldn't compete on a price basis with chains. And unfortunately, she really didn't have too many other products to offer. Or at least, none that anyone wanted.*

*Sabine changed that, along with everything else about the store. She made it light, airy, and bright, and turned it into the kind of place where people want to linger. She didn't want to run a "health food" store; that sounded too exclusive, and had too many negative connotations. Instead, she'd chosen to run a specialty and gourmet market, with lots of fresh local produce, interesting handmade products, and green household supplies. She added a small deli with lunch and dinner options, which Dan made fresh daily. The store was still organic, still "healthy"...but now it appealed to a much wider clientele than Sue ever had.*

*Early in 2009, the restaurant next door went out of business. It was good timing. They'd just been talking about expanding the deli, which was one of the most popular components of the store. The place was a mess, of course, but Dan wasn't too worried about it. He could see that Sabine had that determined look in her eyes again!*

## Conclusion

There are no hard and fast rules about valuing a business. A business is worth what the buyer and seller mutually decide it's worth. The methods presented here merely serve as a starting place for negotiations.

Always include your accountant, attorney, and business advisors in the valuation process

However, it's important that you know what rate of return you require, because this knowledge allows you to set a price ceiling. The involvement of your team of professionals will ensure that you make the most objective possible evaluation, so always include your accountant, attorney, and business advisors in the valuation process.

# Chapter 6
# FRANCHISING

*About This Chapter:*
- *Franchising basics*
- *Trends in franchising*
- *Researching and applying for a franchise*
- *Understanding the franchise agreement*

Franchises are an increasingly popular way of getting into business

## Introduction

A **franchise** is a legal relationship under which a **franchisor** grants a **franchisee** the right to sell the franchisor's branded product in a given retail space or geographical area, according to contractually specified rules and quality standards. In essence, the franchisee pays a fee in order to reap the benefits of the franchisor's established brand, customer goodwill, purchasing discounts, proven financial track record, and efficient distribution network.

There are over 900,000 franchises in operation in the United States, comprising every sort of business, from healthcare to DVD rentals to hardware stores. Worldwide, there are many thousands more. The economic impact of franchising is staggering. A few years ago it was estimated that one-third of all retail sales occurred in franchises, and this number is increasing annually.

Most franchises fall into two categories:

- **Product franchises** grant the franchisee the right to distribute goods under its name and trademark. Gas stations are a good example.
- **Business-format franchises** provide franchisees with a standardized method for operating the business, which includes the use of trademarks, trade secrets, copyrights, and marketing and service information. McDonald's is the classic example. Business-format franchisors generally provide significant, ongoing assistance to the franchisee, which is why this is the most common and the fastest-growing type of franchise.

Whether franchising is right for you depends on many factors, from the amount of upfront investment you can afford, to the standards of the community in which you live, to your willingness to be micromanaged by the franchisor. This chapter will explore some of the basics of franchising, and—we hope—communicate the importance of researching franchises and franchising agreements very thoroughly before spending any money or signing any contracts.

## Franchising Basics

One reason that franchises are so popular is because statistics show that independent businesses are about six times more likely to fail in their first year than franchises. Many entrepreneurs like the greater odds of success that franchises provide.

However, a franchise is not a sure thing. Like any other business, franchises require long hours, people skills, business acumen, market research, and intense personal commitment.

That said, let's take a look at some of the advantages and disadvantages of franchising.

### Advantages

The primary advantage of franchising is that the franchisee is immediately able to compete with larger companies by utilizing the goodwill, quality standards, and experience of the franchisor. These assets would take years to acquire if the owner operated an independent shop.

Other advantages include:

- Access to expert help
- Increased purchasing power
- Aid in lender negotiations
- Sample business and operating plans

The best franchisors are looking for win-win relationships with their franchisees. They view franchising as an interdependent relationship, and do their best to engender trust, provide ongoing educational opportunities, and give franchisees input into the franchise system. A relationship with a franchisor of this type can be personally rewarding as well as profitable.

### Disadvantages

If you long for complete freedom, be aware that you may not get it as a franchisee! Some franchisors are control-oriented, and will monitor and regulate virtually every aspect of your business. For example, some franchisors require franchisees to purchase products, raw materials, fixtures, equipment, and furniture only from the franchisor or franchisor-approved suppliers, even if an alternative supplier can meet or exceed quality standards at a better price.

How much franchisor involvement is acceptable to you?

On the other hand, some franchisors are hands-off organizations that won't be responsive to the problems you face as a start-up. You should think carefully about how much franchisor involvement is acceptable to you.

Many new franchisees assume that they'll make a profit right away. This is often not the case. The average franchise requires an initial investment of between $100,000 and $250,000. It may take a year or two—or three—to make your franchise truly profitable, depending on location, competition, fees, royalty schedules, and your own business skills.

## Scams

You should be aware that numerous corrupt franchising opportunities lure the uninformed entrepreneur into an investment scheme in which the franchisor literally takes the franchisee's money and runs.

One way to avoid such scams is to investigate the franchise meticulously before you invest in it. Face-to-face contact with the franchisor can provide a strong sense of the success of the organization.

It's also a good idea to contact franchisees directly to identify any problems they've had with the franchisor. **Due diligence** is an absolute must for the potential franchisee.

Due diligence is an absolute must for the potential franchisee

*After moving to the United States from India, Alisha Roy spent fifteen years in California's Silicon Valley. When the third business she worked for downsized, she decided it was time to go into business for herself.*

*As a software engineer, she had a lot of product ideas, but she also knew that there were many obstacles to starting a tech business. What she needed was a way to get into business quickly, and earn enough to fund another venture.*

*When her husband Michael suggested a franchise, she was skeptical. In the first place, she didn't really want to run a juice stand or sell shoes. In the second place, it seemed to her as though Silicon Valley already had a large number of franchise businesses. How would another one manage to stay afloat, especially if it were run by someone who wasn't really motivated?*

*Last, and most important, she wanted to do something worthwhile...something that would help people, or clean up the environment. And she didn't see much chance of doing that with a franchise.*

*But one day, while browsing online for green business opportunities, Alisha came across a fascinating franchise idea: A company called Biofuelers collected waste cooking oil from restaurants, stadiums, and fast-food chains, and converted it into biodiesel that was then sold to biofuel stations.*

*The equipment and personnel needs were doable, and the work seemed relatively easy. Alisha was intrigued. She decided to do her homework and perform a thorough due diligence on the franchisor.*

## Franchises and the Law

Under the Federal Trade Commission's Franchise and Business Opportunity Rule, franchisors are required to provide you with a **Franchise Disclosure Document (FDD)** at least 14 business days before you pay any money or sign a contract. The FDD includes:

- All costs and fees associated with starting and maintaining the business
- A summary of contract terms, responsibilities, and restrictions (including the length of the franchise agreement, which can range from five to thirty years)
- Copies of all contracts, leases, and agreements you will have to sign
- The franchisor's audited financial statements
- The franchisor's litigation history
- Background information on officers, managers, and other key personnel
- Contact information for at least 100 previous franchisees who are geographically nearest to you
- Exit strategies, penalties for nonperformance, and procedures for resolving disputes

As of this writing, 14 states require franchisors to register with the state in order to sell franchises: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. In all other states, federal law mandates that franchisors offer a disclosure document containing financial statements, fees, litigation issues, and other details that will aid franchisees in assessing the business.

The help of an experienced attorney and a trusted accountant is essential when evaluating an FDD

A number of states also require franchisors to file an FDD with a state agency. In most of those states, it is illegal to offer or sell a franchise until the FDD is filed. Note, however, that this does *not* mean that the state agency, or the Federal Trade Commission, has actually confirmed the information in the FDD. It's up to you to check the accuracy, and assess the implications, of the information in the FDD. While it's technically illegal to put false information in an FDD, actually proving wrongdoing may require time, energy, and resources that you can't spare. For this reason, and many others, the help of an experienced attorney and a trusted accountant is essential when evaluating an FDD, as is talking to as many current and previous franchise owners as you possibly can.

### *Local restrictions on franchises*

Some communities have voted to impose limits on franchises and other forms of "formula retail," in order to protect the local architecture and environment, or to nurture local businesses. In some cases, franchises may be required to forego their standard design in order to meet community standards, or to observe strict size limits. Other cities have limited the number of franchises that can operate within city limits at any one time.

If you're in an area where these regulations are in force, or are being publicly discussed, you should take careful stock of local sentiments before proceeding with your franchise idea. Although the franchisor may be willing to fight such regulations in court, winning may do the franchisee very little good if angry citizens decide to avoid the business.

## Trends in Franchising

Despite the ups and downs of the US economy in recent years, the number of franchises has grown steadily. This makes sense; franchises often appeal to people who have been displaced from the job market, and business ownership is considered by many people to be an attractive alternative to investment in the stock market. In addition, franchising is an increasingly popular way for growing companies to expand.

Of course, not all franchises are created equal. If you want to buy a franchise, you need to find one that suits your personal and professional goals, and you must have good reason to believe that it will remain profitable in your locale over the long term. It's not enough to find a franchise sector that's enjoying growth, or a franchisor that's especially popular. You still have to consider your goals, your competitors, and your regional market. Buying a franchise is never a guarantee of success, no matter what the trends say.

In some areas, turmoil in the banking industry may make it difficult to get a commercial loan for a franchise. On the other hand, declining sales have led some franchisors to offer very attractive terms, including buyback guarantees, and reducing or waiving franchise fees. If such contracts are negotiated correctly, they can reduce a lot of your risk.

With all this in mind, let's look at some of the franchise sectors that are likely to be profitable in coming years.

### Food Franchises

As Americans' lives get busier, and more families require double incomes to survive, the food-franchise industry continues to grow. Fast-food restaurants remain a weekly dining choice for roughly 40 percent of Americans.

At the same time, concern over health and obesity has led to exponential growth in more health-conscious franchises like Chipotle Mexican Grill and Fresh Choice. In response to this trend, Subway has positioned itself as a heart-healthy and vegetarian-friendly alternative to the big-name burger franchises. This trend is very likely to continue.

### Fitness and Weight Loss

The trend towards healthier eating is accompanied by a trend towards fitness and weight loss, which remains one of America's fastest-growing franchise sectors. This trend is also driven by the ever-increasing cost of health insurance, which has made Americans more desperate than ever to lose excess weight. Fitness centers and weight-loss programs are doing well in most parts of the country.

### Personal and Home Services

The time crunch faced by many American workers has led to considerable growth among franchises that, in essence, offer time savings. Cleaning and home organization franchises are popular, as are home healthcare services, tutoring, child care, and senior care. Home renovation, redesign, and painting franchises are also popular in some markets.

Franchises that save customers time are increasingly popular

### Grooming and Other Personal Needs

Even in hard economic times, some services are always in demand. Personal grooming is a good example. There are a number of haircutting and styling franchises available, and most experts believe that such businesses are relatively stable.

### Tech and Business Services

Given technology's lightning-fast evolution, and the ongoing trend towards home offices and start-up businesses, there's an ever-increasing need for people who can install, explain, and fix computers and related technology. Accordingly, tech consulting franchises like Geeks on Call are enjoying strong growth. If you have particular expertise with wireless technology, spyware attacks, or computer security, a tech consulting franchise could be a natural choice for you.

### Green Franchising

Getting into a green version of a traditional franchise could increase your chances of success

All of the types of franchises listed above could be green in some sense, depending on their products, the source of their energy, their waste handling procedures, or the type of building in which they operate. Getting into a green version of a traditional franchise could increase your chances of success, but as always, it's necessary to research your market carefully. This is especially important if you're dealing with a franchise that charges a premium price for green products.

In addition, some franchises actually offer green services, like environmentally friendly cleaning, or energy audits and retrofitting for homes and businesses. Such franchises may be less common in your area than others, and therefore more attractive (provided, of course, that you know a market exists for this service).

*The very next day, Alisha contacted Biofuelers, and got their FDD. She soon learned a fair amount about their business model. Biofuelers had a two-pronged approach to cooking oil: In the first stage, they offered filtration services to clean the oil. This saved the restaurant owner the expense of buying new oil, and it also improved the taste of the food. To add value, they also cleaned the deep-frying area and the overhead air filters during service visits.*

*After the oil had been filtered several times, Biofuelers took it away, processed it, and sold it as biofuel. They'd converted their entire vehicle fleet to run on vegetable oil, so this also reduced the company's overhead.*

*Alisha was pleased to see that the upfront investment was fairly low. It would cost her about $70,000 to start her own Biofuelers franchise. Even so, it was a tough decision. The economy was bad, and it seemed as though more bad news was on the way. Many of her friends were getting laid off, or worrying about the status of their retirement funds. She and Michael had about $150,000 saved up, but times were uncertain. Would it be wise to take a gamble on a relatively new business?*

## Researching and Applying for a Franchise

How do you get started with researching franchises? Go to the library and read whatever you can find. The Internet will have some useful information as well. Talk with people who currently own franchises and see what they say. Check the business section of financial and business newspapers and periodicals; many franchisors and owners of franchises advertise for buyers in these publications.

Franchise trade shows are another option. There will be booths explaining how to select and operate franchises. You may even be able to obtain FDDs from a large number of possible franchisors. Be careful, though: Many of the franchisors at these trade shows are small, disorganized operations.

Before you think of applying for a franchise, get a copy of the FDD, and review it carefully! Here are some questions to consider:

- Is the franchise new to your town, or to your region? Is the business growing, stable, or declining in its other markets?
- Have you visited the franchise? Can you visualize one in your area? Would the demographics and economy of your area support it?
- Could you realistically learn this business, and would you like it? Do you respect the franchise's product?
- What do consumer groups like the Better Business Bureau say about the franchisor?
- What is your break-even point, given the fees and royalties set forth in the FDD? Is it realistic? Will you have an adequate income in the meantime?
- How do their fees stack up when compared to other franchises?

### Using a Franchise Broker

Franchise brokers advertise themselves as experts who can help you find appropriate, profitable franchises and walk you through the application process. In some cases, they can be valuable partners. In others, they may misrepresent their capabilities, or be working for a specific franchisor. By the same token, brokers whose commission is pegged to the price of the franchise may encourage you to take on a bigger franchise deal than you can afford.

What all this means is that you may have to do almost as much research into a prospective franchise broker as you would into a prospective franchise.

Here are some questions to consider before hiring a franchise broker:

- Who pays the broker? Is he or she independent, or affiliated with a specific franchise or group of franchises?
- How many franchises does the broker represent?

- What references does the broker have? What local deals has the broker helped to create? Be sure to get as many names as possible, and follow up with them.
- Does the size of the broker's commission depends on the price of the franchise?

### The Application

After you've researched the franchise thoroughly and decided to apply, the franchisor will want to know some things about you, including your financial status, experience, and ability to perform. In most cases, the franchisor will also be very interested in your willingness to uphold the standards of the franchise network. Generally speaking, franchisors want a team player, not an independent-minded entrepreneur.

Franchise applications are often very detailed, and you may not like giving a stranger all this personal information. However, if the franchisor doesn't ask for much information about you, it may indicate that it is not careful enough about its business.

### Deposit Agreement

Make sure that your deposit is refundable if you can't strike a deal

After your application is accepted, you're typically requested to make a "good faith" deposit of between $2,000 and $10,000. Before you make a deposit, review the deposit agreement and make sure that the deposit is refundable if you cannot strike a deal. Also, make sure that your deposit will be in escrow, instead of being commingled with the franchisor's operating funds. You will also want your deposit to serve as a reservation of your franchise.

*Biofuelers' FDD made a good case for its business model, but Alisha knew that she needed to do some research on her own. First, she needed to know how many sources there were for used cooking oil in Silicon Valley. That was comparatively easy; all she had to do was go through the phone book and look for fast-food restaurants. There were 175. She calculated that she needed to service 60 of them twice a month in order to make the business opportunity worthwhile, and about 90 to earn her target income. Was that realistic? She wasn't sure. And even if it was, how much room did that leave for growth?*

*She tried calling a few of the restaurants. Some were interested, some definitely weren't, and others were already selling or donating waste oil to local biofuel users. Realistically, the best she could hope was that 50 percent of these businesses would sign on. That wasn't enough.*

*While lunching at her favorite Indian restaurant, it occurred to her that there were countless Indian and Asian restaurants in Silicon Valley, and that all of them used deep fryers. This increased the size of her market dramatically. Better yet, she had a competitive edge, since she spoke Hindi fluently.*

*Alisha decided to move forward, and scheduled a meeting with Biofuelers' rep.*

### Examining the Franchisor

Once you've made your application and have qualified, the franchisor should be willing to disclose its financial and operational details. You can expect to sign a nondisclosure agreement at this point.

Read the fine print!

You must make a very detailed examination of this information before signing the franchise agreement. (Remember: If you negotiated your deposit agreement properly, you will be entitled to a refund if you don't like what you see!)

If the franchisor appears reluctant to provide you with information, or is in a big hurry to sign you up, you should take these as warning signs and refrain from going forward with the deal.

Here are some questions to consider when assessing a franchisor:

- Can the franchisor deliver what it promises?
- Is the assistance to your business operations worth the franchisor's interference?
- Have you checked the franchisor's standing with a credit rating service like Dun & Bradstreet? How about the Better Business Bureau in the franchisor's home town? The state attorney general's office? The FTC?
- Does most of the franchisor's income come from franchise fees (immature business), or from royalty payments (ongoing successful franchises)?
- Are you permitted to interview any franchisees you wish?
- Is there any market research in your area for this type of product at this price?
- Does the location of your shop make sense from a business standpoint?
- Can you construct the type of store the franchisor requires?
- How does the franchisor administer the franchise, and what kind of help is it willing to supply to a new or struggling franchise?
- Are the training commitments more or less than you need?
- Do you have sufficient funds to make the purchase payments without severely affecting your capital needs in the short term?
- Does the franchisor have valid trademarks or patents on its products?
- How many franchises have been sold this year, and over the last five years? How many have failed?
- Do franchisees collectively have a voice in management or a seat on the board?

*Buying an ongoing franchised business*

There are additional questions if you're considering the purchase of an ongoing franchise. First, you must make sure that the franchisee has the right to sell it to you. Most likely, you will need the consent of the franchisor. Is your seller considering this a sub-franchise, where he or she will take royalty payments in addition to the purchase price and those royalties that you are obligated to pay directly to the franchisor? Does your seller operate competing franchises within your area? If so, are they successful, and would you want to become part of a team, or be a competitor, with your seller?

Because you will be buying into a complex business relationship, you should investigate the business as if you were buying the franchise directly from the franchisor, and study the terms of the franchise agreement accordingly. We recommend that you have a feasibility study prepared by an expert to determine whether you are buying into a booming or declining enterprise. (In retailing, this is often referred to as **product life cycle analysis**.)

One thing that makes investigation difficult is that the franchisor often has restrictions against distribution of the information in its operations manual to third parties. But it is essential that you review these documents carefully before buying an ongoing franchise.

*At her meeting, Alisha learned more about Biofuelers' service. The company primarily signed contracts with fast-food franchises, schools, hospitals, and stadiums. However, they were open to finding other markets, and granting franchisees a certain amount of leeway to drum up business. They also had plans to expand into other environmental services for restaurants, like recycling, waste reduction, and energy management solutions.*

*The rep explained that while many franchisors tend to stifle innovation and independent thinking, Biofuelers felt that this was inappropriate in a green economy, which thrives on collaboration, transparency, creativity, and the free flow of information. In short, they were always on the lookout for new ideas, and they were particularly intrigued by Alisha's technical background.*

*Alisha liked the sound of this! Everything that she had assumed would be a liability—her values, her independence, and her willingness to rock the boat—was turning out to be a plus. But she wasn't ready to fill out an application, let alone pay the deposit. First, she needed to approach a few Indian restaurant owners, and gauge their level of interest. And after that, she had to track down plenty of existing franchisees, and ask them if the business had lived up to their expectations.*

## Understanding the Franchise Agreement

Franchise agreements are always negotiable

The franchise agreement is a contract that specifies the terms of your arrangement with the franchisor. Every franchise comes with different problems and opportunities, and these must be addressed clearly in the franchise agreement. Don't be afraid to ask the franchisor to explain why a particular term is fair or necessary; the agreement is negotiable even though it comes on a standard form. Remember: All your careful analysis is wasted if you agree to a contract that is unfair, or that you can't perform!

You should seek legal counsel to help you negotiate a fair deal, and you can always walk away if you can't reach a fair agreement with the franchisor. Note, too, that unlike a traditional contract, franchise agreements often establish a relationship in which the franchisor can unilaterally change policies and procedures without the franchisee's knowledge or consent.

Every franchise agreement is different, but most of them address the following issues in one form or another.

### Contract Term and Extensions

Is the initial term long enough, and can the franchisor restrict renewal in some way? You may want a short initial term in case things don't work out, but you may also want the automatic right to renew without additional fees.

Many states regulate how franchisors grant extensions, so that they can't be cut off early to the detriment of the franchisee. Also, the type and length of notice required prior to renewal is very important. If you miss that date, you could find yourself unable to renew.

### Franchise Fee and Royalties

The initial franchise fee usually doesn't include the inventory, fixtures, or supplies you'll be required to purchase.

The royalty you pay can be based on net or gross sales. When is the royalty due? Is there a cap, or a declining percentage in your favor, as your sales go up? How often—and at whose expense—will an audit of your books take place? If your books are in error, the agreement will typically provide that you pay the expense of an audit, which can be substantial. Thus, you should understand the extent and nature of your reporting requirements, and the required accounting methods.

### Supplies

Are you required to buy all your supplies from the franchisor? Do you get a discount based on economy of scale, or do you pay a premium for name familiarity? Are the initial stock-up requirements merely a disguise for a clever pyramid scheme?

### Territory

A franchise is not always an exclusive right. One of the critical elements in a franchise agreement is the extent of the territory over which you have been granted a franchise. You must determine whether it is exclusive or nonexclusive (i.e., whether other franchises can be granted in the area by the same franchisor).

How much territory does your franchise cover?

Will you have an obligation to open additional stores in the area, or else lose your exclusivity or even your franchise? Is the exclusive market area so large that it will overextend your resources, or so small so that you will find yourself competing with another franchisee in your area? The franchise agreement should not allow the franchisor to open a new outlet that competes directly with yours.

*One of the first things Alisha learned when she contacted Biofuelers' franchisees was that you can't necessarily trust a business owner to give a stranger an accurate picture of his or her business. A number of the franchisees she talked to sounded very positive, but when she asked how many facilities they served, it was well below her target number. She realized that she was asking people to admit that they had made a mistake, or to reveal themselves as bad businesspeople or underachievers, and their pride was getting in the way. Clearly, there wasn't one simple way to learn what she needed to know. Nothing could be taken at face value; everything needed to be checked and doublechecked.*

*Other franchisees seemed to be doing well. One was negotiating a contract with the local military base. Another had just added a third truck to his fleet, and was looking for new employees. These seemed like more realistic indications of success. So why did some franchises succeed where others failed? That was what Alisha needed to find out.*

*As her research continued, she found that most of the successful people were interested in the business and the environmental side of things. The most successful franchisees were the people who were excited about providing an environmental solution, but also had an excellent grasp of the financial side of the business.*

*The one thing she heard from dissatisfied franchisors was that Biofuelers didn't provide much oversight or guidance once the business was up and running. Again, that seemed like an upside, for Alisha. Her outlook was basically entrepreneurial, and she didn't like the idea of being micromanaged. Biofuelers was looking like a very good fit for her.*

### Sourcing

Look at sourcing requirements before you sign a franchising agreement

Many franchisors require franchisees to buy raw materials, fixtures, equipment, furniture and other supplies from the franchisor, or from an approved vendor with whom the franchisor has formed a relationship. In some cases, vendors may provide kickbacks to the franchisor in return for becoming a sole supplier to the franchisees.

This arrangement can benefit the franchisee, in that it streamlines the ordering process, maintains quality standards, and—in some cases—keeps prices low. However, it can also prevent franchisees from cutting costs or improving quality by seeking other vendors. Before you sign, look carefully at sourcing requirements to ensure that they're fair.

### Physical Plant

Many retail franchises require a standard physical appearance. Will the franchisor own the building and lease it to you, or will you be expected to construct the improvements?

Identify the extent to which the franchisor controls or assists you in locating a site, making improvements, and furnishing the interior. Also, determine what rights the franchisor has to inspect your premises and operations.

### Training
Many franchisors will give you the equivalent of a master's degree in small-business administration, while others throw you a manual and tell you to get to work. Your agreement should clearly state what training is offered, when and where, and at whose expense. Will your employees receive training from the franchisor, or is that your obligation?

### Management Assistance
Generally, business practices throughout the franchise system must be uniform. This can be a great benefit to the small-business owner who does not have the experience, education, or desire to work up management procedures for the business and maintain them. Your contract should spell out what ongoing management assistance the franchisor will provide.

### Marketing
Name and product recognition are crucial to franchises. For this reason, the existing marketing program of the franchisor comprises a major advantage for the franchisee.

What type of national marketing or advertising programs does the franchisor undertake? Will you be required to spend a certain percentage of your gross sales on national or additional local advertising? What percentage of your royalty payment will go to area, regional, and national marketing by the franchisor? Do you have the right to audit the franchisor's books to make sure it's meeting its obligations?

### Quality Control
It's important for both the franchisor and the franchisee to see that uniform standards of quality are maintained throughout all franchises. A bad product or sleazy business practice in one location will hurt all franchisees, because your trade name is theirs, too.

Quality control is essential to the success of franchises!

The franchisor should insist that you and all other franchisees maintain an established standard of quality. You should insist that the franchisor hold the other franchisees to the same high standard, and give you remedies if they fail to do so.

### Trade Secrets
Most franchises are based upon the franchisor's "trade secrets," which include the product, the operations manual, and the management system. The franchise agreement will often provide that every aspect of the business is a trade secret, and you may be required to keep that information confidential. You may also be prohibited from competing against the franchisor when the franchise terminates, and from opening non-franchised outlets while the agreement is in place.

Without these protections, the franchisor is subject to unfair competition. However, you should review these provisions carefully to avoid undue restrictions on your right to operate a similar business once the franchise ends.

Review the transferability provisions of the agreement carefully

### Transferability

The franchise may be the most substantial asset in your estate. At some point, you may wish to sell the business or pass it on to your children. For this reason, you must review the transferability provisions of the agreement carefully.

The franchisor, on the other hand, has sold you the right to use its name, product, and operational methods on the basis of your financial position, experience, and reputation. Therefore, the franchisor will want to review your buyer's qualifications, just as it reviewed yours when it sold you the franchise. In addition, the franchisor may want to reacquire the franchise. It's quite common to see options, or rights of first refusal, granted back to the franchisor.

*You have to be detail-oriented to be a successful software engineer, and that training served Alisha well as she assessed her franchise opportunity. After a month of research, Alisha had all but memorized Biofuelers' FDD. Thanks to the Internet, she also had a folder of articles about the firm from all over the country. She'd interviewed 37 current and former franchisees, and she'd also talked to local restaurant owners in the Indian, Chinese, Vietnamese, and Thai communities. She knew where the biofuel stations were in the Bay Area, and she knew who else was manufacturing biofuel, how much they were charging, and where they were getting their waste oil.*

*And of course, she'd gone through all the numbers with her CPA, estimated how long it would take to reach her break-even point, and prepared a pro forma cash flow and budget.*

*That left the franchise agreement. She brought it to her lawyer, who recommended that she take it to a franchise attorney named Carol Davis.*

*Carol had a few complaints about the agreement. "It's not the worst I've seen," she told Alisha. "Not by a long shot. But as it stands now, I wouldn't sign it." The main issue was that the agreement specified that any disputes would be resolved by mandatory arbitration.*

*"Arbitration can be problematic when it comes to franchises," Carol said. "You're much better off keeping all your legal options open, if you can."*

*What really worried Carol, though, was what wasn't in the contract. Biofuelers had talked about their commitment to innovation and creativity, and expressed interest in Alisha because of her technical background, but there was no provision in the agreement for assigning rights to intellectual property. If Alisha came up with some great new idea that benefitted Biofuelers, who would own it? That was something that would have to be resolved thoroughly before the deal could go forward.*

## NxLEVEL® TECH TIP

BUSINESS RESOURCES AND THE WEB

Many franchisors have elaborate Websites that allow the prospective franchisee to take a virtual walk through the business. Here are a couple of Websites with links to dozens of franchise home pages.

**Entrepreneur's Franchise and Business Opportunities** (www.entrepreneurmag.com/franchises) has information on franchises in every field imaginable, including candles, tanning, custard, vitamins, and autopsies!

**Bison Franchises and Franchising News** (www.bison.com) calls itself "the most comprehensive site devoted to franchising and franchises." The site showcases hot companies, provides contacts and basic information for 1,500 franchises, allows you to download application forms, and discusses personal screening and loans. It also maintains a useful list of green franchise opportunities at **www.bison.com/GreenFranchises**.

### Cure Periods

Pay close attention to the amount of time that you and the franchisor have to "cure" your respective contract defaults. Some agreements may grant the franchisor as many as 90 days to fix problems, while imposing a much shorter grace period on the franchisee. An equitable agreement should give both parties equal time to cure defaults.

### Termination

You must give careful consideration to the termination provisions in any contract, but this is especially critical in a franchise agreement.

Pay close attention to the termination provisions of your franchise agreement

The franchisor will want to be able to terminate the agreement if the franchisee fails to follow the program; is unsuccessful; takes the process to another location or provides it to a third party; or fails to make timely royalty payments. For these reasons, the termination provisions in a franchise agreement often favor the franchisor.

That said, you need to protect your investment, and you also want the ability to terminate or get damages if the franchisor is not delivering what it promised. You may also want to include a buyout provision, just in case you wish to terminate the franchise voluntarily. Buyouts often have complex formulas because the franchisor may want the continuing royalty payment, but cannot quickly get a new franchisee in place. In a buyout, the franchisor wants you to pay damages based upon the expected return for the remainder of the contract term, less the franchisor's costs of performance of its duties to you.

If the franchisor defaults and the agreement is terminated, does the contract provide for your recovering some portion of your initial franchise fee? Does the contract provide for liquidated damages? What items must be returned to the franchisor? You will want a clear delineation of these matters so you are not subjected to claims after termination.

### Venue and Legal Fees

Some franchise agreements stipulate that disputes must be litigated, arbitrated, or mediated in the franchisor's home state. If you're in Maine, and the franchisor is in Texas, this could greatly increase the cost and inconvenience of resolving disputes.

Some agreements also require the franchisee to pay all of the franchisor's legal fees if the franchisor wins the dispute, but don't require the franchisor to pay if the franchisee wins. If the franchisor refuses to change such clauses, you should consider it a deal-breaker.

## NxLEVEL® GREEN TIP

ENVIRONMENTAL BUSINESS RESOURCES

From organic foods to solar panel installation to pesticide-free lawn care, green businesses are one of the most popular franchise choices today. Even in the midst of an economic downturn, green franchises have been one of the few franchise sectors to show healthy, consistent growth!

Here are some sites that track the latest trends in green franchising.

- **Green Franchise Directory** (www.greenfranchisedirectory.com)
- **Earth Friendly Franchises & Business Opportunities** (www.franchise.com/environmentally-conscious-franchises.cfm)
- **Green and Eco-Friendly Franchise Opportunities** (www.franchisedirect.com/greenfranchises)

*The negotiations with Biofuelers were long and difficult, but when the smoke cleared, Alisha was satisfied. Biofuelers agreed to waive the provisions for mandatory arbitration. They also spelled out the legal implications of technical and service improvements. In the case of actual technical innovations—like a new software system—Alisha would retain the rights, but Biofuelers would have the first option to license the system. And if they did so, Alisha and the franchisor would divide the profits.*

*Two years later, Alisha's franchise is doing well. She's servicing more restaurants, processing more oil, and selling more biofuel than any other franchisee in the state. Better yet, her growing familiarity with energy use at restaurants has inspired her to design a Web-based software application that will help to optimize oil temperature, exhaust-fan cycles, and cleaning schedules, thereby saving restaurants money and streamlining Biofuelers' operations.*

*In the end, franchising was not just a good choice for Alisha in financial terms. It also helped to further her professional goals as a software engineer, and allowed her to fulfill her dream of helping the environment.*

## Conclusion

Franchises are an increasingly popular way of doing business. They offer the franchisee strong advantages in purchasing power, name and product recognition, tested physical plant layout, operations manuals, training, and business management assistance.

However, they can also be burdensome in terms of paperwork, supervision, and expense. Always use caution when considering a franchise! A good franchise arrangement will benefit both parties equally.

# Chapter 7
# HOME-BASED BUSINESS

*About This Chapter:*
- *Trends in home-based business*
- *Advantages and disadvantages*
- *Setting boundaries*
- *Legal, tax, and insurance issues*
- *Managing a home-based business*

## Introduction

The rapid advance of telecommunications and computers has caused consumer purchasing to evolve towards a decentralized model that favors home-based businesses, while simultaneously making such businesses increasingly feasible for the entrepreneur At the same time, layoffs have hit almost every major industry sector, and many displaced workers are scrambling to create home-based businesses in whatever field they left, or to provide services and support for other small businesses.

According to statistics, a new home business starts every 11 seconds, creating 8,219 jobs each day. These businesses generate over $401 billion per year.

Home-based business is on the rise!

In this chapter, we'll look at the trends that affect home-based businesses, as well as the advantages and disadvantages of working at home.

## Trends in Home-Based Business

Dramatic changes in our society have forced many people to rethink traditional ways of earning a living. The ups and downs of the US economy have taken a toll on the American workforce, as has the emphasis of larger employers on cutting costs by working with self-employed independent contractors, or outsourcing jobs to foreign workers.

At the same time, the advancing age of the American population has led to an explosion in home-based businesses run by seniors, as well as home-based businesses that provide services to seniors, or to people who care for them.

### Global Competition

Technology continues to aid home-based entrepreneurs by extending their reach into markets outside their geographical area. Of course, this means that they may face competition from all over the world. That's why home-based entrepreneurs must be very careful to get accurate, complete market research data. Even if you have no e-commerce capability, you may find yourself competing with international or multinational firms that sell directly to your neighbors!

### Virtual Assistants

Traditionally,  most successful independent contractors have worked in professional fields like accounting, graphic design, and computer services, and market their services to large and mid-sized companies. However, home-based businesses are now springing up to meet other corporate needs, like handling phone calls and e-mail, setting up and managing social networking sites, or collecting debts.  They frequently work with small and start-up businesses that wish to appear larger than they are, or to have more time to focus on core business tasks.

These independent contractors are usually referred to as **virtual assistants**. They offer their skills from home on a contractual basis, to large or small firms that wish to save money or improve efficiency by outsourcing. This is an increasingly lucrative field, but it's also a competitive one—not least because many Americans have effectively been forced into it by corporate downsizing. To remain competitive, virtual assistants must be extremely detail-oriented and organized; have a good understanding of new and emerging technology; and have excellent self-marketing skills.

There are advantages and disadvantages to working at home

## Advantages and Disadvantages

Is your home the best place to locate your business? As usual, there are advantages and disadvantages.

### Common Misconceptions

To most people, working at home sounds like a dream come true. And indeed, it does have many advantages. But the reality is not always as glamorous as it sounds!

Here are some misconceptions you should give up before starting a home-based business.

*Working at home means less stress*

It's true that when you work at home, you don't have to deal with some nightmarish commute. And you may not have to suck up to a disagreeable boss, tiptoe around the fragile egos of co-workers, get blamed for other people's mistakes, or attend pointless meetings.

On the other hand, you may very well find yourself doing everything else. You may end up being the accounting department, the IT department, the phone bank, the marketing staff, the receptionist, and the janitor...all at once! If too much stress and responsibility chased you out of your former business, you may want to think twice about working at home.

*I can work when I want to*

Can you really? Your customers may have other ideas. On the one hand, you need to be there when your customers need you. On the other hand, your customers may feel they can contact you at all hours, and on weekends. After all, you work at home!

If you don't want to end up working 80 hours a week, you need to structure your time formally, so that you can balance the competing demands on your time. We'll explain how to do this below.

***I'll finally be able to catch up on my housework***

If you didn't have time for housework when you were working nine to five, you probably won't have time for it when you're working at home. Most entrepreneurs put in very long hours, and home-based entrepreneurs are no different. If anything, they tend to work even longer hours, because they don't have a clear boundary between work time and home time. Again, effective time management is key.

*Judith Butler is a baker and caterer who works out of her home in Bloomington, Indiana. In 2008, her daughter Mary urged her to develop a Website. Judith didn't really see the point.*

*"Bloomington's not that big a town," she said. "And I've been here a long time. People know how to find me."*

*Mary was persistent, though. Bloomington is a college town, she reasoned. People come to it from all over the country. Suppose a parent in Cincinnati wanted to send his daughter a birthday cake? Suppose he typed "Bloomington bakery" into Google, and Judith's bakery was at the top of the list?*

*When Mary explained it that way, Judith became intrigued.*

## Setting Boundaries

One of the biggest challenges of working at home is setting strict boundaries between home and work. When it's five o'clock in an office, people can get up, go home, and leave their jobs behind. When you work at home, your job is always right there.

### Structure Your Workday

Set a routine, and stick to it!

It's important to get into good working habits from the outset. It's very tempting to ease into the workday slowly, over a leisurely breakfast. The next thing you know, it's time for lunch!

Allocate your time carefully, by setting aside certain hours for the tasks you do every day. Use a timer or alarm clock, if you have to. If you devote the first part of the morning to answering e-mails and phone calls, monitor the time that chore takes over the course of a week, and come up with an average. Do this with all your regular business activities, and you'll have an idea of how much time your basic routines take.

As a general rule, it's easier to start with a strict deadline and adjust it, than to try to impose order on chaos.

### Make a Clean Break

Many entrepreneurs who work at home fall into the trap of dawdling or getting distracted during the day, and trying to play catch-up at night. This is a very bad habit to get into!

Set a cut-off time for work, and stick to it. It helps to have some kind of ritual—like having dinner, watching a movie, or working out at the gym—to help you switch gears and feel that work is over for the day. If possible, have it be something you do with friends or family members, so that you have a commitment to them that you can't break easily.

If it's hard to stop working on the weekends, consider taking a trip early Saturday morning. Have a picnic, or visit the farmers' market or a museum. Find something you like to do, and get into the habit of doing it, so that your free time has some structure.

Set clear boundaries between work and your personal life

Of course, you'll occasionally have to work in your free time. The goal is to reduce these times to the bare minimum. If work keeps infringing on your personal time, you need to restructure your working habits, not your time with family and friends. Having the ability to relax, unwind, and have fun is just as important to your success as a strong work ethic. If you're overwhelmed with work, you might have to consider hiring an employee or independent contractor, or finding an apprentice.

### Separate Yourself

You should also strive to set your work space apart from the rest of your house. If you can put it in an outbuilding, that's ideal. Otherwise, choose a room that's as distant as possible from the rest of your home. Decorate and light it differently, so that it really feels like you're going to work when you walk through the door.

Above all, choose a room with a door you can close and lock, where household noise won't disturb you. You may not be able to do some of these things in your current situation; in that case, treat them as an ideal, and try to find creative ways of setting emotional and physical boundaries between work and private life.

## Legal, Tax, and Insurance Issues

There are special legal and tax considerations for people who work at home. Rules vary from state to state and town to town, and they may change with little warning. This book can't describe all of these rules, or keep up with them every time they change, so it's up to you to research the applicable laws in your area thoroughly, and get professional help with anything you don't understand.

### Zoning

When considering a home business, you need to be familiar with the zoning laws in your neighborhood. Zoning laws vary from community to community, so contact your city hall and request the zoning ordinances for your area.

The most common restrictions are:

- No onsite sales, deliveries, or inventory storage
- Restrictions on signage, noise, hazardous waste, and odors
- Fire regulations
- No employees other than family members

*Judith had a computer, and she used it to go online, but she didn't know the first thing about Websites and e-commerce. Luckily, Mary knew a lot. She showed Judith how to register her domain name (www.butlerspantry.com), and how to get her site hosted.*

*Mary's fiancé Evan was studying computer science at Ivy Tech State College, and he agreed to design and optimize Judith's site for $300 and a dark chocolate almond cake.*

*Evan designed a simple site, with very basic e-commerce capabilities and a blog that Judith could use for announcements, contests, and posting recipes. He got a photographer friend to take professional pictures of Judith's cakes; the photographer charged Judith for the film, and took the cakes for his time. (Judith was starting to wonder if she could get away with sending a cake to the phone company every month, in lieu of cash!)*

*He also created a Facebook fan page for the bakery; in addition to increasing Judith's visibility with local college students, this allowed customers to sign on as "fans," and receive mass mailings and special offers.*

## Taxes and Home-Based Business

No matter where you operate your business, you're entitled to the normal business tax deductions. However, home-based business owners may be able to take an additional home-office deduction.

A home-based office can save you money!

In order to qualify for home business tax deductions, you must show the IRS that you regularly use part of your home exclusively as a place of business. You must meet at least one of the following criteria:

- Your home is your principal place of business
- A structure on your property that is not attached to your house or residence is your principal place of business
- You meet with customers and clients at home

In addition, you must have no other fixed location where you conduct substantial administrative and management activities of your business.

## NxLEVEL® TECH TIP
BUSINESS RESOURCES AND THE WEB

**The Home Based Business Network** (www.homebasedbusiness.com) is a busy social networking site for entrepreneurs who work at home. Once you join, you can upload a personal and business profile, take part in discussions on business issues, download audio and video content, make friends, read blogs, or write a blog of your own.

Since one of the worst threats a home-based entrepreneur faces is isolation, joining this site (or a similar one) is a great way to network with people who share your concerns, values, struggles, and frustrations. You may also find that you attract new customers or partners.

A word of caution, though: Time can fly very quickly when you're on a social networking site. Don't get so caught up in discussion and debate that you lose sight of your daily goals and responsibilities. Instead, you should decide on clear goals for your social networking, and regularly devote a set amount of time to achieving them.

In any given year, deductions indirectly related to your business cannot exceed the gross earnings of the business. Indirect expenses include real estate taxes, mortgage interest, rent, utilities and services, insurance, repairs, and depreciation. The business portions of these expenses are deductible. You can only deduct a percentage of the home expenses equivalent to the square foot percentage of your home that your business occupies. Direct expenses that benefit only the business part of your home, such as painting or repairing your work area, are fully deductible.

The IRS publishes special guidelines and tax packages to assist the home-based entrepreneur in figuring his or her tax deductions. We recommend that you hire an accountant to help you with your taxes.

### Home-Based Business Insurance

Protect your business with insurance

Every type of business needs insurance, yet many people starting home businesses fail to consider their insurance needs. A carefully planned insurance program is vital to the protection of your business and personal assets.

You have three basic options for insurance:

- **Endorsement to an existing homeowners' policy.** Standard homeowners' policies usually cover no more than $2,500 for business equipment. An endorsement can double your business property coverage for as little as $14 a year. However, they're usually only available to businesses that generate $5,000 or less in annual receipts.

- **In-home business policy.** These policies were designed specially for home businesses. They allow you to insure business property for up to $10,000. You can also buy up to $1 million in liability coverage. In-home business policies also cover lost income from damage to your house, and offer limited coverage of valuable documents and off-site property.
- **Business owners' policy (BOP).** This is an off-the-shelf policy designed for small to midsize companies. It's available in most states, and offers broad coverage. Check with your insurance broker for more information.

When organizing your business insurance program, make sure you define the different perils your business may face, and rank them according to the greatest risk of loss. You should cover your largest risk first. Be sure to cover vehicles and employees!

Define the different risks your business faces, and cover the largest one first

Since insurance coverage is an important and complex matter, you should work closely with an insurance broker. See Chapter 17 *Managing Risk* for more information.

*Judith's site was unassuming and down-to-earth. It had a small biography, a menu with attractive pictures, a list of ingredients, and a couple of recipes. If you wanted to place an order or ask a question, you could click on her e-mail address. Evan also added a PayPal button so that customers could pay over the Internet.*

*Beneath that placid exterior, Evan had shrewdly optimized the site to show up in search engines. He used keywords, metatags, and title-tags that would ensure that people searching for bakers and caterers in Bloomington would find her site at or near the top of the list. That gave her the ability to compete for business with companies much larger than hers.*

*Evan's careful optimization paid off; her business ranks number-one in Google for "Bloomington bakery." Judith is still competitive in terms of local business, but she's also significantly increased her sales to out-of-towners. She routinely gets orders from Indianapolis and Chicago, and on one occasion she got a large order from Edmonton, Canada!*

## Managing a Home-Based Business

In order to run a successful business, you need to manage time, money, and people. The more efficiently you run your business, the greater its chances for success.

### Setting Up a Functional Office

Many homes—especially older ones—may lack adequate power, lighting, Internet connectivity, soundproofing, and air conditioning. Before you start a home-based business, you need to make sure that your prospective office space is up to the job.

Does your home have what it takes to be a place of business?

*Electricity*
Setting up a home office can increase your energy use dramatically. This can increase your electricity bills, and it may also be dangerous. If you're going to be running a lot of new office machines, you may want to have an electrician check your wiring. To keep your energy costs down, look for appliances that have earned the Energy Star® designation, which are designed to use very little electricity.

You should also buy one or more UPS (Uninterruptible Power Supply) units to protect your equipment from power surges and outages.

*Internet connectivity*
Some houses and neighborhoods have limited or unreliable Internet connectivity. You'll probably want a high-speed or wireless connection, so you should make sure that this service is available from your ISP. If the infrastructure in your neighborhood is poor, your connection speed may be slow or erratic. Make sure your ISP offers a reasonable trial period for any upgraded Internet connection.

Depending on where your office is located, you may also need to have new outlets or cables installed by a professional.

*Lighting*
Good overhead lighting will reduce eyestrain, and make your office more pleasant for you and your clients. If your office doesn't have it, you should install it. Compact fluorescent bulbs are quite bright, and can last for five to ten years. (Bulbs with replaceable ballasts may last for up to thirty years.)

Skylights and solar tubes are another option; unlike racks of fluorescent bulbs, these additions are likely to be very attractive to buyers if you sell your house down the line.

*Air conditioning*
Your office must have good ventilation, and effective air conditioning. You won't be happy working in an office that feels like a sauna in summer and an icebox in winter, and your customers won't like it either. The ability to make your customers feel comfortable and relaxed in all kinds of weather is a basic home-office requirement.

### Projecting a Professional Business Image

Developing a professional image is an important part of building credibility with your customers. What business image do you project? Factors to consider include:

- Your address (you may want a post office box instead of a rural address)
- Your neighborhood: does it fit your business image?
- Business graphics—logo design, business card, letterhead, signs, etc.
- Business-only phone, fax, and e-mail
- Separate place of work and business entry
- Establish regular hours of work
- Prompt response to mail, phone, and e-mail messages
- Businesslike communications

### Staying Connected

Does starting a home-based business mean leading a life of loneliness and isolation? Not at all, if you follow a few basic tips:

Stay connected through networking

- Become active in your related professional organization; stay abreast of changes in your profession; become better known among your peers
- Join a formal networking group, or an online community dedicated to entrepreneurship; your local Chamber of Commerce or similar networking groups offer regular networking sessions and business seminars
- Start an informal support group; meet with other home-based business owners to discuss common business issues
- Take a course; learn a computer program or become certified in your industry
- Schedule regular social activities; plan a weekly lunch with a friend or an exercise class at the gym
- Give back to your community by volunteering

Networking business-to-business is one of the most important ways of marketing your home business. Your involvement in even one established home-based business network could mean the difference between success and failure.

## NxLEVEL® GREEN TIP

ENVIRONMENTAL BUSINESS RESOURCES

Energy and resource calculators can help you to keep your home office costs down.

The US Department of Energy offers a variety of useful energy calculators at **www.eere.energy.gov/consumer/calculators**. These online tools can help you evaluate your energy use and determine whether energy efficient products or renewable energy are right for you and your home business.

**Hohm** (mshohm.orcsweb.com) is an online application from Microsoft, which allows users to view how much power they're using, and offers personalized solutions. Hohm also functions as a social network that allows users to communicate and collaborate on energy-saving strategies.

**Google PowerMeter** (www.google.org/powermeter) allows consumers to monitor their electricity consumption on their personal iGoogle homepage.

**The Ecological Footprint Quiz** (www.myfootprint.org) estimates the area of land and ocean required to support your consumption of food, goods, services, housing, and energy.

## Conclusion

Home-based businesses have led many entrepreneurs to new freedom and prosperity. As a home-based entrepreneur, you can overcome feelings of isolation—and give and receive valuable information—by joining networks and being active in professional and trade associations. This can also build a marketing network for your product.

Before you start a home-based business, you should consult with your accountant and lawyer. Your accountant can help you to set up an organized, orderly recordkeeping system and advise you on tax issues specific to home-based businesses. Your lawyer can give you advice on which business entity to choose, and how to protect yourself from liability.

# Chapter 8
# FAMILY-OWNED BUSINESS

*About This Chapter:*
- *Family and business systems*
- *Managing by communicating*
- *Planning for succession*

## Introduction

A family business is one in which two or more family members have a substantial ownership interest and, in most cases, also participate in senior management. In most family enterprises, ownership is closely held and concentrated within the family.

Family businesses now employ more than half of the nation's work force. They account for 80 to 90 percent of all commercial enterprises in the United States, and are growing at a time when many large, publicly held corporations have been downsizing and restructuring.

Family businesses are responsible for 60 percent of the nation's employment, and 78 percent of its new jobs. They account for more than 50 percent of US gross domestic product (GDP), and constitute a third of all companies listed on the New York Stock Exchange.

Some family-owned enterprises are not only quite large, but are well known to the public (e.g., Tyson Foods, Cargill, and Bechtel).

Family-owned businesses face unique problems that arise from overlapping family roles and work relationships. For this reason, many family business owners have professionalized their management practices by adopting policies that maintain clear boundaries between family and business systems.

For family businesses, success and survival require a professional management culture

These policies include formal plans for training the younger generation; rules of entry, advancement, and exit that apply to all family members equally; and a willingness on the senior members' part to discuss company policies and succession plans candidly. In addition, business owners often consult outside advisors to get an independent, objective assessment of strategies and succession plans.

To build the strongest possible foundation for this new professionalism in family-owned businesses, owners and employees must learn the basic principles of MBC—Managing By Communicating.

*Ellen Wringham ran Frostbite, a frozen-food business in Henderson, Nevada, with her sons George and Robert. The brothers had always had a volatile relationship. Ellen thought that putting them to work together would teach them to cooperate. And if that failed, she figured they'd at least work hard trying to outdo each other!*

*Unfortunately, that's not what happened. Instead, they battled constantly over turf. It seemed that neither one of them was willing to risk being outdone by the other. They preferred to launch personal attacks on each other's ideas and methods from the outset, so that virtually nothing got done.*

*Meetings were the worst. If Robert had an idea, George hated it. If George had one, Robert hated it. Ellen often found herself saddled with the role of "chief emotional officer" when called upon to referee fights between the two brothers. Each tried to get her to take his side, but she refused. "You're grown men," she told them. "You need to work it out yourselves."*

## Family and Business Systems

Family businesses are unique in that they represent the merger of two distinct and sometimes incompatible systems. This means that decisions may be guided not only by the goals of the business, but by the expectations of the family. Sometimes this makes sense: a parent may naturally want his or her child to manage the business, even though a more qualified non-family member is available. Unfortunately, it can be difficult and stressful to integrate the demands of both systems in ways that lead to satisfactory outcomes.

### Overlapping Roles

The owner's children also have to deal with the confusion of overlapping roles. In the family, fairness may require equal treatment of children without regard for performance. In business, reward is traditionally based on performance alone. The family is characterized by strong emotional feelings having a long and complex history. Rationality and objective judgment are applauded in business. The family is based on love, while business relations are based on respect, which in turn depends on performance.

It's up to the leader to define the boundaries between family and business roles

Integrating the expectations of the two systems is one of the most difficult tasks the family business leader must perform. It requires competence in managing relationships, and communicating expectations about those relationships to family members, especially when family and business roles overlap.

Although all family members share responsibility in this task, it's up to the leader to define the boundaries between the two systems.

## Professionalization: The Key to Family Business Survival

In today's increasingly competitive climate, success and survival require a professional management culture. Statistically, less than one third of family businesses survive through the second generation, and fewer than one in ten last through the third generation. The average lifespan of a family business is just 24 years. Bad economic conditions and poor business judgment explain some of these failures, but the major cause is an inability to develop a coherent business succession plan. There appear to be five reasons for this:

- It's tough for senior family members to face their own aging and mortality.
- Many seniors worry that the younger generation's way of running things won't be as good as their way.
- Many seniors are concerned about their own long-term financial security, which sometimes causes them to postpone transferring control until it's too late.
- Many juniors who enter the business don't have sufficient humility to know what they don't know.
- Many juniors pursue change for change's sake, and end up tearing down the structures on which the business was built.

## Establishing Boundaries

Members of a family business are likely to disagree on the extent to which family interests should be allowed to intrude into the business.

Family members must also work to prevent entrenched family expectations from entering the workplace. For example, if the family has a history of dismissing Junior's ideas around the kitchen table—because age and experience are all that count when debating ideas at home—his good business ideas may be dismissed just as arbitrarily around the conference table. When this happens, he is apt to question his value to the business, and may decide to leave.

Family workers should be held to a higher standard than non-family workers

## Expectations for Performance

In well-run family businesses, family members are held to higher standards than other workers because of the stewardship obligation that comes with ownership. Although this is usually an unspoken principle, it's intuitively understood by family and non-family employees alike, and is one of the unique strengths of a family-owned business.

Employee morale suffers when family members are hired and promoted without meeting or exceeding the skill and education levels required of non-family employees. A child who receives favored treatment may find that non-family employees are less likely to take him or her seriously.

Many family businesses deal with this problem by encouraging younger family members to work elsewhere before entering the family business. (Sometimes this becomes a formal policy called a **rule of entry**.) After building a solid track record working for somebody else, they're able to enter the family business with more skills, wisdom, and credibility.

It's a good idea to create and communicate rules of entry and exit as early as possible, so family members know that the rules are fair, and exist to ensure the well-being of the business. For example, if family members who leave the business know that they must sell back their stock, or that a college degree is a prerequisite for entering management, everyone knows the score in advance, reducing the likelihood of conflict.

*The bickering at Frostbite was getting disruptive. So why didn't Ellen tell her sons to shape up or ship out? Legally, she couldn't. They were equal partners!*

*It had happened in her lawyer's office. She wanted to bring Robert and George into the business, and while they were working out the details, the lawyer asked Ellen how she wanted to structure the ownership of the corporation. A lot of things went through her head. She knew she couldn't give one brother more power than the other...that would be a disaster! They had to have equal amounts. But how much?*

*Then, as though she were slicing a cake at a birthday party, she said, "We'll split it three ways. That's fair."*

*Her lawyer was surprised, and privately confided his misgivings to her. But she'd said it in front of Robert and George, and as far as she was concerned, that settled it.*

*Two years later, the conflict between Robert and George was threatening to destroy the business. Worse, other employees were getting sucked into it, as the brothers jockeyed for position and tried to make alliances.*

*Ellen had to do something. But what more could she do? She'd always tried to be fair. She'd never played favorites, and had always been even-handed. She didn't take sides in arguments, and had always had faith in the ability of rational people to work things out.*

## Managing by Communicating

Successful management of a family business depends on how well the younger and older members manage their communications within the family, within the business, and with non-family employees. Precisely because the leader of the business exercises ultimate authority, he or she must be a good listener so that all perspectives get a hearing when important issues arise. It all boils down to MBC—Managing By Communicating.

### Conflict Must Be Dealt With, Not Avoided

Don't avoid conflict... manage it!

Conflict can be healthy. Avoiding it can harm both the family and the business. MBC requires candid discussion of disagreements. If Dad fails to deliver an objectively negative assessment of his son's lackluster work performance because he doesn't want to hurt his child's feelings, the son won't be able to grow in the business.

## Transparency

As a general rule, entrepreneurs like to keep important information to themselves. And in many cases, this is a wise strategy.

But in a family-owned business, one of the most important parts of communication is *not* keeping secrets. Withholding information from family members almost always causes more problems than it solves. Not only does it communicate your mistrust of the people from whom the information is withheld, but it also gives rivalrous family members a weapon to use against each other. In many cases, rumors and suspicions turn out to be much more disruptive than the truth. Furthermore, it takes work and energy to keep secrets, and that effort would be better spent on communication and resolving problems.

Whenever possible, share information with the spouses and children of family employees

With all that in mind, here are some tips on improving transparency.

- **Share compensation information.** It's best for everyone to know how much other employees are earning, and why. In addition to building trust, it prevents the owner from falling prey to the temptation of basing compensation on emotional or family-related issues (e.g., giving a little extra "help" to a family member who's having a hard time, or boosting a child's pay in order to keep him or her tied to the business). If you're worried that people will find out how much you're paying a family member, that's a sign that you're running your business badly. Your compensation decisions should always be able to stand up to scrutiny.
- **Keep non-employee family members in the loop.** Whenever possible, share information with the spouses and children of family employees. When information really must be withheld, don't play favorites: make it clear that there is a blanket policy that applies to all non-employees. But at the same time, remember that you're asking employees to withhold information from the people who are closest to them, and consider the effect it may have on these relationships. Is it realistic to believe that the secret will be kept? Can you afford to have a family member's spouse or child resenting you and the business? Will you gain more than you lose by keeping secrets? Always ask yourself these questions before excluding a family member.
- **Don't ignore problems.** Many families function by leaving important or painful things unsaid, in order to "keep the peace." This rarely works in family life, and it never works in a business. If your business is to succeed, conflicts must be addressed and resolved. An outside mediator can be very helpful in this process.
- **Acknowledge the different roles that family members play.** One of the difficulties of running a family business is that members aren't always sure of the context in which communication takes place. Are you talking to your son as a parent, or as the CEO? Are you angry about a lost shipment, or because your daughter let your grandson get a tattoo? Separating personal feelings from business issues will make it easier to play the right role at the right time, and prevent family employees from feeling that they're being criticized for something other than job performance.

Make sure the next generation has been adequately prepared for succession

## Planning for Succession

Studies show that roughly 40 percent of family-business CEOs have no succession plan. This is a recipe for disaster! If you're a senior family member and have ownership, you have a duty to initiate this planning. Make sure family members participate, and that the next generation has been adequately prepared for senior management positions. All family members and non-family employees should understand the rationale for the choice.

Of course, working out a formal succession plan will go smoothly only if family relationships were managed properly during the early years, long before the attorneys and financial planners are called in to hammer out the details.

The founder and other members of the senior generation need to understand that they have to pass the baton of leadership at some point. They may be reluctant, especially if they really enjoy their work. Also, most of them know that their kids won't run the business the same way they did. And for many, "not the same" means "not as well."

It's not pleasant to address one's own aging and mortality, but to transfer a family business from one generation to the next, it's essential.

### Planning for Financial Security

Seniors who depend on the success of the business for their post-retirement livelihood need a plan that provides the necessary safeguards for themselves, while giving the younger generation sufficient operational control over the business. Some retiring owners do this by maintaining control at the board level, transferring their voting shares to children in the business over a period of years. In other cases, the seniors may receive preferred stock with fixed dividends, or retain company real estate with a long-term lease to the company.

*During a particularly bad scene in Ellen's office, Robert pointed at his brother. "I'm doing his job and mine," he yelled. "He's trying to land the Luxor as a client, which will never happen, and I'm stuck here holding everything together!"*

*"He's always been like that," countered George. "Thinking small. No ambition."*

*Later, Ellen described the argument to her operations manager, Dave.*

*"Who's right?" Dave asked.*

*Ellen was taken aback. "What do you mean?"*

*"Robert says George is wasting time trying to make deals with big casinos. George says Robert's not ambitious enough. Who's right?"*

*She'd never looked at it that way. Finally, she said, "I don't think we're in a position right now to go after big casinos."*

*Right then, something clicked. She realized that in every conflict between her sons, she'd been neutral. They were coming to her for answers about business questions, and she was refusing to take sides, just as she'd always done. No wonder they were frustrated!*

### Planning for Life Outside the Business

Planning for the post-management years should be just as important to retiring seniors as their financial planning. The succession is more apt to go smoothly when seniors have something to occupy their time after leaving the business. Before retirement, they should cultivate outside interests, and experiment with different hobbies and activities. Those who don't wish to exit the company completely may choose to stay on as an advisor or consultant, while others may launch a new career altogether. If the family has created a charitable foundation, involvement in philanthropy is another option.

### Whose Job Is It to Plan for Succession?

A succession plan isn't something that owners can simply turn over to their attorneys, accountants, and financial planners. Although these specialists are important, the plan deserves the owner's serious attention. Family members and key non-family employees should be involved as well.

The children especially should be consulted about the plan. When the owner neglects to include members of the younger generation in this planning, he or she risks having the business controlled "from the grave." Successors then have very little choice but to accept the business as it was left to them.

By incorporating the younger generation's ideas into the final plan, the owner can rest more easily, knowing that the responsibility for the future of the business has been shared.

Outside advisors can offer objective judgments about the company's future

### How Outside Advisors Can Help

Outside advisors and consultants can provide an objective view of the skills and experience successors will need, given the company's future direction. They stand apart from both the business and family systems, so they're less likely to play favorites, and can help ensure adequate representation of conflicting interests. By contrast, family members usually have vested interests to protect when it comes to determining the successor.

Another advantage of involving outside advisors is that parents are spared the painful dilemma of having to choose the successor from among several children. An objective judgment from non-family advisors may lessen the disappointment of those who are passed over for succession.

If you decide to establish a board of advisors made up of experienced individuals who provide occasional advice—but lack the authority and legal responsibilities they'd have as directors—you must be certain you receive unbiased, objective opinions. As regards succession planning, advisors should have no financial stake in the outcome.

Above all, your advisory group should focus on the long-term interests of the company. If you decide that compelling family needs come first—which could mean having to make sacrifices in the business—you will at least have had the independent views of unbiased outsiders to aid in this decision.

### Prepare the Younger Generation

For most members of the younger generation, preparing for a new leadership role means learning, which also means learning from mistakes. Owners should give their children increasing amounts of authority over time. With each accomplishment, they should get more authority.

It's usually better to give too much control than too little

There's an important difference between giving members of the younger generation more authority and responsibility because they insist on it, and giving it based on demonstrable achievement. Still, when in doubt, it's better to err in the direction of giving too much control, rather than too little. This means that the senior generation must feel comfortable relinquishing a certain amount of control before succession. This also means allowing the younger generation to fail, and thus learn from their mistakes.

Younger members of the family need not stand idly by, waiting for new responsibilities to be thrust upon them. Instead, they should seek new responsibilities whenever possible. This doesn't mean getting involved in a power struggle. Rather, younger members should make their case for taking charge by bringing forth a careful plan for change, backed up by innovative ideas and compelling arguments.

### Develop New Designs for Succession

Owners are coming to understand the advantages of innovative new designs for succession. For example, passing the business to the eldest child, which had been the prevailing succession pattern, is no longer an automatic decision. One solution that has worked for a number of companies is to hire an interim CEO—an experienced non-family outsider—to run the company and mentor younger family members until they're ready to take control.

The "president for life" pattern of tenure that characterized most family businesses in the past is also changing. Some owners decide that they're ready for a change well before the normal retirement age. In most organizations today, the average tenure in a managerial job is four to seven years. While this is not true of every family business owner, it's becoming an increasingly popular option. Of course, this means that the senior generation should be working on a succession plan and preparing the next generation sooner rather than later.

What happens if the evaluation of two or more children who are active in management turns out to be a toss-up—just too close to call? Both may be equally eager to run the business, and both may be equally qualified. Although the rule against having a divided leadership is standard wisdom in mainline organizational practice, co-successor strategies—often called "co-presidencies"—sometimes work out well. One of the successors gets the title and responsibilities of CEO, while the other assumes the duties of president. In other cases, several family members constitute the "office of the president," all sharing equally in the exercise of control.

How well this works out depends on how well the individuals get along; sibling rivalries, for instance, may preclude this type of arrangement. Yet there are also many cases in which sisters, brothers, and cousins with a good work relationship based on love, trust, and mutual respect can easily work together as co-successors.

## NxLEVEL® TECH TIP

### BUSINESS RESOURCES AND THE WEB

Here are a few Internet resources geared specifically to family businesses.

- **Fambiz.com** (www.fambiz.com) features hundreds of articles on family business issues, many of which are also pertinent to more general entrepreneurial concerns. This site also has many links to other family business Websites, and extensive news archives.
- **Family Business** (www.familybusinessmagazine.com) is a popular magazine dedicated to advancing family business. Its site includes family business planning tips and a bookstore. You can also sign up for an e-newsletter.
- **The Family Firm Institute** (www.ffi.org) is "the premiere international body for advising and research in the family business and family wealth fields." Nearly 75 percent of its members are advisors or consultants in family business or family wealth. The FFI also publishes *Family Business Review*, and an online journal called *FFI Practitioner*.
- **UMass Family Business Center Online** (www.umass.edu/fambiz) bills itself as "The World's Largest Free Family Business Resource." It offers hundreds of free articles, as well as networking opportunities and a "family business advice column" that provides answers to selected questions from readers.

*Ellen sat her sons down and explained to them that in trying to be fair, she'd been unfair. She told George that Robert had been right: selling to casinos in Las Vegas was not an option at that point, and existing contracts were suffering from his focus on it.*

*To her surprise, George agreed.*

*She talked about the past, too, because she'd never done it before and it seemed like the right time. It was hard at first, but it got easier, and she felt better for having done it.*

*Did things change overnight because of this conversation? No. But they felt more manageable. And over the next few months, the tension gradually ebbed.*

*Robert and George understood that they knew far less about the business than Ellen did, and as she became more assertive they became more accepting. They realized, eventually, that part of the tension had come from trying to excel at a job they hadn't really grown into.*

*And for his part, George realized that he'd never really wanted the sales job in the first place. He'd simply felt that if Robert had it, he had to have it too. Eventually, he agreed to work on accounting and financial planning issues, and leave the day to day management to Robert and Ellen.*

*Ellen also decided it was time to do a formal business plan, so that everyone would know the why and how of running the business. Both boys learned a lot from this experience, and discovered that they actually agreed on many issues.*

*One year later, the Wringham family and its business are both doing well!*

### Communicate the Succession Plan

Passing the baton from the older to the younger generation involves more than just the drafting of a formal succession plan. It begins much earlier, and involves both generations in a process of communication and learning as preparation for the eventual transfer of control.

When the time for passing the baton finally arrives, you need to communicate the succession decision in the right way to your children, other relatives, and non-family managers. Bear in mind that no matter how rational your plan is, and no matter how objective the assessment process was, some relatives and employees will be disappointed.

MBC can make the difference between success and failure

Here, too, MBC can make the difference between success and failure. Even though you've put the company in the right hands and have used the right estate planning tools, you must still communicate the decision in a way that will preserve goodwill among family members and non-family employees.

## Conclusion

All family members in the business, both the senior and the younger generation, share responsibility for creating a professional business environment. This means balancing the expectations appropriate for family relationships and the criteria appropriate for business decisions. Success in this collaboration between seniors and the next generation will determine whether the current owners will be able to pass the baton to the next generation, and whether the younger members will be prepared to accept the baton and run with it.

Above all, it's important that family members candidly discuss their concerns and decide how to set the boundaries between the two systems. If they neglect to do this at an early stage, they risk real trouble when it's time to create a succession plan. Communication is the key!

# Chapter 9
# EXPORT AND IMPORT

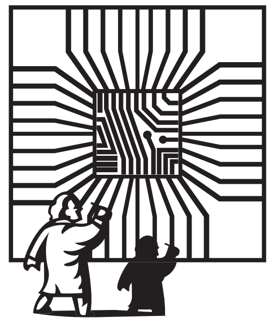
*About This Chapter:*
- *What is globalization?*
- *Evaluating export markets*
- *Meeting environmental standards*
- *International sales and distribution*
- *Getting paid*
- *Shipping and documentation*
- *Export financing*
- *Becoming an importer*

## Introduction

Until recently, the prevailing wisdom was that international trade was strictly for larger firms that could sell enough to justify the effort and expense. Today, globalization and e-commerce have changed everything, and small businesses are finding profitable and exciting opportunities all over the world.

Here are some benefits of going global:

- Foreign sales may result in higher profits, or solve seasonal cash flow problems
- New markets may have few or no competitors
- New markets may extend a product's life cycle, or present opportunities for new or improved products



New markets present opportunities for new or improved products

That said, international trade is not for everyone. To succeed, you need to have exceptional selling, negotiating, and management skills, and plenty of flexibility and patience. Here are a few potential pitfalls to consider:

- Focus on international business may hurt domestic business
- Promotional materials, manuals, e-mails, and Websites may need to be translated
- Product may need to be modified to meet foreign standards
- Legal disputes may be difficult or impossible to resolve
- Payments may take longer
- You may need to apply for special export licenses
- It may be difficult to obtain and enforce intellectual property protections
- Political, social, or economic instability may affect sales or payments

This chapter will help you to understand the skills that exporters and importers must have. It also explains where to get the expert help you'll need if you decide to go global.

## What is Globalization?

In the broadest sense, "globalization" refers to the convergence and homogenization of global culture, communications, economics, politics, and technology. Homogenization is central to globalization, in both ideological and practical terms. It begins with the assumption that people's needs and demands are converging, and concludes that you can profitably build a McDonald's in Beijing as well as Omaha.

Factors that fuel the advance of globalization include:

- **Logistical innovations.** Examples include containerization, intermodal transportation systems, and the hub-and-spoke organization of air transportation.
- **Computerization.** Without small, powerful computers, many of the efficiencies that businesses realize today—like the integration of assembly lines with order processing systems—would be impossible.
- **Communications.** In the late sixties, it wasn't possible to dial Tokyo or Paris directly from major US cities. Today, we chat with people all over the world, on cell phones that can also access databases, and send e-mail and digital media.
- **Re-engineered, extended supply chains.** Success in the global marketplace requires viewing all parts of the supply chain as an integrated whole.

Globalization is defined by these trends:

- The building of a global infrastructure
- Global harmonizing of commodities and standards
- De-emphasizing borders

How do you build a global infrastructure, and what does it entail? Some of the engines that drive globalization are **multinational corporations (MNCs)**, **transnational media organizations (TMOs)**, **intergovernmental organizations (IGOs)**, and **nongovernmental organizations (NGOs)**.

Some MNCs have financial and technological assets greater than those of most Third World nations. As they do business around the world, they generate wealth, transfer knowledge and technology, establish new commercial and social channels, and change political and economic environments. TMOs facilitate these changes by communicating ideas and images instantaneously and globally.

### Globalization and Law

Traditionally, each sovereign nation has been at liberty to develop its own laws governing economic and public health issues. Globalists view this situation as a legislative Tower of Babel. Critics counter that the basic principles of self-determination and democracy give each country the right to tailor its laws and standards to its own cultural, economic, and political needs.

Globalists favor a single, planet-wide standard to which everybody owes compliance. For example, trade standards are set by the World Trade Organization (WTO), and the WTO court adjudicates conflicts. In their vision of the future, the WTO regime would be universal and mandatory. This vision is rejected by those who place a higher priority on self-determination, and all it entails.

### Coping with Globalization

Small businesses create the majority of jobs and diversity in our nation, and take the lead in innovation. Therefore, anything that's bad for small business is bad for the United States. The same rule is likely to hold true for the global economy.

Even the most optimistic globalists concede that globalization brings with it a risk that large companies will squeeze small businesses out of local markets. However, things aren't quite that simple! A dominant corporate culture brings with it entrepreneurial niche markets that are not only viable, but lucrative and sustainable. Web-based businesses that take on global niche markets are just one example.

The most successful small businesses tend to be open, transparent, accountable, and flexible. By developing and capitalizing on these qualities in your dealings with foreign consumers and business partners, you can achieve win-win results that will give you a strong competitive edge in the global marketplace.

Successful small businesses tend to be open, transparent, accountable, and flexible

### Trading Blocs and International Organizations

Trading blocs allow for less restrictive trade between member nations, which are usually geographically close. There are four primary types of trading blocs:

- **Free trade areas** trade freely amongst themselves, while maintaining barriers with other countries. NAFTA is the most famous example.
- **Customs unions** have some degree of unification of custom or trade policies. A **common external tariff (CET)** applies to countries outside the customs union.
- **Common markets** are similar to customs unions, with the important difference that they allow unrestricted movement of labor and capital between member countries. The South American trading bloc Mercosur is an example.
- **Political and economic unions** are similar to common markets, but with a higher level of integration between member states. The European Union (EU) is the best example.

#### *World Trade Organization (WTO)*

The WTO (www.wto.org) is located in Geneva, Switzerland. Since it's global in scope, it can't really be thought of as a trading bloc. It has some authority, ceded to it by its members, as an enforcer of trade agreements. It also acts as a continuing forum for member countries to negotiate further reductions of tariffs and other trade barriers.

You can find an evenhanded, politically neutral look at the WTO online at **www.soyouwanna.com/site/pros_cons/wto/wto.html**.

*European Union (EU)*
The EU is a political and economic union comprising 27 member states. Although it's authorized by member states to enact laws and pursue common economic and social policies, individual member states remain sovereign in certain areas. You can visit the EU's Website at **europa.eu.int**.

If the EU were a country, it would be the world's third-largest by population, after China and India. In 2008, the EU had the world's largest economy, with a GDP of $15 trillion.

A single market is less complex than having to deal with each country's laws and regulations

If you're thinking about selling to the EU, the single market is less complex than having to deal with each country's laws and regulations. Still, you'll need professional help from export marketing companies, freight forwarders, agents, and lawyers with expertise and connections in the EU.

*North American Free Trade Agreement (NAFTA)*
NAFTA groups Canada, the United States, and Mexico into a free trade area. While it remains controversial in all three countries, NAFTA does present many lucrative opportunities. With proof of origin of your product within a NAFTA country, you can take advantage of low preferential tariff rates.

NAFTA is supervised by the NAFTA Secretariat (www.nafta-sec-alena.org). Its physical offices are located in Ottawa, Mexico City, and Washington.

*Asia-Pacific Economic Cooperation (APEC)*
Established in 1989 as an "informal dialog group," APEC comprises 21 countries in a consultative body. From the US perspective, its importance grew when President Clinton took a personal interest in using it as a vehicle to promote free trade in the Pacific. One of its main accomplishments has been lowering the cost of business transactions. APEC includes all heavyweight national players on the Pacific Rim, including Australia, Canada, China, South Korea, Japan, Singapore, Taiwan, and the United States. APEC is online at **www.apec.org**.

*Association of Southeast Asian Nations (ASEAN)*
Set up in 1967 to promote stability and economic growth in Southeast Asia, ASEAN was seen as part of the Cold War struggle against communist expansion in Southeast Asia. Having survived its original context, it now functions more as a trade group. ASEAN has a population of about 500 million, a combined GDP of $737 billion, and a total trade of $720 billion. ASEAN has plans to create an economic community by 2015.

The United States and ASEAN operate a joint project called the Alliance for Mutual Growth (AMG), which is designed to develop business opportunities in each other's markets. ASEAN's site is at **www.asean.org**.

*Southern Common Market (Mercosur)*
Mercosur is a free trade zone comprising Brazil, Argentina, Uruguay and Paraguay (Bolivia, Chile, Colombia, Ecuador, Peru, Mexico, and Venezuela are associate members). Mercosur is the world's fourth-largest economic entity, after the European Union, the

United States, and Japan. As of 2009, it had about 267 million consumers and boasted a combined GDP of almost $3 trillion.

In 2004, Mercosur merged with the Andean Community trading bloc to form what is now known as the Union of South American Nations (UNASUR). In addition to eliminating tariffs by 2019, it intends to model itself on the EU by creating a common currency, parliament, and passport.

*Greater Arab Free Trade Area (GAFTA) and Gulf Cooperation Council (GCC)*
GAFTA formed in January of 2005, as the result of efforts by the Arab League to form an economic bloc of all Arab nations. In 2008, some members of GAFTA (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates) formed the GCC common market, eliminating all barriers to cross-country investment and trade.

*The United Nations Family of IGOs*
Conceived of as a collective security organization in the aftermath of World War II, the United Nations affects many spheres of international activity. The UN bodies with the most impact on trade include:

- **World Bank group.** This includes the bank itself; the International Development Association; the International Finance Corporation; the Multilateral Investment Guarantee Agency; and the International Centre for Settlement of Investment Disputes. All are accessible online via **www.worldbank.org**.
- **International Monetary Fund (IMF).** The IMF (www.imf.org) is a restructuring regime that lends money to developing countries. The conditional loans of the IMF generally involve forcing down interest rates, severe governmental spending cuts, and increased trade liberalization.
- **World Intellectual Property Organization (WIPO).** The WIPO (www.wipo.org) is dedicated to protecting intellectual property.

Another way in which UN agencies impact trade is in overseeing international agreements on specific topics such as child labor; shipping safety and anti-pollution requirements; and civil aviation standards. You may be indirectly affected by such oversight through US government implementation of agreements to which it is a party.

International treaties and agreements may affect your business

*Other International Governmental Organizations*

- **World Customs Organization (WCO).** The WCO (www.wcoomd.org) has established a classification of commodities for the application of customs tariffs.
- **International Chamber of Commerce (ICC).** The ICC (www.iccwbo.org) governs the conduct of business across borders.
- **Organisation for Economic Cooperation and Development (OECD).** The OECD (www.oecd.org) is a forum in which 30 member countries develop economic and social policy. Some meetings lead to formal agreements (e.g., legally binding codes for free flow of capital, and agreements to crack down on bribery).

- **Permanent Court of Arbitration (PCA).** The PCA (pca-cpa.org) offers a broad range of services for resolving disputes between states, disputes between states and private parties, and disputes involving intergovernmental organizations.

### Nongovernmental Organizations (NGOs)

The United Nations uses the term "NGO" to distinguish nongovernmental political and advocacy groups from those allied with government. The origins of today's NGOs can be traced to the anti-slavery movement of the mid-nineteenth century, in particular the World Anti-Slavery Convention, which was founded in 1840. Another early NGO was the International Committee for the Red Cross, which was founded in 1863.

Today, NGOs take positions of advocacy for every conceivable issue, and operate in virtually every part of the globe. According to one estimate, some 30,000 groups now qualify as internationally active NGOs. Some of them are hostile to certain types of business, while others seek to work with entrepreneurs as partners. Either way, they are an important factor driving social and political change.

*Julia Patterson had her second daughter in the fall of 2007. By the following summer, she was back at her full-time job as a graphic designer for a Web development agency in Hillsboro, Oregon.*

*After four months back at work, she began to feel the pull of her family. She wanted to be both a businessperson and a mom, but commuting to work each day from Portland made it impossible. She started thinking about starting a home-based business.*

*The same interest in design, patterns, and colors that made her a successful designer also fueled her interest in textiles. Julia was an avid collector of Mexican blankets, Russian shawls, Provençal napkins, and Indian print cottons. But her favorite type of fabric was the hardest one to find in the United States: Indonesian ikats. Their scarcity reinforced an idea that had already begun brewing in her mind: she'd import ikats for home decorators and trade buyers.*

## Evaluating Export Markets

Are other countries ready for your product? Start by considering these factors:

Is your target market large enough to generate the revenue you need?

- **Unmet needs.** Is there a need for your product that isn't being met by domestic or international competitors? Is your target market large enough to generate the revenue you need?
- **Familiarity.** Are you selling something people already know about and appreciate, or will you need to educate consumers?

- **Income level.** Is your product a necessity or a luxury? Can people in your target market afford it?
- **Competition.** Who is your foreign and domestic competition? How and where do they sell? How does your quality and price compare to theirs?
- **Capacity.** Does your target country have the infrastructure to support your product? Consider transportation, roads, electrical systems, refrigeration, phone lines, water scarcity, and so forth.
- **Alternative uses.** How do people in your target country use your product? Is another type of product meeting the same need, resulting in "hidden" competition?

Next, consider your own abilities and resources.

- **Ability to adapt.** Does your product require adaptations to foreign safety, quality, technical, or cultural standards? Does the cost outweigh potential benefits?
- **Commitment.** Can you commit to exporting, given that your investment in time and resources may not pay off for years?
- **Knowledge.** Are you familiar with the culture, laws, and business practices of the foreign market? Do you speak the language, or have a trusted employee who does? Do you have relatives, friends, or business partners living in your target country?
- **Capacity.** How many markets or countries will you initially target? Are your goals realistic? What is your plan for growth? Do you have adequate facilities, personnel, and capital to meet the demand of additional sales? Can you afford to take foreign business trips, some of which may be necessary on short notice?

## Topics To Research

### *Product modifications*

Doing business in foreign markets may require you to modify your product in a number of important ways:

- Language changes to labeling and packaging, or conversion to the metric system
- Different electrical standards
- Different environmental or technical standards
- Different sourcing of raw materials
- Local preferences such as color, texture, and graphics

You also may need to redesign your product to conform with specific technical requirements. For instance, the European Union's CE Mark signifies compliance with European health, safety, and environmental standards. Products that require a CE Mark include toys, machinery, and electronic goods. You can find more information at **www.export.gov/cemark/index.asp**. Many other countries have similar systems.

Does your product require adaptations to conform with foreign safety, quality, technical, or cultural standards?

*Export controls*

In the wake of 9/11, there are stricter laws governing export of "dual use" products that can be used in a military or terrorist capacity. You'll have to comply with the Export Administration Regulations (EAR) of the Department of Commerce. In addition, you must comply with embargoes, border control measures, and antiboycott regulations. For more information on these regulations, visit **www.bis.doc.gov**.

- **Trade restrictions.** The US State Department maintains a list of individuals, entities, and countries with whom you may not do business.
- **Border control.** Customs regulations and inspections are more strict for some exporters and importers. For instance, under the Bioterrorism Act of 2002, food products face new import hurdles.
- **Antiboycott laws.** Some foreign buyers may want you to make certain representations as to the source or content of your goods (e.g., a statement to the effect that no ingredient of your product comes from Israel). Penalties for complying with these requests can be serious.

You may need to set up an **export management and compliance program (EMCP)** to guide your compliance efforts. See **www.bis.doc.gov/complianceandenforcement/emcp.htm** for details.

You must research and comply with all regulations of your target country

Note that you must also research and comply with all import regulations and restrictions of your target country.

*Cultural considerations*

There are countless cultural issues to consider when doing business in foreign countries. Gestures and body language mean different things in different places. Colors that generally appeal to Americans may have very negative associations elsewhere. In addition to time zone differences, the perception of time and the importance of punctuality can vary a great deal from country to country. Therefore, you must pay close attention to the ways in which business is conducted in other countries. You should talk to experienced exporters, and visit target countries and companies in person.

For a fee, a **localization** service can help you to adapt your products and Website to foreign standards.

*Distribution*

Some countries don't have the distribution capabilities you're used to in the United States. Loads may have to be broken down into smaller quantities and distributed by light rail, pickup truck, or hand cart. Check the capabilities of carriers in the country to which you plan to ship, and plan your shipments accordingly.

*Tariffs*

**Tariffs** are taxes imposed on imported goods. Unless you're trading with Canada or Mexico, or in markets in which similar trade agreements apply, they can raise the price of your goods to the point that they're no longer competitive.

*Pricing*

Pricing is one of the trickiest parts of exporting. A price that's ideal in one market may be outrageous in another. Also, you face additional expenses when exporting, such as:

- International market research, advertising, and marketing
- Export distribution fees and sales commissions
- Translation and localization services
- Product redesign and repackaging
- ISO or other certification
- Consulting, accounting, and legal fees

You must also consider the costs of getting your goods to the foreign consumer, which may include:

- Shipping and documentation
- Insurance certifications and policies
- Hazardous materials fees
- Packaging recovery and waste management fees
- Freight forwarder, customs broker, and other fees
- After-sales services

A prime research objective in each of your foreign target markets will be to obtain information on local prices. You might find this information online, or by contacting distributors and agents for similar products. Of course, the best way to do this is by visiting the countries in which you want to do business.

You will need to find information on local prices in each of your foreign target markets

### Conducting Market Research

Market research can be tough even in one's own country, where regional and economic differences—even within a single state—can be profound. It can be very hard to find out what's important to customers in a different country, but this is precisely what you must do to be successful.

The first step is to identify the Harmonized System (HS) code for your product. These codes are available from the National Trade Data Bank (NTDB). Having this code will help you to find valuable export market data, as well as information on any tariffs that will apply. You should also know your product's Standard International Trade Classification (SITC) code, which will help you to access international data.

Once you have these codes, you should start researching prospective countries. Look for countries that have a significant market for your firm's products, and assess the growth of that market over the past three to five years. You should also consider smaller countries that may have unmet needs or fewer competitors. Once you've identified five to ten promising countries, choose the best three for further research.

Can you afford to price your product competitively?

As detailed in the previous pages, you'll need to consider direct and indirect competitors (foreign and domestic), economic factors and income levels, demographic and psychographic trends, distribution and infrastructure, legal restrictions, cultural standards and expectations, localization issues, tariffs and other trade barriers, shipping costs, recycling fees, and US export controls and incentives. Having done all this, you'll need to decide whether you can price your product competitively in your target country.

If you don't find the ideal country right away, don't despair. There may be other very attractive markets that you overlooked on the first pass. And the research process will become easier as you get more familiar with it.

*Sources of market research data*

Thanks to the Internet, researching foreign markets is easier than ever before. Much of the information you need may be readily accessible online. Furthermore, there are plenty of public and private experts who can help you with the market research process.

A more expensive—but sometimes necessary—option is to hire a market research company in your target country.

- **US Commercial Service** (www.export.gov) offers country and industry reports, Webinars, and Webcasts. You can also get customized market research and due diligence reports for a fee. In addition, the USCS Market Research Library contains more than 100,000 industry and country-specific market reports. You must register with Export.gov to access this resource.
- **US Trade and Development Agency** (www.ustda.gov) USTDA's mission is to help US businesses expand their reach into global markets. It provides conferences and orientation visits that provide US exporters with the opportunity to meet personally with foreign decision makers.
- **National Trade Data Bank** (**www.stat-usa.gov/tradtest.nsf**) compiles international market research, trade and procurement leads, Country Commercial Guides, and other useful documents.
- **Exporters' associations** usually provide education, tutorials, and research libraries for their members. The Small Business Exporter's Association (www.sbea.org) is a good example. You should also contact your state's nearest World Trade Center.
- **Trade associations.** There are thousands of US trade associations, and many of them provide assistance to members who wish to pursue international trade. For more information, visit the Federation of International Trade Associations (www.fita.org).
- **Chambers of Commerce** sometimes have staff members who are international trade specialists. If not, they may be able to refer you to an expert in your area.
- **Foreign embassy commercial sections.** It may be helpful to consult the Commercial Attaché assigned to your target country's embassy. Visit **www.embassy.org/embassies** for contact information.

## Meeting Environmental Standards

It used to be an article of faith that consumers were primarily concerned with price. Anything that caused prices to go up—such as removal of a toxic component, or higher safety standards—would cost a firm its competitive advantage.

Like most received wisdom, this belief doesn't stand much critical examination. Not only do countless consumers buy products for reasons that have nothing to do with saving money, but countless businesses are proving that it's very possible to improve the efficiency and safety of products while *reducing* costs.

It's very possible to improve the efficiency and safety of products while reducing costs

Recyclable or reusable products, and soaps that don't contain phosphorus, were once targeted at narrow niche markets. Now, they're common even in the largest chain stores. If you go into a chain drug store and look at the shampoos, you'll find many that say "This product is not tested on animals." It wasn't too long ago that no bottles said this, but objections to testing cosmetic and beauty products on animals became so widespread that most manufacturers felt they had to address them to remain competitive.

While environmentally conscious shopping decisions are common in America, other countries have gone far beyond this point. Environmental views that seem extreme to some Americans are mainstream in many parts of the world. In this section, we'll look at a few of the standards, policies, and agencies that may affect US exporters.

### Extended Producer Responsibility (EPR)

EPR requires producers to take back spent products so that they either can reuse, recycle, or remanufacture them. EPR can also mandate that manufacturers change packaging, ingredients, and disposal methods to meet environmental standards.

The underlying philosophy of EPR is that placing responsibility for waste management on producers creates an incentive for them to design products with a low environmental impact, instead of creating a costly disposal and public-health problem for taxpayer-funded municipalities, or the developing countries to which waste materials are frequently shipped for processing.

By shifting the burden of these external costs from government to private industry, EPR laws oblige manufacturers either to rethink their production processes, or to set a price that more accurately reflects the cost of doing business. This is also known as the **polluter pays principle**.

The concept is increasingly popular in the United States. As of 2009, 19 states have adopted EPR laws that require manufacturers to pay for the collection and recycling of electronic products including TVs, computers, keyboards, printers, fax machines, and DVD players. Similar laws are pending in other states.

If you sell a product in Europe, the European Packaging and Packaging Waste Directive requires you to recover its packaging for reuse or recycling. Since most companies don't have the time or the inclination to recover packaging from foreign consumers, they normally pay a packaging recovery company to do the job for them. The cost of this arrangement varies according to the type and amount of material used, and by country. These costs may be passed on to the consumer, or they may be offset by savings realized from more efficient packaging or production.

In European countries, companies that pay a recovery company are authorized to use the Green Dot logo on their packaging, to signify that they are in compliance with that country's national packaging recovery scheme.

Although some American industry leaders are displeased with foreign EPR laws, it's worth taking a moment to consider the benefits of compliance:

Remanufacturing or refurbishing returned products may be less costly than building new ones, and may reduce production time

- Cutting production costs by using less packaging and materials
- The redesign process encourages innovation by challenging assumptions, thus offering opportunities to create attractive designs, novel branding strategies, and economies of scale. (A patent for an innovative, environment-friendly form of packaging might end up being worth more than your original product!)
- Remanufacturing or refurbishing returned products may be less costly than building new ones, and may reduce production time
- As American states and cities increasingly implement forms of EPR, compliance with stricter foreign laws may bestow a competitive advantage in domestic markets.

Here are some hints on meeting EPR packaging standards:

- Eliminate unnecessary packaging (e.g., an outer box)
- Change package shape to decrease package-to-product ratio
- Choose recyclable or biodegradable packaging
- Don't use composite materials that are difficult to recycle (e.g., thermoform blisterpacks)
- Use containers and caps made from the same material
- Ask your printer to use vegetable-, water-, and soy-based inks

### Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH)

REACH is an extremely complex EU law that regulates the production, use, and importation of chemicals in order to protect human health and the environment. Because it applies not just to chemicals themselves, but also to products that contain chemicals, it has the potential to affect most, if not all, businesses that export to EU countries.

REACH also identifies Substances of Very High Concern (SVHC), sets regulatory thresholds for products containing them, and requires manufacturers to seek environmentally preferable alternatives.

Gradual implementation of REACH began in June of 2007, and is expected to continue for almost a decade. In order to help businesses comply with REACH, the European

Commission has created a software application called the International Uniform Chemical Information Database (IUCLID), which can be used to collect, store, and submit information on chemicals. The program is available for free at **iuclid.eu**.

### Sustainable Manufacturing Initiative (SMI)

The Department of Commerce has launched this Initiative in order to help US manufacturers "make more efficient use of resources, ensure compliance with domestic and international regulations related to environment and health, and enhance the marketability of their products and services."

The Sustainable Manufacturing site at **www.trade.gov/competitiveness/sustainablemanufacturing/index.asp** provides access to a catalog of federal government programs that support sustainable manufacturers, and information on the development of metrics that will help industry and government to benchmark sustainable manufacturing programs. You can also sign up for regular e-mail alerts on SMI policies and processes.

### The International Organization for Standardization (ISO)

ISO is a worldwide federation of nongovernmental bodies from roughly 100 countries. It was established in 1947 to promote the development of technical standards that enable scientific, technological and economic cooperation. Suppose you use your ATM card in London to access your bank account back in Cleveland? The magnetic strip on back of your ATM card was developed by the ISO. Suppose you ship your widgets to Taiwan in a container that travels intermodally by truck, train, and ocean carrier from Omaha to Kaohsiung? The standards for the container were also developed by the ISO.

The ISO has developed two families of quality management standards:

- **ISO 9000** comprises a series of universal quality-management standards.
- **ISO 14000** covers measures that minimize adverse consequences to the environment. ISO 14001 sets forth the basic requirements for an **environmental management system (EMS)**, which is a program of continuous environmental improvement through cleaner production methods and **pollution prevention (P2)** policies. It's estimated that roughly 50 percent of the pollution generated in a typical plant can be prevented by making simple and cheap process improvements.

Roughly 50 percent of the pollution generated in a typical plant can be prevented by making simple and cheap process improvements

In addition, ISO 19011 combines the 14000 and 9000 series into a single protocol that guides the auditing of quality and environmental management systems. This has the potential to streamline operations, save time and money, and avoid duplication of effort.

In order to do business globally, it's increasingly necessary for enterprises to become ISO-compliant, which requires help from an accredited auditor and registrar. The ISO has prepared a useful book called *ISO 9001 for Small Businesses*, which you can purchase through their Website (www.iso.org). Books on ISO 14000 and 19011 are also available.

## International Sales and Distribution

Your choice of entry strategy depends on your product, your resources, and the economic, political, and cultural environment of your target country.

### Direct Exporting

**Direct exporting** ranges from selling to the consumer through a foreign office, Website, or catalog; to establishing a relationship with an importer or foreign distributor. It lets you retain control of the product, and earns a higher profit margin than indirect exporting. However, you must assume all marketing costs, and take responsibility for shipping the goods.

- **Sales reps and agents.** Reps and agents work on commission. The two terms are often used interchangeably, but there's an important difference: agents are legal representatives of your company, and can make commitments on its behalf.
- **Distributors.** Unlike agents, distributors take title to your goods. Using a distributor means you'll lose some control of the product and earn fewer profits. That said, the distributor takes on local responsibility for sales and service, and may build business you wouldn't be able to create yourself.
- **Buying agents for foreign governments.** Foreign government agencies may have procurement needs, leading to opportunities for US firms.
- **Partnerships and strategic alliances.** Some foreign firms are looking for goods to complement existing product lines. They may also be interested in co-managing businesses that wish to combine their resources.
- **Retail and direct sales.** If you produce consumer goods, you may be able to sell direct to a foreign retailer, either through a sales rep, direct mail, or the Internet. Direct sales to end-users are another option. E-commerce is an easy and profitable choice for many firms.

Get legal advice before signing a contract with any foreign business partner!

Your agreement with any foreign business partner should address performance requirements, whether the arrangement is exclusive or nonexclusive, and other issues. Get legal advice before signing a contract!

*The best ikat suppliers were located on the islands of Bali and Java. Julia decided that if she were serious about launching her business, she'd need to visit them.*

*She booked her trip online, using Expedia.com. She searched for the best airfares to Surabaya, Java for the dates she wanted, and ended up getting a great deal on the same airline with which she had her frequent flier account. She booked a hotel in Surabaya for three nights, and a small guest house near Danpasar for five nights.*

*She downloaded flight schedules from Java to Bali, and even found online restaurant reviews for both islands. She also got general information about traveling in Indonesia from Lonelyplanet.com. She wanted to be well prepared, and get as much out of her trip as possible.*

*It was easy to find contact information for ikat dealers and manufacturers on the Web. From there, Julia began a daily routine of faxing and e-mailing prospective suppliers in Bali and Java. Many of them were able to correspond in basic English, and some were fluent.*

### Indirect Exporting

Many small businesses use intermediaries to deliver their products to foreign markets.

- **Export agents** usually work on commission, and thus don't take title to the goods. This allows you to retain control over your goods and avoid paying an in-house export staff. Although the commission does cut into your profits, agents may be able to help you with packing, shipping, and documentation.
- **Export Management Companies (EMCs)**. Most EMCs work on commission; others take title to the goods. EMCs will conduct market research; promote your product at foreign trade shows; locate foreign reps or distributors; negotiate export contracts; handle logistics; provide after-sales support; and give legal advice on domestic and foreign regulations. They can be pricey, but you can specify in your contract that you'll pay nothing until the first order comes in. In addition to the expense, you run the risk of losing control over marketing and service.
- **Export Trading Companies (ETCs)** are similar to EMCs. They usually take title to your goods and pay you directly, which eliminates a good deal of your risk. **ETC cooperatives** comprise exporting businesses who market similar products.
- **Foreign Trading Companies (FTCs)**. Trading companies outside the United States may wish to import your goods.
- **Repackagers** buy products for export and repackage them to meet the requirements of the target country. They reduce most of your risk, but you may lose control over foreign pricing and branding.
- **Piggyback exporting** means allowing an exporter with existing distribution channels to sell your goods.

### Gold Key Matching Service (GKMS)

Under this program of the US Commercial Service, in-country staffers match American exporters with foreign buyers and partners. GKMS is most commonly used in Latin America, Europe, and Asia. The USCS also offers a videoconferencing service that allows you to meet prospective business partners without leaving the country. To request this service, contact your local Export Assistance Center by visiting **www.export.gov/eac/**.

*Bali Ikat Ltd. was one of several textile mills that Julia learned about while traveling in Indonesia. It was recommended to her by an importer she'd chatted with while visiting the Surabaya Mall. The importer even arranged an introduction for Julia with the sales team at Bali Ikat.*

*Bali Ikat's sales agents were pleased by her letter of introduction from the importer in Java, and were surprisingly direct about discussing business. They were interested in developing long-term business deals with US importers like Julia. Better yet, they had relationships with carriers and freight forwarders in Indonesia.*

*After meeting a few times with Julia, Bali Ikat Ltd. offered her a complete package of export services. As a supplier and a broker, Bali Ikat would supply Julia with a selection of ikat textiles from their own factory, as well as partner manufacturers in other areas of Java and Bali.*

*By the time Julia got home, she was feeling very confident about her new business!*

## Getting Paid

Choosing appropriate payment methods and terms is crucial to your cash flow, and therefore to your success as an exporter. In addition to negotiating payment terms that are safe and appropriate for your business, you can minimize your risk by researching your customers thoroughly, and insuring yourself against defaults, currency fluctuations, and political risks.

### Methods of Payment

Here are some common methods of payment, along with their advantages and disadvantages.

*Cash in advance*

If your customer pays in full up front, there's no risk to you. However, buyers usually prefer not to pay cash in advance. If you insist on cash up front, you may lose sales to competitors.

If you insist on cash up front, you may lose sales to competitors

*Letter of credit (L/C)*

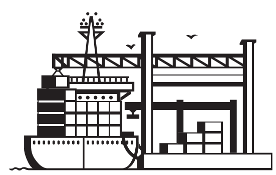
This form of payment allows a bank to substitute its creditworthiness for that of a buyer. An **irrevocable letter of credit** essentially eliminates all risk for an exporter, since the bank has committed to pay the invoice in the name of the importer. Since the L/C is a formal contract enforced by the bank, it protects both the buyer and the seller by making sure the terms of sale are met on both sides.

**Letter of Credit Procedures**

1. The exporter receives an order, and sends the buyer (importer) a pro forma invoice detailing the conditions of the transaction.
2. The importer takes this invoice to a bank and applies for the L/C.
3. The bank verifies the terms of the deal and makes a credit decision, then opens the L/C and sends it to the exporter's bank.
4. The exporter's bank authenticates the L/C and mails it to the exporter.
5. The exporter checks the pro forma invoice to ensure that the exporter can ship before expiration of the L/C, and that all conditions of the invoice are incorporated in the L/C.
6. The exporter prepares an invoice and packing list, with the help of a freight forwarder. These documents must be completed exactly as specified in the L/C. The exporter also prepares a shipper's letter of instructions (SLI), and any other necessary documentation (e.g., export license and certificate of origin).
7. The freight forwarder receives the goods and documentation in accordance with the terms of the L/C.
8. Once the goods are shipped, the forwarder or exporter submits the L/C and documents to the exporter's bank.
9. The exporter's bank verifies that the documents comply with the L/C, and forwards them with a draft and payment instructions to the importer's bank.
10. The importer's bank reviews all documentation and, if they meet the requirements, credits the exporter's bank and debits the importer's account.
11. The exporter's bank credits the exporter's account. At the same time, the importer's bank releases the documents to its customer. With these documents in hand, the importer can take possession of the goods.

*Drafts*

**Drafts** require the buyer to pay the full amount in accordance with specified terms. The buyer takes title to the goods after accepting or paying the draft. A draft is for all intents and purposes an account receivable, so the seller is essentially providing short-term financing, with all the risk that entails. Drafts cost much less than L/Cs for the buyer.



There are several types of drafts:

- **Sight drafts** are paid on presentation. If the buyer can't or won't pay, returning or disposing of the goods is the exporter's problem.
- **Time drafts** are paid a certain number of days after the buyer accepts the draft.
- **Date drafts** specify the date on which payment is due. When a sight or time draft is used, a buyer can delay payment by delaying acceptance. Use of a date draft can prevent this.

Drafts are less risky to the seller, because they create a written obligation to pay. However, if the buyer doesn't acknowledge or accept the documents, the exporter must absorb the cost of finding another buyer, or of having the goods returned. Drafts can often be sold, although only at a discount.

*Open account*
You should only consider selling under an open account if you have an longstanding relationship with a reliable trading partner. If you must sell on open account, be sure to specify the exact date on which payment is due.

*Consignment*
International consignment sales are much like domestic ones, except that they're even riskier. A consignment contract should establish which party is responsible for property risk insurance on the goods. Note that you'll be responsible for the cost of recovering unsold goods!

*Collection payment method*
In this method, the seller consigns the goods not to the buyer, but to the bank. The bank pays the seller for the goods, and in order to obtain them, the buyer must pay the bank for them. Of course, the goods also serve as collateral for the bank if the buyer defaults on the deal.

### Managing Risk
When you conduct business outside the United States, you run additional risks. This section discusses some of them, and offers suggestions on how to manage them.

*Assessing your customer*
Getting paid is one of the most common worries of new exporters, but the occurrence of payment default is actually fairly low in export trade. That said, carefully selecting customers and partners is essential, because pursuing collections or legal action across international borders may be expensive or impossible.

Choose your foreign customers and partners very carefully!

Begin by considering these questions:

- How stable is the currency of your customer's country?
- How stable is the government of your customer's country?
- Does your target country have a good credit history?

Next, you need information about your customer's ability and willingness to pay, and the willingness of your target country to allow payment in a convertible currency.

*Foreign credit insurance*
Foreign credit insurance offsets the inherent risks of exporting. You can obtain foreign credit insurance from many public and private providers. The Ex-Im Bank's Export Credit Insurance Program covers commercial risks, and certain political risks.

- **Commercial insurance** protects you against a foreign buyer defaulting on payment, or declaring bankruptcy (insurers usually demand that you try all reasonable means of obtaining payment before they'll honor your claim)
- **Political risk insurance** protects you against war, currency restrictions, and other disruptive political events

Some risks are not covered by credit insurance (e.g., disputes between the buyer and seller). Consult Ex-Im Bank, or a broker specializing in credit insurance, to learn more.

*Foreign exchange risk*
There are two primary types of foreign exchange risk:

- **Economic exposure** is the risk that your costs will rise due to fluctuations in the exchange rate, making your goods uncompetitive.
- **Transaction exposure** is the risk that the exchange rate will change unfavorably between initiation and completion of a contract. If this happens, your payment may be less than you expected.

The best way to avoid foreign exchange risk is to quote all prices in USD. Unfortunately, this isn't always possible, especially in markets where other exporters offer better terms. If you use foreign currency, you must minimize the risk of loss from exchange rate fluctuations. One way of doing this is by transferring your foreign accounts receivable to a **factor**, who handles them in return for a percentage of the proceeds. The cost of factoring varies according to the risk level of the transaction.

If you use foreign currency, you must minimize the risk of loss from exchange rate fluctuations

Another option is **hedging**, which locks in an exchange rate for the transaction. This is a fairly sophisticated technique that involves some cost, but it does eliminate the risk of unfavorable currency fluctuation.

For more information on hedging and other financial strategies, contact an experienced international banker.

*Other types of risk*
Your enterprise may need three additional types of insurance:

- **Cargo insurance** is for loss or damage to cargo during shipment. (The carrier's liability for loss or damage is limited by law, and by the terms of carriage.) Whether the buyer or the seller buys this insurance depends on the contract terms of the sale.
- **Product liability insurance** is for foreign claims that may arise against you. If your insurance applies only within the United States, it will not cover a foreign court's decision against you.
- **Workers' compensation insurance** covers you and your employees during business trips to your export markets. You'll need coverage that explicitly covers accidents overseas.

## Cross-Cultural Negotiations

International business negotiations are fundamentally different from domestic negotiations, and thus require a different set of skills and knowledge. There are seven important ways in which international negotiations can differ from domestic negotiations.

- **Multiple laws and regulations.** Negotiators are subject to the laws and policies of at least two countries.
- **Currency fluctuations and restrictions.** Since the relative value of different currencies fluctuates over time, the actual value of contract terms may change, resulting in sudden financial losses.
- **Political and economic turmoil.** Disruptive events—such as war, revolution, the rise to power of a new government, or currency devaluation—can have a shattering impact on international business agreements.
- **Government involvement.** In some countries, the government may be deeply involved in regulating how national businesses operate. In extreme cases, the business may be entirely state-controlled.
- **Ideological differences.** Foreign negotiators may subscribe to very different ideologies that inform their views on labor, globalization, private investment, profit, the environment, and human rights. In such cases, negotiators will have to present ideologically acceptable proposals.
- **Cultural differences.** Foreign businesses differ in the ways they value time, conduct business, and treat their employees and partners.
- **Language differences.** Even when your trading partners speak English, there may be problems with the interpretation of business and contract terms.

Your goal is to work harmoniously with international business partners

Your goal is to work harmoniously with international business partners, not to bully them into doing things the "right" way. In a word, this means compromise. Of course it can be difficult and frustrating to do things their way...but if you try to do everything your way, you'll get nowhere fast.

Here are some basic issues to consider:

- **Differing perceptions of time.** In some countries, you may have to wait for an hour or two before your negotiating partner arrives. Don't get frustrated; bring a book, or spend the time going over important facts and figures.
- **Respect for age.** In many countries, a young negotiator may not be taken seriously. In Germany, Asia, and the Scandinavian countries, for instance, age confers a status that must be respected and deferred to. The person who negotiates on your firm's behalf should be decidedly mature.

- **Table manners.** When having meals with business counterparts, it is wise to avoid bringing up the subject of business. Many cultures prefer not to discuss such mattters while eating. Wait to see if your counterpart brings the subject up. Otherwise, treat meals as a chance to work on cultivating a personal relationship. It is polite in any culture to try different foods. You need not pretend to love everything you eat, but you should never make a negative comment about the food. Every country—including the United States—has a few idiosyncratic traditions, taboos, or superstitions related to eating and drinking. This is a matter you'll want to research in some depth before traveling to your target country.
- **Body language.** When you're dealing with international colleagues, chances are your mind is focused on the language of business: fees, contracts, sales, agreements and so on. But in global business, it can be those things you don't focus on—like how close to stand to someone, or when to smile—that can make or break a deal. For this reason, researching body language and gestures is an important part of doing business overseas.

Researching body language and gestures is an important part of doing business overseas

Remember: When in doubt about how to act in a certain situation, you can always ask questions! Your counterparts will be likely to appreciate your concern and interest. For further information, see ***Going Global: NxLeveL® Guide to International Trade***.

*Within a couple of months, Julia had created a marketing plan for BaliTex Imports. Once it was finished, she flew once again to Bali in order to finalize her negotiations with Bali Ikat. Under the terms of their agreement, Bali Ikat would quote her CIF (cost, insurance, and freight) Portland. They'd charge her a set fee to begin with, then charge an additional fee based on the size of the shipment.*

*They'd manage all buying and negotiating for her, as well as on-site quality control before shipment. They'd handle the packing, documentation, and shipping of her goods. They even provided guidance on clearing US Customs, via a US-based agent!*

*Julia placed her first order for a total of 500 yards of multicolored ikat weaves that June. Having carefully coordinated the time her supplier needed to produce, pack, and ship the textiles, Julia felt confident that the goods would arrive in time to fulfill the delivery terms she had with her US customers.*

*BaliTex's first customers were three interior design showrooms based in San Francisco and Los Angeles. Each business had ordered fabric to be delivered no later than September 12th. Although Julia was new to importing, she'd taken every precaution to ensure the shipments would arrive on time. She'd budgeted two extra weeks to receive, log, and repack the orders for shipment to her customers. She was expecting to have her first shipment of ikat textiles by August 21st.*

## NxLEVEL® TECH TIP
BUSINESS RESOURCES AND THE WEB

One of the Web's best resources for international trade is its variety of online currency converters. These converters are linked to live sources of exchange rate data, so their calculations are always current. Many of them can be also customized and added to your own site, or your e-commerce shopping cart.

The **Universal Currency Converter** (www.xe.net/ucc/). Apparently somewhat unclear on the meaning of the word "universal," this site also offers a "Full Universal Currency Converter," which calculates rates for every world currency. You can sign up to receive daily e-mails on currency rates, which is a very handy feature! There are also instructions on adding the converter on your site.

**FXConverter** (www.oanda.com/converter/classic). This multilingual site converts 164 currencies, allows you to look up the conversion rate for past dates, and provides instructions on using the service in your online store. It also includes a collection of user-submitted foreign exchange resources, and a messageboard for discussion of foreign exchange and currency issues.

## Export Financing

The best time to get financing is before you actually need it

The best time to get financing is before you actually need it—which, in the case of an exporter, is well before your expected sales. Shopping around for financing, negotiating terms, and finalizing details takes time. Plan well in advance, so you don't lose sales while you wait for financing!

### Types of Financing

There are two main types of financing:

- **Working capital loans** are used to acquire materials for work in process, to acquire inventory, or to satisfy an order. Your ability to qualify depends on the strength of your balance sheet, and your sales prospects over the life of the loan (among other things).
- **Trade finance** supports transactions that are self-liquidating (i.e., that pay themselves off through proceeds of the transaction). Usually, the lending bank receives payment, and applies the proceeds towards the loan before crediting the remainder to the exporter's account.

The US Department of Commerce divides export finance into the following categories:

- **Pre-export loans.** Pre-export loans are often used to pay for labor, materials, marketing, and inventory. Most small businesses need pre-export financing to help them gear up for a particular export sale.
- **Accounts receivable loans.** These are given on the basis of the volume and quantity of the borrower's foreign accounts receivables, which must be backed by export credit insurance. Banks will often make loans totaling 50 to 80 percent of the value of the receivables.
- **Market development financing.** Outside financing for market development activities (such as attending trade shows) can be difficult to obtain because these activities are highly speculative. Usually, small businesses finance market development from their own working capital or cash flow.

### Federal Export Financing Programs

If you can't get financing from a bank, government agencies may provide it. The US government has a keen interest in increasing exports, and dedicates considerable resources to helping small businesses export.

The US government has a keen interest in increasing exports

Government export intermediaries may provide short-term financing, or may simply purchase the goods directly from the manufacturer. This eliminates many risks, as well as the need for financing.

### Export-Import Bank of the United States (Ex-Im Bank)

Ex-Im Bank (www.exim.gov) is an independent agency of the US government that helps to finance and facilitate the export of US goods. It offers five types of programs to help exporters: insurance, working capital, guarantees, intermediary loans, and direct loans.

Ex-Im Bank helps small businesses through five regional offices and a nationwide network of partners, and participates in trade shows and seminars that focus on small exporters.

Ex-Im Bank also supports exporters of environmentally beneficial goods and services (many of whom are small businesses). Eligible products and projects include:

- Pollution control
- Waste collection and disposal systems
- Ecological monitoring
- Hazardous and toxic material handling
- Water purification
- Improved energy efficiency
- Alternative energy (solar, wind, hybrid, biomass, fuel cells, waste to energy, hydroelectric, coal gasification, geothermal)
- Toxic waste cleanup projects

*Working Capital Guarantee Program (WCG)*
The WCG gives exporters the working capital they need to fill export orders, post performance or bid bonds, and finance foreign receivables. The loans are made by commercial lenders and backed by Ex-Im Bank. This is Ex-Im Bank's sole pre-export program; their other programs finance post-export shipments.

To be eligible for a WCG, you must be located in the United States, have at least a one-year operating history, and have a positive net worth.

Currently, the WCG covers 90 percent of the loan, including interest. For loans to minority, woman-owned, or rural businesses, Ex-Im Bank may increase coverage to 100 percent. The exporter must put up collateral, but Ex-Im Bank is flexible about what it will accept. You may be able to offer raw materials, foreign receivables, or certain fixed assets.

Ex-Im Bank has authorized certain regional and local banks to act as its delegates. They can help you fill out your WCG application, and can approve loans onsite. For more information, visit **www.exim.gov/products/work_cap.html**.

*Direct loans*
Ex-Im Bank can provide fixed-rate loans to creditworthy international buyers so that they can afford to buy your goods. There are restrictions on the products for which these funds can be used, and loans may not be available to buyers in certain countries. Contact Ex-Im Bank for more information.

*Loan guarantees*
Ex-Im Bank also assists exporters by providing guarantees or insurance to banks, allowing them to lend directly to creditworthy international buyers. As with direct loans, restrictions apply.

### Small Business Administration (SBA)
The SBA offers financial and business assistance to help small businesses export. SBA district and branch offices administer term loan programs locally, while personnel based in US Export Assistance Centers (USEACs) administer export loan programs.

For a list of USEACs, visit **www.export.gov/eac/index.asp**.

*SBA Export Express*
Export Express offers loans and lines of credit up to $250,000, which may be used to finance such things as:

- Participating in foreign trade shows or trade missions
- Translating brochures or catalogs for a foreign market
- Developing foreign markets (including through use of EMCs)
- Acquiring, constructing, renovating, or expanding US facilities for the production of export goods

For more information, visit **www.sba.gov/services/financialassistance/sbaloantopics/SpecialPurposeLoans/exportexpress/index.html**.

*Export Working Capital Program (EWCP)*
In 2004, the SBA and Ex-Im bank joined forces to co-guarantee loans of up to $2 million to small-business exporters under EWCP. The program guarantees repayment of up to $1.5 million or 90 percent of the loan amount, whichever is less.

The EWCP application is comparatively short and simple, and turnaround time is usually 10 days or less. Applicants must submit cash flow projections to support the loan request. After the loan is made, the recipient must submit progress reports. The SBA does not prescribe the lender's fees or interest rate.

*International Trade Loan Program (ITL)*
Under this program, the SBA will guarantee up to $1.75 million for facilities and equipment (including land and buildings; construction of new facilities; renovation, improvement, or expansion of existing facilities; and purchase or reconditioning of machinery, equipment, and fixtures). The proceeds of the loan must enable the borrower to be in a better position to compete. ITL funds may not be used as working capital.

### State Export Finance Programs

In many states, the Department of Commerce and other international trade organizations sponsor financing programs. Many cities and states have established cooperative programs with Ex-Im Bank and can provide export finance counseling. Details of these programs are available through your state department of commerce.

Many cities and states have established cooperative programs with Ex-Im Bank and can provide export finance counseling

### Private Export Finance Companies

These utilize a variety of financing techniques in return for fees, commissions, participation in the transactions or combinations thereof. International trade associations, or any USEAC, can assist you in locating a private trade finance company in your area.

*On August 22th, Julia got a call from her broker. Her shipment had arrived safely!*

*Unfortunately, because Bali Ikat had made some small revisions to the packing list at the time of shipment, it didn't match the pro forma invoice. This caused a delay of several days while the packing list was reconciled. To make matters worse, Julia's customs broker lost her pro forma invoice. This was key documentation that certified the value of the shipment for Customs.*

*In the end, Julia's shipment was held up in customs for three weeks before it was released to her. She telephoned her customers to let them know. Two of the design showrooms were understanding. The third exercised its contractual right to cancel its order.*

*Julia learned a big lesson from that canceled order. After her orders went out, and she found new customers to take the extra 200 yards of ikat, she wrote a carefully worded letter to her customs* *broker. It explained what their mistake had cost her, and why she would no longer work with them. Then, she began the search for a new customs broker.*

*Six months later, BaliTex had a new customs broker, and 20 more orders had come in. Julia worked at home three days a week. The other days, she worked at a small rented warehouse space.*

*She was spending more time with her family. Not having to commute meant she could stay in bed an hour later in the mornings, and her family could eat breakfast and lunch together.*

*And as a bonus, Julia no longer had any trouble finding her favorite ikats!*

**NxLEVEL® GREEN TIP**

ENVIRONMENTAL BUSINESS RESOURCES

An increasing number of businesses worldwide are embracing the practice of **sustainability reporting**. Just as financial reports offer hard data on financial performance, sustainability reports offer hard data on environmental performance.

The **Global Reporting Initiative** (www.globalreporting.org) has come up with the most widely used standards for sustainability reporting, based on input from a wide variety of stakeholders, from business leaders and investors to scientists and representatives of worldwide NGOs. You can download the most recent edition of their official GRI Guidelines for sustainability at their Website.

The site also offers tutorials on sustainability reporting for small businesses, podcasts on sustainability issues, and a template for basic reporting.

Sustainability reporting demonstrates a commitment to transparency, responsibility, and continuous improvement, and it may give you an edge, particularly in foreign markets. But even if you're not ready to take the plunge, reviewing these materials will give you a valuable understanding of the international effort to create standardized benchmarks for environmental performance.

## Becoming an Importer

Most export topics apply (in reverse) to importing. You'll need to address the following questions when preparing your marketing plan:

- **Market demand.** Is there a demand for the product? Will importing give you an advantage over competitors?
- **Quality.** Does the product meet your quality standards?

- **Price.** How does the price compare to that of domestic and imported counterparts? Is the savings large enough to justify importation?
- **Quantity.** Does your foreign vendor have the capacity to fill your order?
- **Tariffs.** Are there US tariffs on the product?
- **Standards and laws.** Do they meet all applicable standards? Do any legal restrictions apply?
- **Political stability.** Will changes in the foreign government affect your business?
- **Promotion.** How will you market your imported goods?
- **Distribution.** How many hands will the goods pass through before they leave the country? Can you lower the price by importing more directly? What distribution channels will you use? Will you be able to ship the goods directly from the port of entry?
- **Transaction risk.** How will you mitigate the risk of nonperformance on the part of your foreign supplier?

### International Sales and Distribution Options

What form will your import business take? There are many possibilities:

*Direct marketing*

In this case, you're the first source to whom a foreign supplier sells, and you resell directly to the end user. The advantage of this method is a higher share of the profits. The disadvantage is that your marketing costs may be higher, since you're responsible for marketing to the end user. In addition, you must have the financial wherewithal to pay for all the goods you import, and have sufficient cash flow to cover expenses until you get paid by the US buyer.

*Becoming a distributor or agent*

If you decided to import chili peppers from Mexico as an agent, your role would be to research markets, promote the product, and make sales. In most cases, agents receive a commission on sales.

As a distributor, your responsibilities go further. If you imported sardines from Norway as a distributor, you'd arrange for the purchase of the sardines—including all customs, insurance, and freight requirements. You'd take title to the goods, so the business risk would transfer to you sometime after they were shipped (depending on the terms of sale). Distribution is riskier than being an agent, but the rewards can be greater.

*Partnering and strategic alliances*

Many foreign companies hope to expand their business to the US market through an American company.

Many foreign companies hope to expand their business to the US market through an American company

### Other Import Considerations

Most issues relating to shipping, documentation, payment, and managing risk are similar to those that affect exporters. Your customs broker can help you with these matters.

Since 9/11, there are a couple of important things importers should take into account. Under the Maritime Transportation Security Act of 2004, a $5,000 fine will be levied on any container left on a pier for seven days. A customs broker and international banker can help you comply with this law and others.

Increased scrutiny of imported goods means that you must allow greater time for goods to arrive

Also, increased scrutiny of imported goods (food products, in particular) means that you must allow greater time for goods to arrive. You may wish to adjust your order size and inventory levels accordingly.

*Customs-Trade Partnership Against Terrorism (C-TPAT)*
C-TPAT is a voluntary initiative intended to improve supply chain and border security. Companies that follow the prescribed steps to enhance supply chain security receive preferential treatment at customs, including reduced inspections, monthly or bimonthly account-based payments, and self-policing privileges. For more information, visit **customs.gov**.

**Importing Steps**

1. Understand import rules, regulations, and procedures under US Customs law
2. Source goods from overseas exporter
3. Receive pro forma invoice, and negotiate final price and terms of sale
4. Open a letter of credit at your bank
5. Confirm shipment from port of exit
6. Receive documentation from the exporter
7. Direct your customs broker to clear goods through US customs
8. Declare value, receive classification number of import shipment, and pay import tax if appropriate
9. Clear customs and load goods on inland carrier
10. Direct payment to exporter via bank

## Conclusion

Managing risk is the name of the game in international trade. To succeed in an import or export business, you need an effective marketing plan. If you're planning to export, pay attention to the special needs of your foreign markets. If you're planning to import, closely examine your market in the United States.

International trade is an exciting and rewarding field, so get ready and go global!

# Chapter 10
# GREEN BUSINESS OPPORTUNITIES

*About This Chapter:*

- *Why start a green business?*
- *Green business practices*
- *The green marketplace*
- *Green business ideas*
- *Greening your business plan*
- *Communicating green benefits*
- *Staying green*

## Introduction

Starting a green business, or making an existing business greener, is a great idea for at least three reasons. First, you'll be entering a relatively new market that has shown strong and consistent growth across the manufacturing, service, and retail spectrum. Second, the sheer volume of green products and services creates unprecedented opportunities for synergies, partnerships, and continuous improvement. Third, running a successful, conscientious green business can offer you a sense of personal fulfillment that goes above and beyond the financial rewards.

Despite the excitement over green business, studies consistently show that consumers lack information about and awareness of green products. When asked how important environmental issues are to their buying decisions, they usually say that they're very important. When asked to imagine making a trade-off between environmental benefits and comfort and convenience, they're somewhat less enthusiastic. And when asked what actually makes a product environmentally preferable, they tend to be confused.

This suggests that there's a strong interest in green business, but the market is far from mature, partly because green businesses need to market themselves better, and partly because the process of educating consumers has only just begun. A market like this creates many opportunities and threats for entrepreneurs, and makes good planning essential.

Green business creates many opportunities and threats for entrepreneurs, and makes good planning essential

As you consider launching a green business, remember that this isn't some easy, magical path to riches. On the contrary, it demands an almost unprecedented degree of discipline, honesty, transparency, attention to detail, research, and flexibility. And above all, it takes a strong personal commitment. You need to believe in it, and be willing to ask the hard questions and make the tough decisions it requires.

If you're ready and able to face these challenges, green business could very well be your ideal path to personal and financial fulfillment.

## Why Start a Green Business?

Entrepreneurs pursue green policies for different reasons. The first and most important reason is that they want to meet customer demands, because that's where the money is. Another important reason is that they need to comply with new and upcoming regulations.

Beyond that, some entrepreneurs go green for reasons of efficiency: they want to save on energy or insurance, or reduce waste-disposal costs. For others, the decision is more philosophical, and might involve a desire to reduce pollution, achieve some measure of energy independence, and be a good steward of natural resources.

What are your reasons for going green? Are you hoping to make the world a better place, get rich, or a little of both?

Depending on how you answer, you will probably have different attitudes to business opportunities. For instance, if your orientation is primarily ecological, you might consider using 100% renewable energy to run your business. But if your goal is to start saving right away on your monthly energy bill, you probably won't have the time, capital, or inclination to pursue this goal.

One of the best things about starting a green business is that you can get things right at the outset, and build a solid foundation on which to grow. Unlike businesses that are trying to overhaul their entire structure and impose a green culture from the top down, you can start with a clear sense of direction, learn from other business's mistakes, and hire people who are as committed to green business as you are. This will make the continuous evolution that green businesses must pursue easier, more enjoyable, and more profitable.

One of the benefits of green business practices is that they encourage you to consider the *real* costs of doing business...not just for you, but also for your customers, your community, your country, and your planet.

Your green business ideas need to be appropriate, affordable, and attainable!

That same commitment to realism, and attention to detail, must guide your efforts to start a green business. Good intentions aren't enough to bring you success. Your green ideas need to be appropriate, affordable, and attainable. That's why it's necessary to weigh the costs and benefits of each of your goals, and then plan and budget to achieve the ones that make good sense for you and your business.

*Todd Crafton spent three years as a pool serviceman for a small business called Desert Spring Pools and Spas in Las Cruces, New Mexico. While making his rounds, he often encountered customers who asked him about alternatives to chlorination. He'd heard of alternative water purification systems, of course, but he didn't know much about them.*

*Early on, he'd asked his boss, Carl Schmitt, if they were viable, and received a very negative reply. Alternative disinfectants were a "fad," according to Carl. They were also "expensive" and* *"dangerous" and "stupid." The only people who bought them were "hippies" and "treehuggers," all of whom were "anti-progress."*

*To make a long story short, Carl had no plans to offer alternative pool-cleaning systems.*

*Todd didn't feel that Carl's opinion was relevant to the question of whether or not a market existed for these products. Besides, he'd talked to these customers face to face. They didn't look like "hippies," or radicals of any kind. They were ordinary people, living in ordinary houses in ordinary neighborhoods. The only thing that was even slightly unusual about them, as far as Todd could tell, was that they didn't want chlorine in their pools. And since they were spending their own money on their own pools, Todd didn't see why they shouldn't be able to have whatever system they preferred.*

*Todd had been taught that the customer is always right. He knew that if Carl wasn't going to sell these customers what they wanted, someone else would. Why shouldn't it be him?*

### What is a Green Business?

Terms like "green" and "sustainable" are often used interchangeably, but in practice there are important differences between the two. So before we go any further, let's define some of the common terms used to describe environmentally aware businesses.

**Green** is a catch-all term that typically refers to businesses that attempt to address or prevent environmental problems, either by reducing or eliminating pollutants and waste. If that sounds vague, that's because it is. There is no accepted standard for what constitutes a "green business," which makes things easy for people who simply want to cash in on the latest buzzword, and difficult for people who've made a sincere commitment to green business practices.

Because this term is vague, people have sought more specific ways to describe "greenness."

- **Light greens** are concerned about the environment, and willing to make certain lifestyle choices to protect it, but it's not their primary motivation.
- **Bright greens** are committed to the health of the environment, and their buying decisions consistently reflect that orientation. They tend to be optimistic about the effect of their personal decisions, and believe that we can improve our standard of living and enjoy some measure of economic growth while reducing or reversing our environmental impact.

Many businesses have taken some steps to reduce waste or avoid using specific chemicals. This doesn't make them green, however, any more than not smoking cigarettes makes a person healthy. Like being healthy, being green requires you to look at the big picture, and pursue a broad range of interrelated, beneficial actions.

Being green requires you to look at the big picture

By contrast, bright green businesses try to operate in ways that solve, rather than cause, environmental and social problems. These businesses adopt principles, policies, and practices that improve the quality of life for their customers, their employees, their communities, and the environment.

Here are some of the policies that a bright green business might pursue:

- Environmentally and socially responsible sourcing
- Full compliance with local, state, national, and (often) international environmental regulations
- Pollution prevention
- Reducing, reusing, and recycling waste products
- Conserving energy, water, and other natural resources
- Substituting nontoxic chemicals for hazardous ones
- Product redesign
- Becoming a carbon-neutral or zero-waste business

**Sustainable** refers to businesses that seek to meet present needs without reducing the ability of future generations to meet their own needs. As such, it's tied to the notion of **intergenerational equity**, which states that we must preserve natural resources for the generations that will come after us. (We will discuss this concept further in Chapter 16 *Business and Environmental Ethics*.)

To understand the difference between a green business and a sustainable one, consider a business that builds housing developments using eco-friendly materials and energy from renewable sources. Most people would consider this to be a green business.

But from a sustainability standpoint, larger questions arise. Housing developments consume land, water, and other resources, and they also affect ecosystems. A sustainable builder would take these issues into account when planning and siting projects.

Businesses that claim to be sustainable are usually held to a higher standard than green businesses

Businesses that claim to be sustainable are usually held to a higher standard than green businesses, so it's best not to use the term unless you can back up your claims.

**Clean technology** (or **cleantech**) is pretty much what it sounds like. Its goal is to create cleaner, safer, more efficient products and processes, based on an understanding of biology and ecology, in order to reduce or reverse human impacts on the environment. Familiar examples include solar, wind, and tidal power, as well as alternative fuels and biodegradable packaging.

**Socially responsible business** is another vague term. Generally, such businesses are committed to the environmental policies listed above, but they also attempt to give back to the local, national, or global community through volunteering, investment, donations, education, humanitarian projects, and so forth. They usually focus on human-rights issues throughout their supply chain, and often have some sort of profit-sharing mechanism for employees. They also tend to be committed to high levels of transparency, and may issue public reports that detail almost every aspect of their business.

The important thing to consider is where you, your product, and your customers fit on this spectrum. Having done so, you can come up with a business plan that fits all three.

**How Green Will Your Business Be?**
Consider the following questions:

- Why do you want to run a green business?
- How do you define "green"? What standards will guide your efforts? Do these standards meet or exceed your customers' expectations?
- How will you create a green culture at your business?
- How will being green help you to compete and succeed?
- How green are your customers? Your competitors? Your suppliers?
- How will you communicate your green values, goals, and plans in your business plan? How much transparency are you comfortable with?
- What aspects of your business will be green? What can you do now, and what are you planning to do later?
- Will you rent, buy, or build your facility? What steps will you take to green it?
- Will you seek green certification? From which organization? What are the costs and benefits?
- How will you ensure that you stay green? How will you learn about and adapt to new technologies, new standards, new laws, and new competition?

*The next time a customer brought up alternatives to chlorine, Todd asked some pointed questions. Why wasn't chlorine an option? Was it the smell or feel of the water? Were there health issues? Were there environmental concerns? How much would they pay for a chlorine-free system?*

*After many such conversations, Todd started to get a sense of the market for chlorine-free pools. The customers tended to be professional people with at least some college education, and children who were still living at home. Their major concern was health, followed closely by cosmetic issues like the effect of chlorine on hair and skin, and then by aesthetic and comfort issues like smell, taste, feel, and eye irritation. A few customers had asthma, or children with asthma, and felt that chlorine made the symptoms worse.*

*Although Carl had categorized these customers as "treehuggers," they rarely mentioned environmental issues. When prompted by Todd, most of them agreed that this could be a concern, and might influence their buying decision if they knew more about it. But only two people volunteered it as a complaint, and both of them had asthma.*

*When it came to price, they were noncommittal. A few of them conceded that they might pay "a little more," but had assumed that using fewer chemicals would save money.*

*What interested Todd most about all this was that there was a fairly wide range of customer viewpoints. "It wasn't some tiny niche of anti-progress types," he says. "Carl was wrong about that. What I found was five distinct types of customers, and it seemed to me that each one of them represented a lot of people in the community. And the other thing was, although they were distinct, you could see their opinions converging. Maybe because they didn't like chlorine, they were looking for more arguments against it, or more practical reasons to make the change they'd already set their hearts on. But either way, I saw myself as having a lot of selling points if I offered chlorine-free pool service at a competitive price. That was why I decided to make my move."*

### Will It Last?

Some business owners wonder if green business is simply a fad that will eventually fade and die. Why spend the money and time to go green, they wonder, if the current excitement won't last?

It's true that nothing's certain in business, but there are some good reasons to believe that green business is here to stay.

The most obvious reason is that it can increase profits, and offer innovative solutions to common business problems. Businesses large and small are finding that saving energy, reducing waste, and increasing efficiency are improving their bottom line. Putting aside the larger debate over environmentalism and sustainability, there's no doubt that focusing on pollution prevention and energy efficiency offers enormous benefits, and will continue to do so as long as the laws of physics hold sway. We may not know what lies ahead, but we can be fairly sure that we're *not* going back to a pre-green business model.

Instead, it's likely many of the practices we now see as controversial or daring will become industry standards, and advances in green chemistry, renewable energy, biomimesis, green logistics, and responsible design will create new benchmarks for green business, and new opportunities for clever entrepreneurs.

What's "bright green" today may be "light green" tomorrow!

Also, competitive and regulatory forces are not likely to let up. And as large businesses take steps to comply, they drive change throughout the supply chain. Businesses that simply call themselves green, without making efforts towards continuous improvement, will quickly be superseded by competitors who can make a stronger commitment. In other words, what's "bright green" today may be "light green" tomorrow.

## Green Business Practices

Businesses that make a commitment to green or sustainable principles usually have relationships with customers, employees, and supply-chain partners that are somewhat different from those of traditional businesses. These differences are often reflected in the business practices they adopt. We'll look at each of these issues in turn.

### Customers

Green businesses place an emphasis on communication, transparency, and ongoing dialogue. They expect and welcome constructive criticism from their customers, and are willing to educate customers—respectfully—when necessary. The greener a business's target customers are, the more these factors come into play, with consumers continually challenging businesses to exceed their expectations, and businesses continually asking for a greater commitment from customers.

Green businesses place an emphasis on communication, transparency, and ongoing dialogue

For most successful green businesses, the relationship with customers is basically collaborative, with each side helping the other to grow and improve. Ideally, this leads to a strong sense of customer engagement that pays off in word of mouth and customer-initiated viral marketing efforts.

### Employees

Even if they haven't made a specific commitment to social responsibility, green businesses are often expected to treat their employees more ethically than other businesses. They may need to offer—or work towards offering—a "living wage," healthcare, childcare, and a safe work environment, and make overall efforts to maintain a certain quality of life for employees. Greening office products and cleaning supplies, improving lighting and indoor air quality, and other green policies can address some of these issues.

Many green businesses share financial data with employees, under an increasingly popular system called **open book management**. The goal is to promote transparency, accountability, and trust, and give employees a stronger emotional stake in the success of the business.

How much data should be shared depends on the business and the owner's attitude towards risk, but sales figures, costs, financial ratios, and investments are common areas for discussion. They can help workers understand how their actions affect profits, and identify areas for cost-cutting and other improvements. (Compensation data are more controversial; presenting compensation as a lump sum may be preferable to revealing individual salaries.)

Green businesses often attract employees who are looking for an emotionally fulfilling, socially meaningful career, and may be willing to make some sacrifices—or accept a certain amount of non-monetary compensation—in order to make things better for people, animals, or the planet.

Depending on how committed you are to sustainability, you may be able hire smart and highly motivated people for less money than they might demand from a traditional business. In addition, loyal and fully engaged employees may reduce your turnover rate, which in turn reduces your staffing and training costs.

### Suppliers and Distributors

Businesses that wish to be bright green usually have to make an ongoing effort towards greening their suppliers, distributors, and other partners. Often, this involves writing environmental standards directly into contracts, and enforcing them when necessary.

This can be a daunting process. But as the green economy continues to evolve, you're likely to find that the other businesses in your supply chain are already making these efforts, due to the pressures they face from customers, competitors, and regulators.

Before you launch your business, you need to learn all you can about your customers' motivations

## The Green Marketplace

While everyone agrees that green business is booming, motivations for green consumerism vary considerably. Some people are trying to reduce their exposure to chemicals for health reasons, while others are more concerned with the health of the environment. Some people are committed to buying green products as a political statement, while others are just following the latest trend. Still others are simply curious, and willing to try something new. Each of these customers will be responsive to a different marketing approach, so before you launch your business, you need to learn all you can about your customers' motivations.

According to the Natural Marketing Institute (www.nmisolutions.com), roughly 63 million Americans have undertaken "lifestyles of health and sustainability" (LOHAS). These are bright green consumers who have a strong sense of personal responsibility for health and environmental issues, which they express through shopping decisions. They tend to be optimistic about their ability to make a difference in the world, and they will seek out and support businesses that share this attitude, so long as it's consistent and backed up by action. This market is currently estimated to be worth about $200 billion per year. That amount is expected to double by 2010, and quadruple by 2015.

Various types of light green consumers comprise about 40 percent of the population. These are people who are interested in green products and environmental issues, but have not made a firm commitment to green buying decisions. They tend to be interested primarily in personal health and wellness, but are likely to choose a green product over a conventional one, as long as it's comparable in price and quality. When it comes to making purchases that benefit the environment, they want to do the right thing, but they aren't sure what the right thing is. They may be unclear on the nature of environmental problems, and have inconsistent or illogical ideas about solutions. If they're educated and encouraged, they're likely to become bright green consumers.

Next, there are the people who are open to buying green products, but only if they save money or confer some other direct benefit. These are people who might buy CFLs to lower their bills, but not to reduce their carbon footprint. Special offers, promotions, and risk-free trials are often necessary to overcome their natural skepticism, and compel them to give a green product a chance. These consumers will usually approve or reject green products on a case by case basis, without pursuing an environmentally conscious lifestyle.

Last, there is a smaller group of consumers that is either disinterested in or actively hostile to environmental products and lifestyles. According to most surveys, this group comprises between 10 and 15 percent of the population. Many of these people either don't have the time or energy to worry about an issue that seems irrelevant to them, or believe that their individuals decisions make no real difference. Still, these consumers are likely to buy some green products, if only because that's what the market favors. Some of them may go on to become light or bright green consumers as the market matures.

While it's still common to think of environmentally aware consumers as liberal, and disinterested or hostile people as conservative, that's really not accurate. If you have any such biases or preconceptions about green consumers, it's a good idea to give them up before proceeding with your market research. You'll find people who claim not to care about environmental issues on the left, and people who support green business on the right. While different groups may have different ideas for solutions, and different buying patterns, it's unwise to think of green consumers as having a specific political identity.

Nor do green consumers belong to a single demographic. They may be urban, suburban, or rural; male or female; college educated or not. They may earn salaries in the high six figures or the low five. This makes psychographics especially important for green marketers. It's vitally important to understand what need your product meets, and whether it's psychological or pragmatic. People who are buying for psychological reasons like security, status, self-realization, or altruism tend to place a higher value on green products. People who are buying for pragmatic reasons tend to be more price-conscious.

It's vitally important to understand what need your product meets

No matter which group or groups you target, you must know how to reach them effectively, which means knowing what technology they have access to, which media they pay attention to, how much they're willing and able to spend on products like yours, and what competing products are currently meeting their needs.

### The "Green Premium"

Surveys routinely show that many consumers are willing to pay up to 20 percent more for green products. Or at least, surveys show that this is what consumers routinely tell interviewers. Whether they really will pay more is a matter of dispute. Some studies suggest that the green premium is actually no more than 7 or 8 percent. Whatever the case, everyone agrees that most consumers have not yet put their money where their mouth is when it comes to green products.

In some ways, green products are a victim of their own success. As they move out of the environmentalist market and into the mainstream, they are increasingly forced to compete not just on price, but also on style, attractiveness, effectiveness, durability, and so forth. Therefore, if you want to compete in today's marketplace, it's not enough to be green. As eco-friendly products become more common and harder to differentiate, traditional concerns like convenience and customer service return to the fore.

Today, the most successful green products are those that explicitly offer direct benefits like health, safety, style, and convenience. This doesn't necessarily mean that consumers are selfish, though. They may simply want results that they can understand and measure. It's easier to know what will benefit you than it is to know what will benefit a person or animal or ecosystem halfway around the world. As consumers become more informed about larger social and environmental benefits, altruistic buying patterns may increase.

## NxLEVEL® GREEN TIP

### ENVIRONMENTAL BUSINESS RESOURCES

Here are some blogs that offer interesting news and views on green business trends and practices.

**Environmental Capital** (blogs.wsj.com/environmentalcapital) is the **Wall Street Journal's** daily blog on environmental business, featuring analysis of current news and trends.

**Environmental Economics** (www.env-econ.net) is a lively blog featuring informed analysis of green business, environmental policy, and economic theory. Although it's written by professors of economics, it's generally informal and down to earth.

**Triple Pundit** (www.triplepundit.com) bills itself as "a conversation about conscious, responsible business in the context of today's environmental and social challenges." The emphasis here is on the triple bottom line, or as TP puts it, "people planet profit."

**Green Options** (greenoptions.com) is a network of environmentally focused blogs that offers a broad spectrum of information and guidance on making sustainable choices.

*Todd didn't feel right about planning his new business on Carl's time, so he left Desert Spring in order to concentrate full-time on researching potential products and customers.*

*A few weeks later, Todd attended a trade show in Albuquerque and talked to some people who were selling an ozone-based purification system. Todd was intrigued...until he saw the price tag. They cost quite a bit more than the systems he was used to.*

*"Do people actually buy this stuff?" he asked.*

*The seller started talking about the explosion in eco-friendly goods, and the appeal of helping the environment. But Todd was skeptical. He'd talked to enough customers to suspect that the environment was not high on their list of concerns. And he also knew that even though some customers were willing to pay a "green premium," the price of this system was still on the high side. He'd have to research sales figures for alternative systems carefully before he took the plunge.*

*The most useful thing the salesman told him was that by using the chlorine-free system, he could avoid the hazmat and fire regulations that had been a thorn in Carl's side. "Being able to start my business without worrying about those regs was definitely a big deal," Todd says. "On the other hand, none of that meant anything unless the system really worked, and people were willing to buy enough of them to keep me in business. So that's what I focused on."*

## Green Business Ideas

What kind of green product should you offer? It's usually wise to focus on an industry or hobby in which you already have skills that will give you a competitive edge. If you're a mechanic, you could convert cars to run on biodiesel. If you're a roofer, you might consider installing solar panels and solar water heaters. If you're a gardener, you could offer readymade windowbox or roof gardens for apartment dwellers. If you're a computer expert, you might start a green computing business, and help customers to manage energy and resource use. As with any other type of business, it's good to have a knack for what you do, and to enjoy it.

The next (and most important) step is to decide whether a need exists for your product. Is anyone else doing it? Could you do it better? What kind of customers need this product or service, and how often do they need it? Are there enough of them to support your business? How do they make buying decisions?

Again, a business doesn't succeed just because it's green. You need to offer the right product, at the right price, to the right people, at the right time. That takes research, planning, and more than a little luck. No matter how much excitement there is over green business, it's no substitute for the hard work of getting to know your customers and their motivations, and understanding where their needs and your abilities intersect.

You need to offer the right product, at the right price, to the right people, at the right time

### Green Inventions

As with conventional products, inventing and selling green products is often a difficult path, with high start-up costs. While some inventors have sudden flashes of inspiration, a viable invention is more often the result of specific expertise, coupled with lots of research, thought, and failed attempts.

If you hope to invent a green product, your best bet is to familiarize yourself with a broad range of environmental and health problems—in the United States and the world—and try to come up with a solution. A green invention that solves a serious problem is more likely to succeed than a comparatively frivolous niche product like an eco-friendly bobblehead doll.

The first step with any invention is to discover whether it's already been done. Searching the Internet is a good way to start. After that, you'll want to do a patent search, and if necessary, pursue intellectual property protection. We will explain how to do this in Chapter 18 *Intellectual Property Rights.*

### Green Business Innovations

Just to inspire your own brainstorming, here are a few of the innovative products, services, and promotions that green businesses are currently offering.

- Umbrellas tend to have a relatively short lifespan, which means that most of them wind up in the landfill within a year or two of purchase. A company called Brelli (www.thebrelli.com) offers a biodegradable umbrella that is guaranteed to decompose after one to two years in a landfill.
- IKEA's solar-powered Sunnan lamp (www.ikea.com) provides four hours of light after being charged by sunlight during the day. As part of the promotion for this product, IKEA vows that for every lamp purchased in one of its stores, it will donate one lamp to UNICEF for children who lack electricity.
- A Los Angeles-based firm called MotoArt (www.motoart.com) turns old airplane components into stylish high-end furniture.
- Aveda's Caps Recycling Program (www.aveda.com/aboutaveda/caps.asp) collects bottle caps and recycles them into caps for its beauty products.
- The Eco Media Player (www.ecomediaplayer.com) has a built-in handcrank, and will play forty minutes' worth of music for every minute you spend turning it. You can also use it to charge your cellphone.
- A young designer named Ashley Watson (www.ashleywatson.net) turns old leather jackets into bags and wallets.
- Bag-E-Wash (www.bag-e-wash.com) is a simple product that makes it easy to wash and dry used plastic bags in the dishwasher.

### Greening Existing Products

Studies show that entrepreneurs who improve existing products are more likely to succeed than other businesspeople

Toothbrushes made from recycled materials or reclaimed wood, with replaceable heads. Biodegradeable trash bags. Compostable picnic ware. These are all products that some entrepreneur created by improving on a standard design, or substituting sustainable, nontoxic, organic, or biodegradeable materials for conventional ones. Studies show that entrepreneurs who improve existing products are more likely to succeed than other businesspeople.

Organic products are a good example of this trend. Organic retail sales have grown between 20 and 24 percent each year since 1990. According to a recent study, 75 percent of shoppers buy organic products at least occasionally, while 23 percent buy them at least once a week.

However, all organic products are not created equal. As a general rule, people are more likely to choose organic fruits, vegetables, dairy products, and meats, particularly if they have children. A much smaller percentage of consumers buy other organic products (e.g., pet foods, bedding and clothing). This is further proof that going green or organic is not a guarantee of success; you have to understand your customers' needs and motivations.

Making a product greener can be as simple as replacing one component, or as complex as designing and manufacturing a brand-new item from scratch. Either way, you must look carefully at the market for the non-green product, to decide whether a green version is really viable. (If sales of the existing product are sluggish, for instance, green elements may not be enough to make it profitable.)

### Upcycling

A lot of the things we throw out are potentially useful, either in themselves or as an input into another product. Accordingly, many businesses are doing their best to divert materials from our overburdened landfills, and use them to make new consumer goods.

The practice of transforming a discarded item into something useful or valuable is known as **upcycling**. In addition to lowering production costs, this has real environmental benefits.

According to one study, Americans throw away enough aluminum every year to rebuild the commercial air fleet several times over, enough steel to build a city the size of New York, and enough wood to heat five million homes for 200 years. Upcyclers seek to gather such materials, and extend their useful life indefinitely.

Terracycle (www.terracycle.com) is a good example of a company based on upcycling. Their raw materials include juice boxes, candy wrappers, potato-chip bags, and yogurt cups, which they recycle into a wide variety of products. This has kept its costs extremely low, and enabled it to place its products with price-conscious retailers like Wal-Mart, Target, and OfficeMax.

Other entrepreneurs are busily turning computer circuitboards into clipboards and notebooks, innertubes into wallets, manual typewriter keys into bracelets, and rice sacks into purses.

If you're interested in upcycling, try looking online for a **materials exchange** in your area. These are sites where businesses offer unwanted materials for a low price, or even for free. You might find anything from used clothes, to empty plastic containers, to old building materials and hardware.

Find an innovative use for one of these items, and you may be able to get a year's supply of raw materials for the price of a truck rental!

We discuss materials exchanges at greater length in Chapter 24 *Managing Green.*

*While working on his business plan, Todd realized that he needed to test the ozone-based system in his own pool. If it didn't work, there was no point in taking things any further.*

*He monitored the water over two months, checking pH, bacteria growth, and water quality frequently. He was pleased to find that the treatment seemed to work, and even more pleased to find that his family seemed less inclined to take long showers after swimming. That meant less hot water, less energy, less shampoo...it was amazing how connected everything turned out to be!*

*On the other hand, the system had a learning curve, and definite parameters you had to stick to in order to get good results. For some customers, that would be no problem. For others, the maintenance needs were likely to be a dealbreaker.*

*Todd had other concerns, too. The purification system only worked when the pump was running. How much would this increase energy costs? Would the pumps and filters be able to handle the increased circulation? Granted, customers would be paying less for chemicals—which had been one of his best selling points—but what would it cost them to achieve those savings?*

*Over the next couple of weeks, Todd did his best to figure out exactly what it cost to maintain a normal swimming pool. He didn't just look at the upfront cost. He also considered the time involved, which he knew was a big consideration for many of his customers. Sweeping, changing filters, applying algaecide, and testing pH were not things that most pool owners liked to do. If the new system required more maintenance of this sort, the price-conscious customers Todd had spoken to were not likely to pay more for it.*

*At the end of the process, Todd concluded that his customers could realize health and financial benefits with the new system, but only if they stayed on top of maintenance. Unfortunately, he wasn't sure they would do that.*

*And if they didn't, and the system didn't perform as expected, he knew who they'd blame.*

*Todd was starting to feel like he'd walked into a brick wall.*

### Addressing Humanitarian Issues

Some green businesses form in order to solve a problem in another country, or among the world's poor. For instance, many businesses vie to create the cheapest and simplest water purification methods. LifeStraw (www.lifestraw.com) is an excellent example.

These products are most successful when they are tailored to local conditions, culture, raw materials, and infrastructure (hence the term **appropriate technology**).

Typically, these businesses sell to aid agencies or charities, who then distribute the goods to the people who need them. Although the unit price may be low, the volume of sales can be huge.

### Importing Green Products

Environmental regulations and standards are currently less strict in the United States than they are in a number of other countries (e.g., the European Union and Japan). This means that there are many products worldwide that were created to meet these stricter standards, some of which may be saleable locally or nationally (particularly if similar regulations are imposed in the United States).

Water conservation tools and methods are an obvious example. Solutions that are common in Africa or the Middle East may be adaptable to parched regions of the US market. When looking for these opportunities, don't forget to look at homemade solutions and other forms of appropriate technology.

### Revisiting Old Technology

People tend to think that "progress" results in new products and processes that are better than old ones. In fact, one form of technology may win out over another for reasons that have little to do with overall efficiency, cost, effectiveness, or ease of use. Political and cultural forces often determine which technologies will succeed, and which will fall by the wayside.

Older technologies and products may be green by default

This means that there may be any number of forgotten or "outdated" inventions and processes that are either ideal from today's green perspective, or could be adapted and improved to meet emerging needs. As a simple example, there are several freight shipping lines that are experimenting with a new sort of sail that takes advantage of the constant, strong wind stream at higher altitudes. This would allow ships to cross the ocean with much less fuel, which would greatly reduce costs and pollution.

The drive towards sustainable business practices has inspired engineers to revisit many old-fashioned ways of doing things—many of which are green by default—and look for ways to improve them. Traditional green roofs, milk-based paints from Colonial days, and the 200-year-old Stirling engine (which is used in modern solar-thermal plants) are examples of old technologies that have taken on new value and appeal in a resource-conscious economy.

And of course, it's not just the green aspects that are selling these products. Many people also appreciate the aesthetic and historic qualities of older technology.

### Goods on Demand

One major trend, not just in green business but across the competitive landscape, is to rent or lease products that have traditionally been purchased. As Amory Lovins of the Rocky Mountain Institute famously said, "If I want to hang a picture, I don't need a drill; I need a hole." In essence, the goal is to shift the consumer's focus from ownership to use.

The growing popularity of tool rental libraries is a good example of this trend. Instead of going out and buying a power tool that you might use only a couple of times a year, why not rent the tool as needed, for a fraction of its purchase price? This approach was already common with specialty tools like power washers, but it's increasingly being used for smaller, everyday items.

Another clever example is the rental of baby clothes. Since infants soon grow out of their clothes, it makes sense to rent them for the duration that they're needed, and then return them so that they can be rented to another family.

Similar ideas are being pursued in a wide variety of industries. Not all of them bill themselves as green businesses, but they do tend to save considerable resources and energy: it's much less resource-intensive for 30 people in your neighborhood to rent the same drill as needed, than for 30 people to buy a drill at the hardware store. For businesses and homeowners who are trying to cut costs, renting goods on an as-needed basis also makes good economic sense.

### Green Services

Popular green services include installing solar, wind, geothermal, or microhydropower systems; converting cars to run on biodiesel; supplying natural pest control services; building rain harvesting systems; and green demolition.

What services you choose to provide depends to some extent on your locale. For instance, installing water-powered energy systems is probably not a viable option in much of the Southwest. But **xeriscaping—**which is a form of landscape gardening that uses drought-resistant plants—might be quite popular.

Green service providers have a golden opportunity to position themselves as trusted guides and partners

To some extent, the very things that make the green marketplace uncertain for product-based businesses create special opportunities for service businesses. In a market where many customers want to go green, but don't feel they have the necessary knowledge, tools, and time, green service providers have a golden opportunity to position themselves as trusted guides and partners.

Here are some other green services you might want to offer.

- **Green consulting.** Many homes and businesses would benefit from adopting green practices, but their owners often don't know where to start. As a green consultant, you might inspect homes and offices, and help clients to achieve the greatest possible environmental and efficiency benefits while remaining within their budget. Other options include helping green businesses to find start-up money, produce marketing plans, or comply with regulations.
- **Green cleaning services** present an excellent opportunity because they address health concerns, time concerns, comfort and convenience, and environmental issues all at once. Even in an economic downturn, homes and businesses need to be cleaned, and green services may provide the extra value people are looking for.
- **Green construction and remodeling.** In addition to helping the planet, green building practices can increase efficiency, save energy, improve indoor air quality, and increase the value and attractiveness of homes and businesses. You can greatly increase the value of this business by recycling or reusing old materials.

- **Green event planning or catering** for weddings, conferences, concerts, festivals, and fairs. A green event planner might offer organic food and linen; living, pesticide-free flower arrangements in compostable pots; green shuttle services; and so on. As more businesses, consumers, and organizations go green, the demand for this service is likely to grow.
- **Bike garages.** As more Americans commute on bicycles, there are opportunities for bike-oriented parking facilities that offer greater safety and convenience. A facility in Washington even offers showers and changing rooms!
- **Eco-tourism.** As more Americans become interested in hiking, camping, birdwatching, adventure travel, and other outdoor activities, there's a growing market for eco-friendly guides, facilities, travel agencies, and transportation.
- **Organic or sustainable gardening.** Many urban areas are creating community gardens that let local residents grow their own vegetables. Often, this is a community development or urban-renewal project, but subscription-based versions of this scheme may also be viable in some regions. Customers could pay for growing space by the square yard, with delivery of harvest-ready plants as an additional option. Note that this ties into a number of strong trends, from sustainability to old-fashioned homemaking to health and wellness.
- **Meeting government needs.** Is your local government pursuing green policies? If so, you may be able to build a business that caters to their needs. For instance, they may have a need for a green demolition service that will sort and recycle useful materials from buildings that are being torn down. Failing that, you might start a business that helps other businesses to comply with regulations. Some businesses will be happy to outsource the green component of contract jobs, in order to concentrate on their core competencies. Environmentally friendly pressure washing is just one example of a job that might be outsourced.

*"After doing all the tests, I was feeling pretty negative about my chances," Todd recalls. "But my daughter Erica really believed in the idea. She's a teacher at Dona Ana Community College, and she said I should go talk to a counselor at the Small Business Development Center on campus. I didn't want to, at first. I guess maybe I felt it was like admitting I was a bad businessman. But she said, 'Dad, getting help when you need it makes you a good businessman.'"*

*When Todd showed up for his appointment with SBDC counselor Estelle Silva, he didn't expect much. He'd spent the past three months thinking about his business day and night. What would she know about swimming pools that he didn't?*

*As it happened, Estelle didn't know very much about swimming pools. But she did know a lot about marketing. She pointed out that when it came to selling a product, there were usually more issues to consider than which system cost more. Granted, Todd's informal research had suggested* *that his customers were unwilling to pay much of a premium for a chlorine-free pool. However, his customers also said that they were concerned about their health. That suggested to Estelle that there was some room for negotiation.*

*The problem, Estelle said, was that Todd's research hadn't been thorough enough. He'd done a pretty good job of gathering information. But on the other hand, he'd interviewed customers as a representative of Desert Spring, which may've explained their unwillingness to talk freely about price.*

*Also, he'd spoken to each of them informally, varying his approach with each customer. That might have affected the responses he got.*

*Estelle suggested that he conduct formal research, by creating an online survey with standardized multiple-choice questions. She helped him come up with questions that would reveal the respondents' attitudes about conventional pools, as well as chlorine-free ones, health, and the environment.*

*Assuming he got a good response rate, she felt confident that the answers would give Todd a more realistic picture of his customers.*

## Greening Your Business Plan

Like any other aspect of your business, the things that make your business green need to be set forth in your NxLeveL® Business Plan. This doesn't mean boasting about how you're going to save the world, of course. Instead, you need to explain how being green will help you to be viable, competitive, and profitable.

Claiming to be green will raise questions, not answer them!

You'll also need to explain what standards you intend to meet, what structures you'll put in place to achieve them, and how you'll monitor and communicate compliance. The more important being green is to your customers and your brand, the more attention you'll have to give to these issues.

If your goal is to become a zero-waste or carbon-neutral business, you may need to set forth a realistic timeline for achieving these goals, too.

As a rule of thumb, you should assume that claiming to be green will raise questions, not answer them. The people who will be reading your business plan are less interested in the sustainability of your product than in the sustainability of your profits.

It's fine to include a statement of environmental ethics early in the plan, in order to communicate why you're passionate about your idea. But after that, every reference to green products and practices should be tied to practical questions like who your target customer is, how you'll market and sell your product, why your price structure is correct, when you'll start earning a profit, what methods of accounting you'll use, and so forth.

An investor or lender may love your idea, but if you can't show that your business model is feasible, and that you have the knowledge and skill to make it succeed, they'll look at it as wishful thinking, not as a plan.

Here are some of the questions a green business plan should answer:

- What specific expertise do you have with green business and technology? This is a big, complicated, evolving field. You may need to show that you've grasped enough of it to compete effectively, and that you will be able to stay on top of new developments while running your business.
- Who are your customers, how many of them are there, and why will they buy? Are you fulfilling a specific green need in a bright-green market, or are you offering a green version of a standard product in a light-green or conventional market? Are you targeting buyers who are actively seeking green products, or will you have to win over people who are skeptical or uninterested?
- What standards will you meet? Your green goals need to be objective, quantifiable, consistent, and transparent. If you can't meet a specific goal at the outset, be honest, and detail your plan to make the necessary improvements when they become appropriate, affordable, and attainable.
- How will you ensure that you meet your green goals? How will you communicate green goals to your employees? How will you find green suppliers? What are the costs and benefits of these activities?
- How will you measure success? Will you formally address social and environmental costs and benefits in your accounting documents?
- How will you handle competition? The popularity of green products means that you're in a highly competitive market. What will you do if Wal-Mart or Costco starts selling a product with the same green features as yours?
- What is your plan for waste management (e.g., chemical wastes, recycling, wastewater, airborne pollution)? How will this plan lower costs, increase efficiency, improve safety, and meet or exceed regulations?

Above all, you need to give readers reason to believe that your business will be profitable, either because of or despite its green elements. If you want your business to be sustainable in the financial sense, you need to excel in traditional areas of business, too. Showing readers that you understand this will improve your chances of success.

If you want your business to be sustainable in the financial sense, you need to excel in traditional areas of business

Unless you're approaching a green lender or investor, it's best not to get too caught up in discussing environmental "big picture" issues. It's possible that you'll have readers who are interested in the effects of your enlightened waste-management policies on the yellow-bellied marmot, but it's more likely that they'll want to know how these practices will help your bottom line.

Back up your claims and assumptions with credible research whenever possible

Last, do your homework, and back up your claims and assumptions with credible research whenever possible. Use white papers and case histories to show how your approach led to substantial savings or increased market share for a similar business, and put them in the Appendix if necessary.

One last point: When compiling research, be wary of citing results achieved by big companies like GE, IBM, or Steelcase. They have more resources, clout, and economies of scale than a small business does, and this has a lot of bearing on how well their green tactics work. You need to find ideas that worked for businesses with resources, equipment, personnel, capital, customers, and goals that are reasonably similar to yours.

*Todd knew he had to give people a good reason to open his survey invitation e-mail, so he decided to appeal to their curiosity and their economic interests. In return for completing the survey, they would receive ten tips that were guaranteed to lower the cost of pool maintenance.*

*In the meantime, he continued to research and test alternatives to traditional pool chemicals. He reasoned that while pool owners might not be willing to spend the money for a new system, they might be willing to try out greener additives.*

*He found a lot of variety among these chemicals. Some simply didn't work as advertised. Some were pretty similar to traditional chemicals, but they were more expensive, or required more frequent applications, or were harder to use. A couple were just ordinary pool chemicals with a new, green-looking label. In the end, after performing the feasibility tests that Estelle recommended, he found several that would be appropriate for his business.*

*A month later, he went over the results of the survey with Estelle. As she'd suspected, he got very different responses to these standardized, low-pressure questions, and this made it much easier to devise a marketing strategy.*

*Based on the responses, they concluded that Todd should emphasize the health and luxury angle: fewer chemicals, improved skin condition, and a more pleasant, comfortable experience overall. The green side of the business focused mainly on energy savings. But Estelle felt that his target customers were interested in learning more about the environmental issues, and suggested that Todd should be familiar with these arguments for the system, as well as energy-saving alternatives like salt water pools and solar heating and purification.*

*"That could be the feature that pushes someone to buy," she told him. "You need to be able to make a good case for it."*

*They also decided that as a special introductory offer, Todd would offer two months of free maintenance with the new system. Todd explains: "That way, I'd prove to customers that the system really does work when you follow the procedures. After that, customers could take over the maintenance, or continue to have us do it for a small monthly fee. I have to say, I came away from that meetings feeling pretty positive about things."*

## NxLEVEL® TECH TIP
BUSINESS RESOURCES AND THE WEB

In response to the green battle-cry of "reduce, reuse, and recycle," many regions of the country have formed **recycling communities** that allow consumers and businesses to donate and receive useful goods. For green entrepreneurs, these communities can be a great way to find office supplies, building and landscaping materials, and other needs. Alternatively, they can be a way to get rid of equipment, materials, and discontinued products that you no longer need, while avoiding the hassle, expense, and external costs of dumping at a landfill. In some cases, recycling communities might even supply you with a free production input, or spark an idea for a brand-new product or business.

With that in mind, here are a couple of online recycling communities that you can browse.

**Gigoit** (www.gigoit.org) allows you to search for items you need within a specified radius of your zip code (up to 1,000 miles). Items being offered at the time of this writing included hard hats, chicken wire, file cabinets, restaurant supplies, and paper shredders.

**The Freecycle Network** (www.freecycle.org) comprises "4,774 groups with 7,003,000 members across the globe. It's a grassroots and entirely nonprofit movement of people who are giving (and getting) stuff for free in their own towns. It's all about reuse and keeping good stuff out of landfills."

## Communicating Green Benefits

The green business boom doesn't mean that everyone who starts a green business will be successful. As with any other type of business, many green start-ups will fail within the first three years. The businesses that survive will be led by people with excellent business and organization skills, a strong customer orientation, detailed knowledge of market trends and new technology, and an ability to communicate *all* the benefits of green products—not just the environmental ones.

Here are some skills that will increase your chances of starting and maintaining a successful green business.

- **Know your target market.** If your customers are primarily interested in efficiency and cost savings, they probably won't pay a premium price for fair-trade knitted goods. And if your target customers are interested primarily in sustainability, they won't be impressed by a non-green product that's marketed in a recyclable "eco-box." How you communicate environmental benefits must take the motivations and aspirations of your customers into account.

How you communicate environmental benefits must take the motivations and aspirations of your customers into account

- **Understand your customers' everyday needs.** It's nice that your product produces fewer greenhouse gas emissions than a competing brand. But if it doesn't fit into the customer's lifestyle, or has a steep learning curve, it's likely to be rejected. The whole point of green design is to reduce the impact of products that people actually use in everyday life. So naturally, green products have to meet those same needs, without requiring too much extra work or knowledge. It's a very common mistake for green businesses to be too far ahead of their customers. It's often better to build a loyal customer base, and then help them to grow and change with you.
- **Don't oversell green features.** People who aren't committed to green products will look at other selling points first, like usefulness, convenience, price, efficiency, attractiveness, and value. People who are committed to green products are likely to see you as one option among others, and assess your environmental and other benefits with a critical eye. Either way, you'll need to market *all* the benefits of your product to win the customer over.
- **Strike the right balance between price and benefits.** How much more people will pay for green products depends on the nature of the product, and the customer's overall perception of benefits. As a simplistic example, a product that will reduce the load on your local landfill may seem more valuable to local consumers than a product that will improve conditions in a rural village in Central America. By the same token, someone who's willing to pay an extra dollar for pesticide-free strawberries may not be willing to pay an extra dollar for biodegradable golf tees. Again, it all comes down to knowing your customers.
- **Be consistent.** Don't overlook the little things that detract from your green image. Even consumers with a minimal interest in the environment can recognize when promotional messages don't jibe with how you actually do business. If your van routinely idles for ten minutes while you're making a service call, people won't take your green claims seriously, which means they won't take your business seriously, which means they'll prefer not to buy from you.
- **Don't exaggerate.** If only one part of your product is green, don't call it a green product. Don't claim you've achieved things until you've actually achieved them. Instead, focus consumer attention on the ongoing process of improvement (assuming, of course, that this process is actually happening and is measurable).
- **Add a "green" page to your Website.** This page should explain what steps you've taken to be greener, and what plans you have for the future. Avoid vague terminology and buzzwords; clearly spell out what you've done, and why it matters. Include any green certifications you've earned, any groups you belong to, and any awards you've won. You may also want to consider adding a green forum that will allow you and your customers to have a dialogue about these issues. (Remember, though, that maintaining and moderating such forums can be a full-time job.)

If only one part of your product is green, don't call it a green product!

- **Don't overreach.** Don't present your business as a powerhouse of environmental righteousness if you can't deliver on everything that message implies. Instead, do fewer things, but do them better. Emphasize that you're working towards green goals, and welcome the public's help and input. Identifying and prioritizing your goals, and building them into your business plan, will help you to explain your strategies to consumers, and encourage them to buy in.
- **Encourage and educate customers and suppliers.** Contests, discounts, and other incentives will help to communicate your values, and encourage customers and suppliers to follow your lead. This can also increase acceptance of new policies. For instance, customers are less likely to mind the fact that you no longer offer plastic bags if they receive a discount for bringing a reuseable bag from home. You can also make people aware of your green efforts through factory tours, lectures, and guest appearances at local schools.
- **Experiment and innovate.** This is an immature, evolving market, so it makes sense to try different price structures and different promotional strategies. (Of course, it will take some thought and effort to experiment with your product, price, and promotional tactics without confusing or irritating your customers. Beta tests and consumer advisory boards may help you to strike the right balance between innovation and consistency.)

Emphasize that you're working towards green goals, and welcome the public's help and input

*Eight months and an SBA loan later, EcoZone Pools was open for business, and doing well. It had three employees, a steady stream of interest, and was adding new accounts every months.*

*"I think three things made our roll-out successful," Todd says. "First, I studied our customers, and familiarized myself with the new systems and products. Whatever there was to know about these products, I learned it inside and out. Second, I had a great team that was able to deal with the problems we hadn't planned for. Last, I had great suppliers who backed me up when I needed them. When a customer had a question my team couldn't answer, they came through with the right answers, right when we needed them. Without that commitment, we would've lost some business for sure."*

*Interestingly, Todd has found that his customers are expecting environmental issues to play a larger role in his marketing efforts and other business decisions, largely because of the efforts EcoZone has made to educate its customers. In fact, one of the customers who initially said that the environment didn't affect her buying decisions recently called to ask why EcoZone didn't install solar panels on its large, flat rooftop. After doing a feasibility study, and researching the availability and terms of loans and incentives, Todd decided that this would be appropriate, affordable, and attainable in the first quarter of Year Two.*

*"It's a natural outgrowth of the solar pool heating systems we were selling," he says. "I felt like we had to stand behind the concept. I wanted to earn people's loyalty by taking the same plunge*

*into renewable energy that I was asking them to take. If we wanted people to buy in, I felt like we had to buy in too.*

*"I feel good about doing that, and I feel good about where things are heading. I feel like if I can travel this road, anyone can, and I'm excited to see where it leads us."*

### Eco-Labeling

Businesses are increasingly using certification labels to assure consumers that their commitment to green practices is real and measurable. These labels show that an independent third-party has verified that a given product or service meets applicable environmental standards.

Certification can be expensive, and it usually requires you to pay annual renewal fees, so you'll want to weigh the costs and benefits carefully before proceeding.

Here are a few of the national organizations that provide green certification:

- **UL Environment** (www.ulenvironment.com) is a project of Underwriters Laboratories, whose ubiquitous product-safety labels are familiar to most Americans. UL will work with manufacturers "to test, validate and certify environmentally sustainable products." The fact that UL is a highly visible brand with over a century of experience is likely to make their certification very desirable for small and large businesses.
- **Chlorine Free Products Association** (www.chlorinefreeproducts.org) is an independent nonprofit accreditation and standard-setting organization that promotes chlorine-free policies, programs, and technologies.
- **Green America** (www.coopamerica.org) offers membership in its Green Business Network to qualifying firms. Though not as scientifically rigorous as other options, it's relatively inexpensive, and can help to establish your credentials as a green business.
- **Green-e** (www.green-e.org) is the nation's leading independent consumer protection program for the sale of renewable energy and greenhouse gas reductions. It offers certification and verification of renewable energy and greenhouse gas mitigation products.
- **Green Seal** (www.greenseal.org) sets product standards and awards its label to a wide variety of products, in order to certify that they have "been tested according to science-based procedures...without bias or conflict of interest."
- **Scientific Certification Systems** (www.scscertified.com) tests and certifies a wide range of sustainable products and processes, including office furniture, building materials, paints, finishes, home and garden supplies, and cleaning products.

Many other countries have their own eco-labeling certification systems. Like their American counterparts, they tend to be expensive. All the same, it's a good idea to familiarize yourself with them. Even if you decide not to go for certification, they may help you to understand your competition and your options.

- **EcoLogo** (www.ecologo.org) is North America's oldest environmental standard and certification organization. It sets standards and certifies Canadian and American products in more than 120 categories.
- **EcoMark** (www.ecomark.jp/english) is a Japanese certification system based on ISO 14020 and 14024.
- **European Union Eco-Label** (ec.europa.eu/environment/ecolabel/index_en.htm) encourages businesses to market environmentally friendly products and services, and to help European consumers identify them.

## Staying Green

If green business isn't just a fad, but is in fact setting a new baseline for best practices and consumer expectations, then staying green is even more important than going green.

This means that you need to be flexible, so that you can act quickly to eliminate waste and improve efficiency. But you also need to be skeptical, so that you're not changing your business around every time some new green product or process hits the market. More than that, it means that you have to be committed to green principles. As competitive and regulatory pressures increase, businesses that can't or won't keep up are likely to fail.

You should assess your green initiatives regularly, and question whether they're still adequate. Here are some points to consider:

Assess your green initiatives regularly, and question whether they're still adequate

- Are you still meeting your customers' needs? Do you need to change your goals or standards to meet new demands?
- Are all lines of communication between you and your customers open and working?
- Have new environmental laws been passed or proposed?
- What are your competitors doing?
- Are your business processes as transparent as they need to be?
- Is your supply chain as green as it could be? Are suppliers and distributors taking advantage of new technology and keeping up with evolving standards? Are you?
- Are waste and inefficiency creeping back into your business processes? Are there opportunities for improvement?
- Will new or emerging technology make existing green goals easier to achieve, or new goals feasible?
- Are your employees engaged by and committed to your green policies? Are they contributing ideas, identifying problems, and offering solutions?

One of the best things you can to do to stay green is listen to your customers and employees. Don't wait for them to come to you with suggestions for making things better; take every opportunity to seek out their advice. You may find that in some ways, they know more about green business ideas than you do. When people come up with an idea you can use, be sure to give them credit by name. And if you want new ideas to keep coming, reward them.

If you haven't joined a green business forum online, do so! This will allow you to ask questions, hear about hands-on experience with new products, and learn from the mistakes and successes of entrepreneurs just like you. It will also help you to keep up on new technologies and regulations, and you may even make a few friends and allies.

Last, you need to stay informed, both about your industry and about green business generally. You should definitely subscribe to industry-related publications, newsletters, and listservs, and set aside time to read them. You should also find some Websites to visit regularly, so that you can stay up to date on green technology, theory, practice, and policy. Some of these sites will undoubtedly have a specific political agenda (which you may or may not support), while others are mainly concerned with the nuts and bolts of green business. We recommend seeking a wide range of opinions, and trying to stay open-minded.

## Conclusion

Green business presents exciting opportunities for forward-looking entrepreneurs who are willing and able to commit themselves to understanding, measuring, and reducing or reversing the effects of their business on the environment.

Far from being an easy road to riches, this is a path that takes unusual levels of discipline and personal responsibility. It also takes a collaborative effort. To make a real difference, you'll need to work closely and transparently with customers, employees, suppliers, shippers, and distributors.

Going green requires you to be honest with your customers, your business partners, your employees, and yourself

Above all, going green requires you to be honest with your customers, your business partners, your employees, and yourself. You'll need to back up your claims with evidence, listen and adapt to constructive criticism, and take an ongoing, critical look at hidden inefficiencies and external costs.

For entrepreneurs who have what it takes to run a truly, consistently green business, the personal and financial rewards can be profound and lasting.

# Part III
# PLANNING YOUR BUSINESS

## Chapter 11
## WHAT IS BUSINESS PLANNING?

*About This Chapter:*
- *The benefits of planning*
- *Defining your business concept*
- *Understanding the planning cycle*
- *Feasibility studies*

### Introduction
Small businesses are often more vulnerable than larger competitors to changes in the economy. It is this vulnerability that makes planning so important for your business.

Too often, planning is simply a reaction to a crucial event, such as seeking financing or buying a business. However, reactive planning is not sufficient to start or grow a successful business. Planning requires constant attention—just like selling and bookkeeping—so it needs to be integrated into your day-to-day management practices.

### The Benefits of Planning
Let's take a look at some of the benefits of the planning process.

- **A look at the big picture.** Daily decision-making often focuses on solving a series of individual problems that initially may not seem to be connected. Planning helps you to discover the underlying causes of these recurring problems.
- **Better guidance for employees.** Entrepreneurs are often frustrated when their employees don't make the right decisions. A business plan guides each employee's daily actions. (Of course, this assumes that your employees are involved in the planning process or, at the very least, receive training about the parts of the plan that affect them.)
- **Accurate communication.** The business plan puts necessary information in writing, which can then be communicated to employees, investors, creditors, and other interested parties.
- **Increased opportunities.** Change always presents opportunities to the prepared business owner, and planning is a systematic way to identify these opportunities.
- **Continuous improvement.** The written plan is not the end of the planning process. In fact, the process is continuous. The ongoing comparison of planned to actual results provides a terrific opportunity to improve business operations.

Change always presents opportunities

- **Action, not reaction.** Entrepreneurs often talk about the burnout that results from handling a never-ending string of problems. A good business plan is like a good fire-prevention plan. Fires may still occur, but they're not as likely, and the best method of response has been determined in advance.
- **Isolating root problems.** The planning process helps you sort through hundreds of concerns about your business, and focus on the handful that are causing the majority of your problems.

Planning helps you discover the cause of recurring problems

## Defining Your Business Concept

Although you may be eager to start planning for a successful future, there are some questions to answer first. As you work on the questions in this section, make a list of any difficulties you come across; it will be helpful in the next section.

- What business am I in?
- What products do I offer?
- How does my business reflect my personal values?
- Who are my target customers?
- Why do customers buy from my business?
- When will my customers buy?
- Where will they buy (online, or retail store)?
- How will customers find my business?
- How much will my customers pay?
- When will they buy (seasonality)?
- What plans do you have for growth?

Review your answers to the previous questions and write a one-page definition of your business. Here's an example of how to do it:

> Simply Shoes is a retail shoe store located at the corner of Fifth and Main. Simply Shoes sells discounted medium- to high-quality dress and casual shoes to adult and young adult customers, by virtue of its relationship with brokers and manufacturers.
>
> Over the coming year, we plan to increase style and size selection, double sales, and develop a loyal customer base through friendly and attentive customer service. Our marketing strategy calls for targeted marketing to identified customer groups, and projected sales of $350,000 for the coming year. We will remodel our existing space, providing more visibility for merchandise, and room for a wider variety of styles.

*MacSharp Sports is an online business that specializes in selling athletic equipment to adult players of recreational team sports. Its owners, Fiona MacLeod and William Sharp, started an online business because they didn't want to keep regular business hours. (They both like to travel, especially to locations that offer outdoor adventure.) Their chosen market niche was the result of extensive market research performed during their last year of college at SUNY-Binghamton in New York.*

*Recently, a sales representative from Webfoot, makers of an innovative all-weather sports sandal, contacted MacSharp Sports about selling their sandals. Fiona was interested; she had worn the sandals during a four-day hike through the Scottish Highlands, during which she encountered many different kinds of weather and terrain. She was very satisfied with the sandals, and had even called Webfoot to say so upon returning home.*

*Adding the sandals seemed like a good idea. Their quality was impeccable, and they could easily be sold over the Internet. But Webfoot sandals had a different target market than MacSharp Sports' products. William and Fiona wondered whether the sandals would fit into their current product mix.*

## Understanding The Planning Cycle

Planning is a five-step process.

1. Plan a course of action for your business.
2. Take action by making decisions that support the plan.
3. Measure the results of the actions taken in Step 2, and note any differences between the results you expected and the results you got.
4. Explain results that varied from planned results. Note that you must do this whether the variance is positive or negative.
5. Make improvements to the plan as a result of what you learned in Step 4.

In a well-managed business, these steps take place every day. Now, we'll look at some hints on how to make the planning cycle a natural and normal part of your business operations.

### Take the Lead

It's important to avoid the temptation of delegating all the responsibility for planning to an employee, a team, or a consultant. It's great to have others organize and participate in the planning process, but you must be seen as a strong and active advocate of the process.

You must be actively involved in the planning process!

### Assemble a Planning Team

Giving employees a sense of ownership in a plan greatly improves its chance of success. You may also want to involve professional advisors. Businesses often hire an outside facilitator to keep the planning process running smoothly. (Note that this person's role is to facilitate the process, not to control or participate in it.)

At the first meeting, set a timeline for future meetings and for completing the planning process. Make sure that each person on the team understands his or her responsibilities.

### Types of Plans

There are different types of plans for different parts of your business. Some are blueprints that guide your overall operations; others are far more specific documents that guide strategies and tactics.

- **Business plan.** A complete business plan contains three major components: strategies, actions, and projected financial statements. (A fourth area, policies and procedures, is also important to the planning process, but is not included in the business plan.)
- **Marketing plan.** This plan focuses solely on the marketing function of your business. Portions of the marketing plan appear in the business plan.
- **Strategic plan.** Strategic planning considers your business environment and the major decisions you face, in order to ensure long-term success. Focus your attention five years into the future when considering strategic planning. The strategic plan is contained, often in its entirety, in the business plan.
- **Operational planning.** This process focuses on short-term actions (one year, usually). When you don't base operational planning on a strategic plan, you run the risk of making decisions that seem good today but could have a negative long-term impact on your profitability. Ideally, operational planning should occur after strategic planning. However, small businesses are usually short-term oriented, and thus emphasize operational planning.
- **Annual work plan.** Annual work plans are the result of operational planning. An annual work plan is very detailed; only the highlights appear in the business plan.
- **Financial planning.** Financial planning includes the process of preparing budgets and projected financial statements. These numbers must be updated whenever any planning activity is undertaken. They are a numerical representation of the strategic and operational planning processes.
- **Financing proposal.** A financing proposal is not really a planning document. Financing proposals are developed for the purpose of securing financing, not for the purpose of managing the business. But most of the financing proposal comes from the business plan, so it's really a byproduct of the planning process.

Financial planning: the process of preparing budgets and projected financial statements

- **Feasibility study.** An entrepreneur who wants to start a new business should always engage in an abbreviated planning process to determine whether to proceed with the new venture. This is called a **feasibility study**. It's an important tool for anyone who is contemplating a start-up business, or adding a new component to an existing business.
- **Individual employee plan.** Great entrepreneurs know that leading and motivating individual employees is one of the keys to business success. Setting goals that are unique to each employee, and are tied to the company mission, is a planning method that's well worth pursuing.

## Feasibility Studies

Rick Dalby owns a successful hobbyist's store. He has an opportunity to expand into an adjacent space that just became vacant. Is this a good idea? If so, should he increase his inventory of existing products, or offer new product lines? How much can Rick afford to spend on remodeling? Will he need to increase his prices to pay for the expansion? An acquaintance recently expanded his auto-parts business by getting into Internet sales, and Rick has been considering this option too. What is his best course of action?

In many cases, you won't be able to complete a comprehensive business plan before making a decision. Preparing a feasibility study is quicker, and can greatly reduce your risk. Small-business owners are continually confronted with opportunities—and questions—like these. Conducting a feasibility study is the best way to decide which opportunities to pursue. A feasibility study enables you to take a realistic look at the benefits *and* costs of your business opportunity, so that you can decide whether it's appropriate, affordable, and attainable.

Conducting a feasibility study is the best way to decide which opportunities to pursue

A business idea that's worth pursuing will satisfy all applicable feasibility tests:

- **SWOT analysis.** When choosing a course of action, you need to take an honest look at your **strengths**, **weaknesses**, **opportunities**, and **threats**. When strengths and opportunities outweigh weaknesses and threats, there's a good chance that your idea is feasible.
- **Financial feasibility.** It's natural for entrepreneurs to be idealistic, but to reach your financial goals, you also have to be a realist. If your business idea is not financially feasible, it's senseless to investigate it further. Don't forget to consider the costs associated with borrowing money to accomplish your goals. If these funds will come out of normal operating profits, you must weigh this against borrowing, or utilizing the profits for other ideas.
- **Feasibility of sales volume.** Any idea can seem financially feasible if you assume a high enough sales volume. Can you really achieve the sales volume you need to make your idea work? This is an area where many entrepreneurs falter, usually by being too optimistic. Granted, sales forecasting is not easy, but extra diligence in this area is well worth the effort.

The best idea in the world won't succeed if you don't have the staff to make it succeed

- **Marketing feasibility.** If your opportunity passes the sales-volume test, you must develop a marketing plan that will outline how your business will reach the projected sales volume.
- **Feasibility of personnel.** The best idea in the world won't succeed if you don't have—or can't hire—the staff to make it succeed. It's vital to have employees and contract workers who have the skills you need, and believe in your product.
- **Logistical feasibility.** Common considerations include the ability to find suppliers, manufacture the product, and provide customer support and service.

Depending on your product, goals, customers, and competition, you may need to consider two more feasibility tests:

- **Environmental feasibility.** If your goal is to be a green business, then certain courses of action may not be feasible for you. These will vary depending on your target market and your level of conviction.
- **Social feasibility.** A decision that's socially feasible will benefit society in some way (or at least, it won't obviously harm it). Harm and benefit are open to interpretation, of course, and not everyone will see a given business practice as beneficial. Still, a typical socially aware business would avoid using products made in sweatshops.

## When to Do a Feasibility Study

A feasibility study can be done before preparing a business plan, or before modifying an existing plan.

*Before starting or buying a new business*

A feasibility study is an important tool for making the right decisions when starting a new business. A wrong decision at this point often leads to business failure. Only 50 percent of start-ups are still in business after 18 months, and only 20 percent are in business after 5 years.

*Before expanding an existing business*

Owners of existing businesses continually face decisions about expansion (e.g., the addition of new product lines, hiring a new employee, or increasing the square footage of the business location). The owner who knows how to perform a quick feasibility study is more likely to make the right choices.

Techniques covered in this chapter can also help you to look at changing prices, purchasing additional advertising, giving pay raises to employees, and almost any other decision that changes the numbers for your business.

## Outline of an Initial Feasibility Study

This section explains how to prepare an initial feasibility study by assembling its main sections in the following order:

1. Scope of the business concept
2. Results of SWOT analysis
3. Financial feasibility
4. Sales volume assessment
5. Conclusion

The details of the study will vary according to whether you're starting a new business, buying an existing business, or expanding an existing business.

*Starting a new business*

**Step 1: Scope.** Define your business opportunity. Are you introducing new products, or improving existing ones? Or are you changing some other area, like energy use or production methods? (Please note that we use the term "product" to refer to products *and* services, except in cases where it's necessary to make a clear distinction between the two.)

**Step 2**: **SWOT analysis.** Strengths and weaknesses relate to internal areas like marketing, personnel, management, and finance. Opportunities and threats relate to external factors like competition, technology, economic and political conditions, and social trends. Note that external threats often result from internal weaknesses, and external opportunities from internal strengths.

External threats often result from internal weaknesses, and external opportunities from internal strengths

- Why does the opportunity exist? Will it exist long enough to become profitable?
- How many competitors do I have? What's their marketing strategy?
- What is my competitive advantage? How will I withstand new competition?
- Is there room for growth?

**Step 3: Financial feasibility.** This is a four-step process.

a. Determine the start-up costs associated with your opportunity, and how much financing you need. Start-up costs include professional fees, remodeling, licenses and permits, inventory, equipment, vehicles, and other fixed assets.
b. Budget your annual operating costs, and determine which are fixed and which are variable. Annual operating costs should be calculated on a cash basis, and include servicing any debt you need.
c. Test financial feasibility by performing a break-even analysis (also called **cost-volume-profit analysis**). This calculation tells you the annual sales volume you will need to cover fixed and variable operating costs.
d. Determine whether you will finance out of regular profits, or borrow to accomplish your goals.

**Step 4: Feasibility of sales volume.** Perform a market assessment to determine whether your break-even sales volume is realistic. First, it's important to define your business concept and your target market concisely. During the SWOT analysis, you examined the industry and the competition. These are also important considerations when answering questions about sales volume.

Completing **cash flow projections** will help to ensure that your ideas are financially sound, and prepare you to manage cash shortages and surpluses. To do so, you must examine all the expenses associated with your new idea and prepare monthly sales forecasts for a three-year period.

**Step 5: Is the idea feasible?** Now it's time to make a simple yes-or-no decision. At this stage, you may want to return to Step 1 and revise your responses to the first four steps. This gives you a chance to fine-tune your idea.

*Acquiring a business*
In this case, the five steps are the same as in the previous section, but you will perform them a little differently. Include the present owner in the process, and obtain copies of his or her business records whenever possible. The first time you go through the five steps, you should analyze current business operations. Remember: You are purchasing the business as it is, not as it could be.

For future iterations, you can modify the business concept, SWOT analysis, financial data, and so forth to reflect the potential of the business. Be very careful when making these modifications! If your first attempt suggested that you should not buy the business, but you still want to, it is easy to make unrealistic changes in order to "prove" to yourself that the business is feasible. (Review Chapter 5 for more information.)

*Expanding an existing business*
**Step 1.** Does this opportunity require you to redefine your current business concept? If so, how substantial is the modification? This is an initial feasibility check. Ideally, the opportunity will fit your business concept, or need to be modified only slightly.

**Step 2.** Review the results of your previous SWOT analysis and determine whether any changes are required. Do the changes indicate an improved or worsened competitive position? A good business opportunity should result in an improved position.

**Step 3.** Here, you have the same three steps regarding financial feasibility as those described for starting a new business. The difference is that you start with your present annual operating costs and make adjustments from this baseline.

Every business opportunity has start-up costs!

a) **Start-up costs.** No opportunity is so simple that you won't have start-up costs!
b) **Annual operating costs.** Analyze your annual operating costs. In most cases, you'll find that these costs will increase. They may not change, but take a good look just to be sure.
c) **Break-even analysis.** This is done only for start-up costs and annual operating costs for the new business opportunity.

## NxLEVEL® TECH TIP

BUSINESS RESOURCES AND THE WEB

**Ameriwest Business Consultants, Inc.** offers a financial analysis template that allows you to put together financial projections for up to five years. Its capabilities include break-even analysis, month-by-month annual budgets for the first five years, and summary income statements. You can input data for an existing business or a start-up; the data can be historical, projected, or a combination of both. If your business is unique, the template can even be customized to meet your specific needs. For more information on this product, go to **www.abchelp.com/Ameriwest_Complete_Financial_Analysis.htm#Ameriwest**.

**Step 4.** A sales volume assessment answers the question: "Is the incremental sales volume realistic?" Be sure to review your industry and competitive analyses.

**Step 5.** The "yes or no" conclusion is a little more complicated for an existing business. You may decide to pursue an opportunity that is not feasible in the short term, because you have a strong belief that it's the right move in the long run. Obviously, your existing business must be profitable enough to support this decision.

*William and Fiona decided to conduct a feasibility study on adding Webfoot sandals to their product line. They started out with a SWOT analysis for MacSharp Sports. Here's what they came up with:*

*Strengths*

- *Well-defined market niche*
- *Very productive mailing list*
- *Good reputation, as measured by many new customers from referrals*

*Weaknesses*

- *MacSharp Sports is poorly capitalized*
- *Well-defined market niche limits new product possibilities*
- *Owners often feel overworked and pressed for time*

*Opportunities*

- *Expand product offerings by adding Webfoot sandals*

*Threats*

- *Large Internet retailers might dominate the market*

### Outline of a Complete Feasibility Study

If the results of the initial feasibility study are positive, this should encourage you to do more thorough research before taking action.

This section explains how to prepare a complete feasibility study by assembling its main sections in the following order:

1. Cover page
2. Executive summary
3. Definition of the business concept*
4. Results of SWOT analysis*
5. Financial feasibility*
6. Sales volume assessment*
7. Marketing
8. Personnel
9. Logistics
10. Environmental benefits
11. Social feasibility
12. Conclusion

*Indicates sections already completed as part of your initial feasibility study.

*Marketing*

Having looked at your industry and competition, you believe you can achieve the sales volume you need. Now, you must decide how to achieve it. This means looking at all of the normal marketing components: product, price, promotion, placement, and so forth.

Ask yourself:

What promises do you make, and how will you keep them?

- What promises does my business make?
- Why are these promises credible, and how will I keep them?
- What price are my customers willing to pay, and how will this affect my profitability and sales volume?
- How will I deliver my product or service? Will the method I've chosen meet my customers' needs and expectations?

*Personnel*

Now it's time to assess the ability of your personnel to take advantage of the business opportunity. First, look at the capabilities of your outside advisors, managers, and employees. List the key tasks at your business, and determine who will perform them.

*When William and Fiona finished their SWOT analysis, they were very concerned that adding Webfoot sandals to their product line would weaken their competitive position. However, they knew that they needed to complete their initial feasibility study before making a final decision.*

*The sales representative from Webfoot had told William and Fiona that their minimum initial order was 200 pairs of sandals. The sandals cost an average of $50 per pair plus freight, so their initial inventory would cost $10,000, plus $250 in freight charges. They estimated a cost of $350 to modify the layout of their catalog and Website to make room for the sandals. A professional photographer would cost at least another $300. Based on their previous experiences, they budgeted another $500 for unknown costs. Therefore, the total start-up cost for adding the sandals was $11,400.*

*They estimated that the sandals required four percent of their total catalog space, and decided that the sandals must cover four percent of the printing and mailing costs, as well as customer database and Website maintenance. Using this formula, they estimated annual operating costs at $3,690.*

*Their research indicated that the sandals could be sold for an average of $80 per pair, plus shipping. Their cost of $50 per pair left MacSharp Sports with a gross profit of $30 per pair. Thus, if they sold 123 pairs of sandals they would cover their additional annual operating costs of $3,690.*

*William and Fiona felt a bit more optimistic. But could they really achieve that kind of sales volume?*

### *Logistical feasibility*

Next, you need to look at everything involved in sourcing, manufacturing, storing, selling, shipping, tracking, and servicing your product.

- **Materials and equipment.** What materials, parts, and equipment do you need to produce your product? Where will you get them? Do you have the space you need to manufacture your product? Will product substitutes perform as expected and meet the required specifications? Will existing equipment be able to meet increased sales, or will you need to expand? If your product is manufactured elsewhere, will that facility be able to meet your needs if you grow?
- **Suppliers and partners.** Who are your suppliers and partners? What services do they provide? Can they meet your needs if you expand or change your business?
- **Transportation.** How will you ship your items? Do they require special handling, documentation, or licenses? Do discount rates apply (e.g., bulk mail)? Can your transportation system handle an increase in volume if sales take off? If you offer services, how, when, and where will your personnel deliver them to clients?

What materials, parts, and equipment do you need to produce your product?

- **Business location.** Do you need an additional or new retail outlet, warehouse, factory, or distribution hub? How much parking do you need for customers, employees, and company vehicles? What are your zoning requirements? Should you be in a retail or industrial district? Do you need to be near other facilities (e.g., an airport, train station, or shopping mall)?
- **Other technology.** Do you need telephone networking or teleconferencing systems? Inventory management, customer management, or accounting software? Cash registers, checkout scanners, credit card and check processing? Devices to accommodate people with disabilities (e.g., automatic doors)? Alarm or camera systems?

*Legal feasibility*
You must research all applicable local, state, and federal laws when developing, producing, selling, and delivering your product. You should also consider intellectual property issues (i.e., patents, copyrights, trademarks, nondisclosure and licensing agreements).

*Environmental feasibility*
Try to assess the environmental impact of your idea through every stage of its life: resource extraction, manufacturing, storage, selling, shipping, consumer use, and disposal. Identify the external costs and benefits for each of these stages, and look for ways to reduce costs and increase benefits by changing ingredients, suppliers, sales and shipping methods, use, or disposal. Can you use materials or packaging that will add value (e.g., that are reusable, or unique in some other way)?

Try to assess the environmental impact of your idea through every stage of its life

*Social feasibility*
Most of us are familiar with the controversy over clothing that's made in sweatshops, often by child laborers. Bad workplace conditions like these have caused tremendous PR headaches for a number of prestigious companies. With this in mind, a business that wishes to consider its social impact should take a look at who makes the raw materials for its products, and how it affects their quality of life and their community. These are the sort of questions you need to look at if you want to assess social feasibility.

*Conclusion*
Last, take a thorough look at your feasibility study. Review the business opportunity in terms of personnel, finances, markets, and other factors. This is your final chance to refine your idea before implementation.

*Executive summary*
After you've completed your feasibility study, write a one-page summary that can be easily read and understood by people who have no special knowledge of your business.

*Cover page*
Prepare a cover page with your business's name, address, phone and fax numbers, and online data. Include the date on which the study was prepared, and the names of the owners.

*The main thing that was bothering William and Fiona was the fact that they had to buy 200 pairs of sandals as initial inventory. It wasn't that they didn't think they could sell them. They were optimists, and they believed in the product wholeheartedly. They also believed in themselves and their marketing skills. They knew they could sell 123 pairs eventually; the question was whether they could sell them fast enough to avoid serious cash flow problems!*

*They calculated that to keep things running smoothly, they needed to sell the requisite number of sandals within six months. Could they negotiate better terms?*

*It turned out that they could. Fiona contacted Webfoot and negotiated an option to return any sandals that didn't sell within the first six months. There was a restocking charge of $10 per pair, but it was worth it. The arrangement greatly reduced MacSharp Sports' financial risk.*

*Now, the question of sales volume was less important. They viewed this as a chance to test-market the sandals, and decided they were ready to proceed.*

**Keys to Success**

- Don't commit to an opportunity until you take a realistic look at it. Remember that there will always be new opportunities for the watchful entrepreneur!
- Do a thorough analysis of each major competitor. Establish your market niche so that you have at least one major competitive advantage when compared with each competitor. This requires some work, but it's worth the effort.
- Identify all start-up costs, and obtain two or more cost estimates for each item.
- Research the financial averages for your industry. These averages represent the performance of existing companies in your industry. If your figures differ greatly, you would be wise to determine why. *Annual Statement Studies*, published by Robert Morris & Associates, is an excellent source. You can also check with your trade association and your accountant.
- Are you smarter than the established competition? An established competitor is doing some things right. You may be focusing on their mistakes; look into their strengths as well.
- Research growth trends. How fast is the industry growing? What is the impact of international trade, environmental issues, and e-commerce? Is it increasing or decreasing? What technological changes can be expected?
- Research the role of small businesses in the industry. What is the role of franchising? Is it increasing or decreasing? Is the industry dominated by large or small businesses?

## NxLEVEL® GREEN TIP

ENVIRONMENTAL BUSINESS RESOURCES

The US EPA's Energy Star program recently released a new site for businesses called **Energy Star @ Work** (accessible through www.energystar.gov). This cleverly designed interactive site offers tips on saving energy in the office, and helps you to locate Energy Star-qualified office equipment.

You also listen to podcasts on energy efficiency at work and at home, by visiting **www.energystar.gov/index.cfm?c=products.pr_podcasts**. Transcriptions are available if you'd prefer to read the information, or keep it on hand as a reference.

*After finalizing their agreement with Webfoot, William and Fiona took a number of approaches to marketing their new line of sandals. First, they marketed the sandals at $80 per pair to their existing mailing list and Twitter followers. Second, they bought a mailing list that targeted whitewater rafters and kayakers, and sent out an attractive PDF brochure. In a form of co-op advertising, Webfoot agreed to pay 25 percent of the cost.*

*Their most successful marketing campaign came as a something of a surprise. Fiona was a talented writer, and she kept a blog detailing her outdoor experiences. She had already described her hiking experiences in Scotland, and had included a heartfelt plug for Webfoot sandals. William had the brilliant idea of putting the hiking story on the MacSharp Website, along with a selection of the pictures Fiona took.*

*Fiona was somewhat skeptical, but the response was very positive. MacSharp sold 49 pairs of sandals from the blog story alone. Soon, Fiona's blog was incorporated into the MacSharp site. It described her adventures in different places, which drew a steady stream of new customers, and kept old ones coming back. Also, it made people feel that they knew her and trusted her, which made them feel good about buying MacSharp's line of products. They knew she was a stickler for quality, and didn't recommend products unless she found them to be really exceptional.*

*In the end, MacSharp had no need to return any sandals to Webfoot. Thanks to MacSharp's careful planning and inspired marketing, they all sold within five months. And today, MacSharp has much more control over its negotiations with suppliers...not least because so many of them are eager to get a prestigious product endorsement on Fiona's blog!*

## Conclusion

A conscientious planning process can have a tremendously positive impact on your business. Conversely, inadequate or disorganized planning can be devastating. Here are the basics that will keep your planning process on track:

- The owner must assume the lead role
- Plans must involve everyone in the business
- Build the plan on the skills of those who will implement it
- Plans must be flexible and realistic
- Always have a contingency plan
- Identify how to achieve specific objectives
- Document your assumptions
- Revise the plan regularly

Is the planning process the same for all types of businesses? Yes and no. The steps in the process are the same, but the results are different. You wouldn't expect a manufacturing company that specializes in high-quality custom orders to have a plan identical to that of a fast-food restaurant. Nor would you expect a wholesaler of farm implements to have a plan identical to that of a consulting company that specializes in customer service training.

You must customize your plan for your business. If you do, you'll be ready to compete today, and—even more important—you'll position yourself to be successful in the long run.

# Chapter 12
# THE NXLEVEL® BUSINESS PLAN

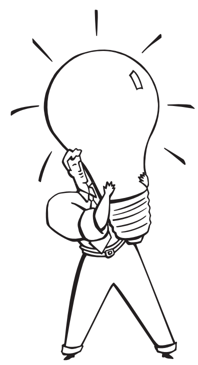
*About This Chapter:*
- *Introduction to the NxLeveL® Business Plan*
- *Getting started*
- *Is your business venture feasible?*
- *A polished presentation*

## Introduction

Whether you're starting a new business or expanding an existing one, the NxLeveL® Business Plan is an indispensable tool. It outlines the basics of your business concept: your business's mission, objectives, products, management, marketing, and financial plan.

When you prepare your business plan, you will learn whether your business idea is truly viable. You will also fine-tune your business concept, making it all the more likely that your venture will succeed and grow.

Why are we presenting the business plan here, before we have introduced basic marketing and financial concepts? Because this chapter shows you where you are headed, and highlights the concepts you must understand. Each chapter in this book contains elements that are related to the business plan.



The NxLeveL® Business Plan is the first step in growing your business

## Introduction to the NxLeveL® Business Plan

Business plans are written for three major audiences:

- The internal management team
- Prospective lenders and investors
- Prospective partners, advisors, and employees

Your NxLeveL® Business Plan will provide essential information to anyone who is seriously considering involvement in your venture, such as prospective employees, mentors, and partners. Banks, investors, and other institutions review business plans before making loans, so that they can judge the abilities of the business owner and the potential profitability of the business.

Lenders, employees, and partners all look for the same information in a business plan:

- Is the business idea viable?
- Are its products new, unique, or better than current offerings?

- Does the business create or cater to a new market?
- Is it a growth market?
- Are the cash flow and sales projections realistic?
- Can the business be profitable and service its debt?
- Does the business understand and place priority on customer needs?
- Is the business concept clear, focused, and intelligently presented?
- Is the business concept based on sound research and analysis?
- Are key people experienced in this business?

*Catherine Baggott began Bag-It Gourmet on the simple premise that most people want good, healthy food, but are too busy to prepare it.*

*This was her own situation from 2005 to 2007, when she sold advertising space for a gourmet magazine. During the week, Catherine would work long hours, go to her health club, and get home late, tired, and hungry. Most of her favorite restaurants didn't deliver, so she often ended up ordering pizza or Chinese food. She soon found herself wishing that more varied, higher quality food was available for home delivery.*

*Catherine spent a year casually researching the feasibility of a gourmet food delivery business. By the end of the year, she had created a business concept: Bag-It Gourmet would take phone orders and deliver food from ten different restaurants to customers within a five-mile radius of her home.*

*Catherine created a business plan for Bag-It Gourmet, clearly outlining its costs (including the purchase of a new mini-van for deliveries) and sales forecasts. She decided the business was feasible, so she prepared a brief description of the business, bundled it with her financial plan, and prepared to leave her job.*

## Components of the NxLeveL® Business Plan

The major components of the plan are as follows:

- Cover Page
- Table of Contents
- Executive Summary
- Mission, Goals, and Objectives
- Background Information
- Organizational Matters
- Marketing Plan
- Financial Plan
- Appendix

The NxLeveL® Business Plan presents the elements that will affect the success of your business

## Getting Started

Before you start drafting your plan, revisit your original business concept and review your assumptions. You should be perfectly clear and confident about the direction in which you want to take your business.

Next, list and prioritize the things you'll need in order to pursue your business idea. Suppose you want to open a café with a laundromat attached. Although there are two other laundromats in your town, they are poorly lit and maintained, and completely lacking in appeal. Your vision is to create a place where people will want to wash their clothes. While they wait for their laundry, they can have a good cup of coffee and a fresh sandwich. They can socialize, or sit at a table and read.

You'd start by making a list of the skills you'd need, such as maintaining laundry machines and managing a café. You might eventually seek outside investors or lenders, so you'd need to think like one. Ask yourself, "What is so great about my laundromat? What makes it unique? What value do I offer prospective customers? What resources are available to me? What green or sustainable business practices could I use to differentiate my business? How long before I make a profit? What is my competition like? What are my long- and medium-term plans for growth?"

Once you've done this, it's time to start drafting your plan. You will write each element of the plan in your NxLeveL® workbook.

### Executive Summary

The **executive summary** is the opening argument of the business plan. Prospective investors will scan it to determine whether or not the rest of the business plan is worth reading, so it must capture and hold their attention!

Be clear, concise, and convincing!

The executive summary comprises condensed versions of the major sections of the business plan. Therefore, you must understand the preceding sections, and how they relate to one another, before you can write an effective summary.

*One year later, Bag-It Gourmet was making over 800 deliveries a week, charging a 20% commission on each delivery. Catherine had a couple of enthusiastic young drivers who were as committed to customer service as she was.*

*But she could see that the landscape in which her business operated was changing. More and more customers were calling from outside her delivery zone, and requesting deliveries from a wider selection of restaurants. Her research indicated that she could more than double her revenues if she went after this new business.*

*Clearly there were opportunities for growth. Catherine was excited about the new housing developments north of town, and decided to expand her area of operation to serve them. She calculated that she'd need another mini-van and another driver.*

*She heard about a successful businesswoman named Lisa Aldridge, who made loans to fledgling businesses. Catherine decided to give her a call.*

### Mission, Goals, and Objectives

Your mission statement describes the focus and scope of your business

As we discussed earlier, your **mission statement** describes what your business hopes to be and do. This is your opportunity to demonstrate the focus and scope of your business.

A good example of a simple, straightforward mission statement was developed by the publishers of a monthly outdoor magazine called TRiPS, which was based in Santa Cruz, California: "The purpose of TRiPS is to promote outdoor adventure and travel so that people see, feel, and know how good it is to be outside."

This is also the place to explore options for growth and product expansion. For example, if your business is a graphic design service, you might eventually offer Website design and editing services to small businesses in your community. Demonstrating foresight in the early stages of planning will impress those who are interested in participating, so use this section of the plan to state specific objectives for growth.

### Background Information

This section describes the industry in which your business operates. What past and present industry trends affect the business? Where is the industry headed in coming years? What economic, social, or political trends affect your industry? How attractive is the industry for your business? How does your business fit into the industry?

### Organizational Matters

This section usually begins by describing the legal form of ownership of the business. Will it be a limited partnership? A sole proprietorship? A corporation?

This section also introduces the people and structures that will make the business run smoothly and successfully. At what point do you estimate you will need additional personnel? What are the responsibilities and qualifications of your team? Businesses often attach resumés to this section to highlight the strengths of the team.

Describe how different parts of the business work together. Who will report to whom? Which areas of the business will be responsible for which functions? Businesses often illustrate this with an organizational chart, which is a blueprint of the management hierarchy. It details relationships, and how different parts of the business exist in relation to one another.

Which tasks will the business be responsible for in-house, and which will be outsourced to freelancers, temporary employment agencies, consultants, and mentors? Will you do accounting and payroll in-house, or hire an accountant? Will you use outside sales representatives, distributors, or agents?

The management section of the business plan is a good place to present potential problems, along with contingency plans for troubleshooting and solving these problems.

The organizational section of the business plan should also explain how records will be kept—and budgets and controls managed—and what strategies your business will use to manage risk.

*Lisa Aldridge was an entrepreneur whose success allowed her to mentor woman-owned businesses. When she spoke to Catherine Baggott on the phone, she was impressed by her enthusiasm and obvious head for business. In fact, Lisa had ordered from Bag-It Gourmet more than once, and thought the business had a huge potential.*

*But when Lisa read the business plan that Catherine had submitted to her, she found that it didn't present a clear picture of Bag-It Gourmet's target market and overall marketing strategy. How did Catherine intend to guide her business's growth? Catherine had completely failed to address this issue in her business plan, and Lisa wondered if Catherine had overlooked other key elements. She wondered, in fact, what rationale Catherine had for wanting to grow her business in the first place.*

*Lisa felt that Bag-It Gourmet needed a clear picture of its customers and markets. Without this information, it was just a matter of time before the business got off course.*

The marketing plan identifies the markets you intend to serve

## Marketing Plan

The marketing plan identifies the markets your business intends to serve. It outlines your business's strengths, and describes how it will be positioned in its market. The marketing plan contains the following sections:

### *Product description*

What products will your business offer? What benefits do they provide to your customers? You might also include information about the seasonality of your product, and whether it's in the introduction, growth, maturity, or decline phase of its life cycle. What growth do you anticipate? What new products will you offer in the future?

### *Market analysis*

**Market analysis** is the result of market research findings. It defines your business's target market, which is the segment of the overall market on which you will focus your marketing efforts.

What is your business's market potential? How large is the target market? How fast is it growing, and what sales volume can it generate? What is the target customer profile?

**Demographic data** and **psychographic data** help you to describe the target market. Demographic data comprise quantitative information like people's addresses, age, income level, spending patterns, and family composition. Psychographic data are qualitative information about people's lifestyles, hobbies, beliefs, and attitudes. Together, these data determine all marketing strategies, including those regarding product, price, promotion, and placement.

**Competitive analysis** describes your competitors. Is the market already saturated with other companies? What does your business offer that's better than the competition? What are its strengths and weaknesses?

A major component of the market analysis is a list of possible barriers to entry. What are your initial start-up costs? What skills or expertise do you need? How long will it take to set up operations? This section explains how you will overcome obstacles to achieve your objectives.

PEST =

Political

Economic

Social

Technological

**PEST analysis** describes the political, economic, social, and technological environment. Which government regulations apply? How is the economy doing, and how is it affecting your customers and suppliers? What social trends and demographics affect your business? How does current and emerging technology affect your ability to produce, market, and sell your product?

*Market strategy*

This section outlines your business's product, pricing, placement, and promotion strategies. What sort of customer service will you provide? How will you package your products? Will the products be widely or selectively distributed? What marketing strategies will you choose? How much will promotional tactics cost, and how long will each tactic be used?

Where will your supplies come from? How will you maintain production levels to meet customer orders?

How will you use the Internet? Will you simply have a Website, or will you also take advantage of e-commerce and social networking capabilities?

General pricing information is also included in the plan. What will you charge for your product? How have you calculated your costs and your profitability? How will your price position you in the market? Will you offer any special discounts to entice new business?

*"What do you mean by a marketing plan?"*

*That was Catherine Baggott's response when Lisa asked for a look at her marketing plan.*

*Lisa explained that Bag-It Gourmet was at a critical point in its growth. If Catherine didn't know what type of customer she served and what needs her business met, she wouldn't know how to guide and control her growth.*

*"Before you consider growing to serve that new housing development," Lisa said, "you have to know if the people who live there fit your target customer profile. Maybe they don't need the services you currently offer!"*

*Lisa asked Catherine to write down the answers to the following questions:*

- *Where do most of your customers live?*
- *What restaurants do they order from most often?*
- *How long are they willing to wait for delivery?*
- *How much are they willing to pay?*
- *How frequently do they order?*
- *What methods to they use to order (phone, e-mail, etc.?)*
- *Why do they order from Bag-It Gourmet?*

*Catherine was humbled. How could she have launched her business without knowing the answers to these basic questions? Although Bag-It Gourmet was profitable so far, she was feeling worried. Had it all been just good luck?*

## The Financial Plan

The financial plan is the longest and most important section of the business plan. This is where you list the financial requirements for launching or growing your business. The financial plan comprises four sections: financial worksheets, cash flow projections, financial statements, and additional financial information.

The financial plan is the most important section of the business plan

### *Financial worksheets*

The financial worksheets offer many important details on the management of your business:

- **Salaries, wages, and benefits.** How much will your business pay each month to compensate your team? What benefits will it provide to which employees, and how much will they cost?
- **Outside services.** What outside contractors or service providers will your business rely on? What duties will they perform? How will services be contracted and managed? How will you measure and ensure quality?

- **Insurance.** Which types of insurance will you use to minimize risk? How probable are losses? What are the premium costs and deductibles?
- **Advertising budget.** What is the overall budget for advertising and promotion? How much will be spent on advertising campaigns?
- **Occupancy expense.** What is the monthly cost of renting or leasing work space? What related expenses does your business have?
- **Sales forecasts.** How much do you anticipate selling in your target markets over the next one, six, and twelve months? Consider presenting separate sales forecasts for different product types, geographic regions, and markets.
- **Cost of goods sold (COGS).** What does your business pay for supplies and other inputs? This includes all costs related to buying, storing, counting, assembling, or enhancing inputs to create the finished product. This category is also known as **cost of product units**.
- **Fixed assets.** What land, plant, and equipment does your business own or lease? What is the market or book value of these assets?
- **Growth expenses.** What expenses will growth require? Consider additional equipment, space, personnel, inventory, promotions, distribution, and production.
- **Miscellaneous expenses.** What other business expenses do you anticipate? Are these one-time or recurring expenses?

What expenses will growth require?

## NxLEVEL® TECH TIP
### BUSINESS RESOURCES AND THE WEB

Need to do some research on trends, demographics, laws, or statistics before you embark on your business plan? The following US government Websites can help.

**Library of Commerce Business Reference Services** (www.loc.gov/rr/business) is a good starting point for conducting research on business and economics.  Supported by a reference collection of over 20,000 volumes, a network of CD-ROM services, and the Adams Building Computer Catalog Center, reference specialists in specific subject areas of business can help you gain access to the wealth of business information in the Library's collections.

**The US Chamber of Commerce Small Business Center** (www.uschamber.com/sb) provides information on pertinent Chamber of Commerce resources; economic policies affecting small businesses; educational and training programs; employment opportunities and internships; expos and trade shows; Chamber of Commerce publications; retirement plans for small businesses; and more.

*Cash flow analysis*
**Cash flow analysis** is the calculation of how much cash flows in and out of your business. This is perhaps your most important financial tool. It's particularly useful for determining when and how much you'll need to borrow during an annual cycle, and how much cash you'll require for monthly bills.

This section is especially important for businesses that have a large number of **accounts receivable**. This is the unpaid balance of money owed to the business by customers. Suppose that a t-shirt business manufactures and ships out 500 shirts, along with an invoice due to be collected in 30 days. If the business has an outstanding bill due in two weeks, it won't be able to count on the income generated by this sale to pay current expenses. Thus, it runs the risk that it will not collect its accounts receivable in time to meet its obligations for the cost of materials and labor.

Entrepreneurs have a tendency to be too optimistic when assessing cash flow. Business ventures often fail because of faulty predictions in the financial planning section.

To calculate your cash flow, start by calculating how much cash you have on hand, then add **cash receipts** (cash generated from sales and collection of accounts receivable, including any loans received from banks or other lenders).

Next, calculate **cash disbursements** by adding together all the uses or payments of cash, including selling, general and administrative expenses, payments of interest and taxes, and any expenses associated with the cost of your product. This includes all payments that decreased your **accounts payable**, which is the unpaid balance of money owed by your business for inventory and supplies. Add to this total the cash you have withdrawn under owner's withdrawals; the sum of these figures equals total cash disbursements.

Subtracting total cash disbursements from cash receipts results in your business's cash flow. When there is more cash coming in than being paid out, businesses have a positive cash flow. If more cash goes out than comes in, then the business has a negative cash flow. When this occurs, businesses are unable to pay their bills.

While it is possible for businesses to operate profitably with a negative cash flow, this is not an advisable course of action for a growing business! Maintaining a positive cash flow at all times ensures that your business can meet its obligations.

Maintain a positive cash flow at all times!

You can calculate the ending cash balance for a given time period by adjusting the beginning cash balance by the current period cash flow you have just calculated. Subtract a negative cash flow and add a positive one.

You must also include a **break-even analysis** in the financial plan. The **break-even point** is the amount of units sold or sales dollars necessary to recover all expenses associated with generating these sales.

To calculate your break-even point, you must total your fixed and variable costs. **Fixed costs** remain the same no matter how many units you produce or customers you serve. **Variable costs** change with the quantity of goods sold.

Here's how to calculate your break-even point:

$$\textbf{Break-even quantity} = \frac{\textit{Total fixed costs}}{\textit{Price} - \textit{Average variable costs}}$$

**Cash flow projections** detail the revenues and expenses expected within a given period of time. They entail the same type of calculations used to determine cash flow, but are based on assumptions about the business and its markets.

You must describe the assumptions on which you based your cash flow projections

For this reason, you must attach a statement describing the assumptions on which you have based your projections (e.g., assumptions about customers, the economy, competitors, available technology, or legal restrictions).

Most business plans contain monthly cash flow projections for the first year, and annual cash flow projections for years two and three.

*Because Catherine had provided her own seed money to launch Bag-It Gourmet, she had never researched and written a complete business plan. She had simply launched the business on the basis of her financial projections, and her confidence in her idea.*

*But now, she wanted answers to Lisa's questions, and more. Was it just dumb luck that Bag-It Gourmet had done well? She needed to know before she took another step.*

*She began by gathering information from the local library, a real estate association, a food industry association, and the local Chamber of Commerce. She also spent hours on the Internet, looking at maps of her area, calculating local mileage and population density, and researching commuting patterns and Internet use. Every day, she learned things that surprised her. The amount of information was overwhelming, but it was also exhilarating to see the pieces gradually fit together.*

*Three weeks later, she felt like she knew everything there was to know about her town and her customers. She scheduled another meeting with Lisa. This time she'd be prepared!*

### Financial Statements

This section comprises several items. The **income statement** is a financial report showing actual revenues earned, expenses incurred, and the resulting net income or net loss. A **projected income statement** presents the income you expect to generate in the future. Typically, this is prepared for the first year of business, and then quarterly for the two years that follow.

Once you've settled on your prices, estimate how much income, or **gross profit**, you expect to generate from sales each month. Then, subtract **cost of goods sold** to determine your **gross profit margin**.

Next, calculate how much you must pay each month for salaries, wages, rent, utilities, insurance, and so forth. The sum of these expenses equals total operating costs, and includes the **depreciation** of any equipment. (Depreciation is the decrease in value of buildings or equipment over time. For example, if your brand-new computer is worth $3,000 today, in a year it may be only worth $1,000. The depreciation of $2,000 must be added to your total operating costs.) Subtract operating costs from gross profit margin to determine your predicted net profit before taxes.

Assets minus liabilities equals net worth

The **balance sheet** lists your business's assets, liabilities, and net worth. **Assets** are any items of value owned by your business, including equipment, accounts receivable, inventory on hand, cash, and any prepaid expenses. **Liabilities** are all debts, including rent, lease payments, accounts payable, bank mortgages, other bank debts, and equipment depreciation. To calculate your **net worth**, subtract total liabilities from total assets.

Net worth is sometimes shown as the **statement of owner's equity**, which reflects the money that owners have invested in the business. This is known as **external equity**. Profits that you earned and reinvested in the business are known as **internal equity**. Hence, the amount of equity in a business is determined by:

- The amount of the owner's initial investment
- Any additional investments in the business
- The income retained or reinvested within the business from earlier periods, minus any withdrawal by the owners

*Additional financial information*
This section of your business plan summarizes the financial needs of your business, its existing debt, and the financial position of the owner(s).

The summary of financial needs explains what your business requires to fuel its growth. **Existing debt** is a summary of all outstanding loans your business has received to date. The **personal financial statement** lists any assets that you are able to invest in the business, and any other sources of income you have.

## Appendix
This final section of the business plan prioritizes and schedules your tasks and tactics. It presents a timetable for action (action plan), as well as any supporting documents.

Given your research, calculations, and projections, can your business continue to be a viable venture? Can you profitably operate your business? What is your long-term vision for the business? What will you achieve in the next one, three, and five years?

Supporting documents might include resumés for the owner and other employees, market research findings, product specifications, brochures, and customer testimonials.

*Since she was still busy with the day-to-day operations of her business, Catherine hired a local business-school student to help her write her marketing plan. Once they began to work, Catherine understood the importance of a good marketing plan, and wondered how she could have missed it before.*

*She also made some startling discoveries. By reviewing her sales records, she found that her average customer ordered food three times a month. The average size of the order was $45.00. The most valuable information she gathered came from a questionnaire that her MBA student suggested: Why not attach a simple ten-question flier to each delivery for the next two weeks?*

*That's what she did, and that's how she found out that most of her customers:*

- *Were professional, married people in mid-life*
- *Had no children at home*
- *Had a household income of more than $80,000 a year*
- *Had high-speed Internet access*
- *Were willing to pay more for organic food and wines, and preferred biodegradable containers and cutlery*

*Catherine quickly realized that the new subdivision outside town did not fall within her target market. Her research showed that these were multi-family units, designed for budget-conscious, first-time home buyers with young children. She doubted that these people would pay premium prices to have organic meals delivered!*

*Obviously, she needed to reevaluate her growth options. She asked herself, "Do I want to grow my business after all?"*

## Is Your Business Venture Feasible?

You've drafted your plan, and completed the NxLeveL® Business Plan checklist. Now, look at the information you've accumulated and ask yourself these questions:

- Does your business plan make sense?
- Is there a real demand for your product?
- Is there a potential for continued growth?
- Will you seek additional investors? If so, who they will be?
- Do you need to revise your business concept?
- Are you targeting the right market?
- Are your financial projections correct?
- Are you operating as efficiently and profitably as possible?
- What additional education or skills do you need?

## The NxLevel® Business Plan Checklist

*Prepare objectives and mission*
- ❑ Growth plan description
- ❑ Stage of development
- ❑ Mission statement
- ❑ Objectives

*Prepare background information*
- ❑ Industry analysis and trends
- ❑ The business fit in the industry

*Design the organization*
- ❑ Business structure
- ❑ Management
- ❑ Personnel
- ❑ Outside services/advisors
- ❑ Risk management
- ❑ Operating controls

*Prepare the Marketing Plan*
- ❑ Description of products or services
- ❑ Market analysis
- ❑ Competitor analysis
- ❑ Market size and trends
- ❑ Sales volume potential
- ❑ Marketing mix strategy
- ❑ Explain market strategy
  - ❑ Price
  - ❑ Placement
  - ❑ Product
  - ❑ Promotion

*Compile the Financial Plan*
- ❑ Financial worksheets
- ❑ Cash flow projections
- ❑ Financial statements
- ❑ Additional financial information

*Assemble Appendices*
- ❑ Timetable
- ❑ Supporting documents

*Write Executive Summary*
- ❑ Analyze target readers (investors/lenders) and write accordingly
- ❑ Consolidate and summarize all accumulated data
- ❑ Adjust original business concept as needed

*Finishing touches*
- ❑ Proofread and edit document
- ❑ Create/collect graphs, charts, and photographs
- ❑ Reread entire business plan
- ❑ Determine overall feasibility of plan
- ❑ Give plan to friends, advisors, or family for review
- ❑ Make changes as necessary

Be sure you've answered these questions before seeking financial assistance from family, friends, other investors, or banks. Once you're satisfied with your results, you can start putting together your executive summary.

A weak plan can be fatal, not only because it may turn away prospective lenders and investors, but also because it won't properly direct you toward success.

A realistic business plan helps to identify your weaknesses and strengths so that you can budget the time, energy, and money to improve areas that need it.

Be honest with yourself when creating your plan!

Be honest with yourself when creating your plan. It's easy to paint a glorified picture of your idea, so do a reality check:

- Are your assumptions accurate?
- Have you addressed all the questions lenders or investors will ask?
- Do you have the right skills and resources?

Also, be sure to seek input from friends, family, employees, and mentors before you commit to your plan.

Don't beat yourself over the head if you find major problems with your plan. Rome wasn't built in a day, and neither are successful businesses. You can always revise and improve your plan. The NxLeveL® Business Plan is a working document. It should evolve over time as you learn more about your market, your business, and yourself.

Finally, don't be a slave to your plan. If new opportunities arise, don't avoid them simply because they weren't anticipated. There's more than one way to get to your destination!

*After some careful reflection, Catherine remained certain that she wanted to expand her business. She loved the challenges and rewards of her business, and felt that she'd just begun to realize its potential. But obviously, she needed to reevaluate her growth options. What would her first step be?*

*In the course of gathering market information, her intern discovered that construction for a large office complex was due to begin in the next month, which would add to an already large and vibrant office community. In fact, the east side of town was rapidly expanding into one large commercial zone.*

*If her goal was to expand business, why not look there?*

*Catherine's drivers began work at 6pm, and her mini-van sat in the driveway most of the day. What if she expanded her business into daylight hours? Bag-It Gourmet could deliver gourmet continental breakfasts, bagels, muffins, and fresh fruit for early business meetings. And why not also deliver gourmet food for lunch-time office meetings and seminars?*

*Catherine incorporated the idea into her revised business plan (she called it her "growth plan"). She was very enthusiastic when she shared it with Lisa!*

## A Polished Presentation

Painstaking research, planning, and documentation mean nothing if you can't present your ideas clearly and convincingly in a few minutes. That's all the time most lenders or investors will take to look at your plan, so you must pique their interest with an organized plan that utilizes visual cues.

Your NxLeveL® Business Plan should be:

- Well organized and logical
- Clear, concise, and easy to read
- Accurate and honest
- Free of unnecessary repetition and vague ideas
- Free of industry-specific terms (unless they're briefly and lucidly defined)
- Absolutely free of spelling and grammatical errors
- Augmented by charts and graphs with consistent styles, colors, and fonts
- Printed on quality paper
- Presented in a hard folder or binder

Once you've checked your document and its formatting, you should pass it along to several trusted friends, relatives, and mentors for review. Keep an open mind as to their input, and revise the plan as necessary.

When possible, find readers who don't know anything about the nuts and bolts of your business. Since you know your idea inside and out, it's very easy to read between the lines and assume that your points are perfectly clear. For this reason, outsiders will provide a more realistic assessment of the plan's clarity. If there's a point your readers don't understand, there's a very good chance that your target audience won't understand it either. By the same token, if your readers feel that they're being beaten over the head with a specific point, you might consider editing the plan to remove redundancy. Saying too much can be almost as bad as saying too little.

When you present your NxLeveL® Business Plan in person, you should:

- Dress cleanly and professionally
- Speak slowly and clearly
- Look directly and confidently at your audience
- Prepare and budget your time in advance
- Prepare and practice your presentation
- Present a compelling executive summary in the first 30 seconds, and use the next two or three minutes to provide details and supporting information
- Finish with a clear conclusion and detail what you want from the listener
- Use simple charts or tables to clarify ideas and focus attention
- Remain courteous and positive, no matter what happens during your presentation

Remain courteous and pleasant throughout your presentation

## N x L E V E L ® G R E E N T I P

ENVIRONMENTAL BUSINESS RESOURCES

Writing a business plan for a green business presents special challenges. Here are some tips that will help you to highlight the green aspects of your product and operations:

- **Treat green and sustainable measures as products.** Explain their features and benefits from the perspective of your business, your customer, your community, and the environment.
- **Emphasize traditional business benefits.** Saving the world is all well and good, but lenders and investors need to see that you will run your business wisely and profitably. Highlight green measures that will increase efficiency, reduce waste, avoid regulation, and improve profits.
- **Include green metrics.** Explain how you will track and measure the green aspects of your business, and who will be responsible for doing so.
- **Defend your case with facts.** Because going green is trendy, a lot of business plans refer to it without really defining it. Take care to document the costs and benefits of your approach.
- **Update the plan frequently** to reflect changing conditions and new ideas.

*Lisa was impressed with Catherine's research. She felt that Catherine's estimate of costs for implementing Bag-It Gourmet's creative new strategy was on target, and decided that the business was worth financing.*

*Her main stipulation was that Catherine needed to expand the online aspect of her business. Currently, the Website had basic information like prices, hours, and links to menus. She was not taking advantage of the potential for offering mobile coupons; setting up monthly and yearly subscriptions; accepting orders through online forms, Twitter, and text messaging; checking delivery status; and so forth. Part of the capital would have to go towards overhauling the site to increase its interactivity and meet the needs of corporate customers.*

*Catherine came away from the meeting with a commitment for funding and a new vision for her business. She felt more confident than ever! Growth no longer seemed like a hit-or-miss proposition. She knew who her customers were and what they wanted, and she knew how to get the information she'd need to keep her strategies up-to-date. It looked like Bag-It Gourmet was in the bag!*

## Conclusion

The NxLeveL® Business Plan is an operating plan for the entrepreneur, a financing proposal for lenders, and a source of inspirational information for prospective partners and employees. It is also the capstone of your participation in the NxLeveL® training program for entrepreneurs.

When you've completed the soul-searching and the hard work that go into the plan, you should be proud. You have taken an enormous step towards making your entrepreneurial dream a reality.

We all have hopes and fears when we begin or grow a business. The NxLeveL® Business Plan will help you confirm your hopes, confront your fears, and make your business a success!

# Chapter 13
# CONTINGENCY AND CONTINUITY PLANNING

*About This Chapter:*
- *Setting your limits*
- *Selling your business*
- *Selling your stock*
- *Business failure and bankruptcy*
- *Business continuity planning*

## Introduction

It may sound odd, but the same day you begin your business you should start preparing your exit strategy, which means defining the circumstances under which you will consider leaving the business.

Your choice of an exit strategy depends on how fast you want out, how much ongoing participation you want in the business, and how much of your ownership you want or need to liquidate.

This chapter discusses scenarios in which you may choose—or be forced—to end your business, including loss of interest, the pursuit of a better opportunity, a terrific buy-out offer, illness, and bankruptcy. It also describes the process of continuity planning, which will allow your business to survive major disruptions like fires, floods, and other disasters.

Welcome aboard! Got your return ticket?

## Setting Your Limits

It's sad but true: many young businesses go belly up and have no choice but to call it quits. But there are also happier reasons for exiting one's business—for example, if someone wants to buy it for a sizable amount of money. Here are some other reasons for calling it quits:

- You've identified a better opportunity elsewhere
- You're bored and want a new challenge
- Your business has achieved all the growth it can
- You're unwilling to commit to growth
- You're no longer willing to work 70 hours a week
- You want to diversify your assets
- You're ready to retire
- You're no longer able to work

Exit limits are a safety net against personal and professional loss

### Knowing When To Say When: Your Business Limits

Exit limits are a safety net against personal and professional loss. Your exit limits, expressed in quantitative terms, might look something like this:

*"If my business experiences the following, I will seriously consider calling it quits":*

- Overdue bills exceeding $25,000
- Sales below $500,000
- Over $100,000 in long-term debt
- Profit margins below 12 percent over four consecutive quarters

*"If my business experiences the following, I will call it quits":*

- Overdue bills exceeding $35,000
- Sales below $200,000
- Over $150,000 in long-term debt
- Profit margins below 10 percent over six consecutive quarters

You might also set limits for your involvement in the business once it becomes too large or too successful, as indicated by a certain level of sales, customers, or employees. Once your business reaches these limits, it will be your signal either to hire a full-time manager to take over, or to bail out and start your next business.

You don't have to carve these limits in stone. You should revisit them often as your business grows. Planning and prior preparation are the key.

### Knowing When to Say When: Your Personal Limits

Knowing when to say "when" is a lot easier if you distinguish your goals from the goals of your business.

Twice a year, you should update your one-, five-, and ten-year personal goals. Consider your personal ambitions, as well as your commitments to family and friends. Here are some examples:

- By age ___, I want to have a personal net worth of $___
- By age ___, I want to be earning $___ a year
- I want to retire at age ___
- I want to own a house by age ___
- I want to spend at least ___ hours a day with my children/family
- I want to take a ___ month trip to South America by age ___

Your goals should be concrete, measurable, time-bound, and attainable. Otherwise, they're not goals, but daydreams.

*For most of the nineties, Kate Pritchard ran a successful investment consulting business in Santa Cruz, California. By 2007, she found that she was spending more time with her computer and telephone than with her young children. She was ready for a change!*

*Working with a good attorney and banker, she sold off her interest in the business and used the profits to start a new venture in couch retailing.*

*In structuring this business, she was guided by insights she gained in her investment business. Her priorities? Spending time with her family, and working in a relaxed environment with people who were part of her community. Her new business, Couch Potato Couches, was open for business four days a week. In those four days, she was able to do the administrative work for the business and sell enough couches to sustain the lifestyle she valued. This left her with plenty of time to spend at home being a mom!*

## Selling Your Business

Selling your business may seem daunting, but you can get lots of help from attorneys, accountants, brokers, investors, bankers, and consultants. (For more information, see Chapter 5 *Valuing and Buying a Business*.)

There are two approaches small business owners generally use when selling their businesses. The most common, inexpensive, and informal approach is word of mouth. If you talk to your partners, investors, friends, neighbors, and network, you might be surprised how quickly you can find a buyer.

If you want to approach the sale of your business more methodically, you can hire a professional business broker. Business brokers usually help one individual sell his or her business to another. They evaluate the business; post listings in various journals, newsletters and newspapers; and advertise the businesses they broker in much the same way realtors do. They operate locally, regionally, or nationally, and often specialize by industry or geographic location. Search online, or check your local yellow pages, for brokers in your area.

### Valuing Your Business

No matter how unique your product is, or how knowledgeable your employees are, buyers value your business on the basis of cash flow and asset evaluation. This can be a simple listing of the valuables of a business, such as assets and real estate.

Buyers value your business on the basis of cash flow and asset evaluation

There are exceptions, as in the case of a business possessing a key piece of real estate. If your shoe store is located on a busy corner, and Starbucks wants that spot, you might find that your business is worth a lot more than the revenues it generates by selling shoes. However, most businesses rely on their cash flow and/or significant tangible assets as measures of their market value.

Other indicators of your business's worth include sales growth, historical profitability, and industry market conditions.

### Evaluating Buyers

If you choose not to work with a business broker, you'll have to evaluate prospective buyers yourself. (Consider hiring a good accountant to assist you in this process!) You should set criteria for selecting a buyer, and rank them according to their importance. These criteria should include:

- Size and financial strength
- Type of industry
- Reputation
- Their experience in acquisitions
- Knowledge of your industry and market
- Geographic location
- Ownership of the company (privately or publicly held)
- Degree of synergy between the businesses

Taxes can affect the structure of a business sale

Entrepreneurs often strike a deal whereby buyers will pay them a small portion of the sale price of their business in cash, and then pay the remaining amounts in installments over time. These installments usually come out of business earnings, so you must assess the buyer's ability to manage your business profitably.

Buyers often ask the seller to stay on and teach them the business. The buyer benefits from the seller's experience, and the seller guards the value of the business, which is especially important when the purchase is financed out of cash flow.

### Legal and Tax Implications

States have various laws governing the transfer of ownership in a business. Also, taxes can seriously affect the structure of the transaction. Therefore, before you sell all or part of your share in a business, you should seek the assistance of an experienced tax attorney and/or securities lawyer.

## Selling Your Stock

Certain start-up software and tech firms have made millions for their founders by going public before earning a profit. Such companies possess unique technical knowledge or intellectual property that makes them attractive to larger companies who want to acquire that know-how at all costs.

In most other industries, earnings and cash flow determine the value of a company. Unless you've developed a unique and innovative technological process or product, you probably won't be going public.

However, if you grow your business to a significantly profitable level (between $5 to 20 million in sales), you might consider offering your stock to the public. Owners of high-growth businesses in select industries do this to raise additional capital, or liquidate their ownership in the business.

## Business Failure and Bankruptcy

Bankruptcy is the inability of a business to pay its debts. Sometimes this is the result of a major catastrophe, such as illness, the default of a large customer, a lawsuit, fire or flood, or the call of a large debt by a lender. It can also be caused by undercapitalization, poor cash management, overexpansion, and technological obsolescence.

It may be harder to reorganize or escape your debts by filing for bankruptcy

Under current law, most businesses that file for bankruptcy do so under Chapter 7 (liquidation) or Chapter 13 (reorganization). We discuss both of them at length below.

In April of 2005, President George W. Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). This act made sweeping changes to existing bankruptcy protections, and made it considerably harder for many debtors to escape debt by declaring bankruptcy. One major effect of BAPCPA is that fewer debtors will be allowed to file under Chapter 7.

By and large, small-business experts consider BAPCPA to be something of a mixed bag for entrepreneurs. On the positive side, you may have a better chance of getting paid by people who owe you money. On the negative side, you may find yourself forced to pay debts you previously would've been able to discharge, which could make it harder to get back on your feet after a business failure.

In the following pages, we'll introduce the different types of bankruptcy. Don't consider the brief, simplified summary offered in this section to be a substitute for expert legal advice! BAPCPA affects many aspects of your business, so be sure to consult with an attorney who specializes in bankruptcy law.

### Chapter 7 (Liquidation)

This chapter covers the most extreme (and most common) cases of business bankruptcy—those in which you must liquidate all your nonexempt assets to pay your debts. Many remaining debts are canceled (approximately 20 types of debt may not be discharged).

BAPCPA made some extremely important changes to Chapter 7, which you should discuss with your legal advisor.

*Means testing*

You may have to undergo a "means test" to determine whether you're eligible for Chapter 7 protection. The court will compare your income to the median income in your area, according to standards set by the Internal Revenue Service. (Note that the BAPCPA means test requires you to disclose your most recent tax return to the court.)

If you earn less than the median income for a household of your size, you're exempt from the means test and may be able to file immediately for Chapter 7. If you earned more than the median income in the six months before filing, and you have the ability to pay at least 25 percent of your unsecured debt, BAPCPA requires you to file for Chapter 13 bankruptcy (see below).

*Stay of eviction*
Under BAPCPA, there is no longer an automatic stay for evictions. If a landlord has already begun eviction proceedings, the renter must either move out or pay the entire rent owed within 30 days.

Be sure to research homestead exemption laws in your state

*Homestead exemption*
State law allows residents of Florida, Iowa, Kansas, Texas, and South Dakota to shield an unlimited amount of home equity from creditors. Other states allow you to shield some portion of home equity.

While many of these protections still apply, BAPCPA restricts use of the homestead exemption in a number of important ways. For instance, if you bought your home less than 40 months before filing for bankruptcy, you may only shield up to $125,000, regardless of your state's homestead exemption allowance.

Your lawyer can help you understand BAPCPA's homestead restrictions.

**Chapter 13 (Reorganization)**
Chapter 13 requires debtors to repay all or part of their debts within five years. Previously, when a debtor filed for Chapter 13 bankruptcy, the court based his or her repayment schedule on monthly income and basic living expenses. Whatever amount the debtor earned above that level was distributed to creditors.

Under BAPCPA, the court will base your monthly repayment amount on the median living expenses for your area, as determined by the IRS. If the IRS median proves to be lower than your actual expenses (which is not unlikely), you may legally request a hearing on the matter.

Formerly, creditors who would receive no money from a Chapter 13 bankruptcy settlement were unable to contest the ruling. Under BAPCPA, they have that right.

**Chapter 11**
When an entrepreneur is unable to pay debts in a timely manner, he or she may voluntarily petition for the protection of the US District Court. The filing process is complicated and costly, but if approved, this protection allows the business to continue operations under legal guidelines that protect the interests of the business's creditors.

The business is given a fixed time in which to submit a reorganization plan that includes provisions for paying off different classifications of creditors, the preference order and timetable for payments, and so forth. In some cases, the court may appoint a trustee to take possession of the company's assets and oversee operations. The bankrupt entrepreneur may also raise new funds by selling shares in the business, borrowing money, or selling assets.

BAPCPA may limit your ability to file for Chapter 11 reorganization. Consult your lawyer for more information.

### Chapter 10 (Involuntary)

Under this chapter, creditors may petition the court to demand a company's reorganization. This petition may be submitted when a creditor's (or group of creditors') claims exceed $5,000. The debtor may contest this petition, and if successful, may seek reimbursement for all legal costs from his or her creditors. If contesting is unsuccessful, the procedure is similar to Chapter 11 proceedings.

Ask your lawyer to explain how BAPCPA affects Chapter 11 protections

## NxLEVEL® TECH TIP

BUSINESS RESOURCES AND THE WEB

There are a number of Websites that can help you understand current bankruptcy law, and help you to locate the best legal help.

**The National Association of Consumer Bankruptcy Attorneys** (nacba.com) is a good site to visit if you want to stay on top of breaking bankruptcy news. Since they're a consumer-oriented site, they do a good job of explaining the issues in plain English. They also have an "Attorney Finder" link that locates bankruptcy attorneys near you.

The **American Bankruptcy Institute** (www.abiworld.org) is another great online resource, which includes daily headlines on developments in bankruptcy law and related topics.

The **American Board of Certification** maintains a nationwide list of certified business bankruptcy attorneys at **www.abcworld.org/search**.

### Other Considerations

- When applying for Chapter 7 or Chapter 13 bankruptcy under BAPCPA, you must agree to receive counseling and a budget analysis, at your own expense. You will also be required to take a financial management course at your own expense.
- BAPCPA states that attorneys must certify your financial statements as accurate, and that they'll be fined for errors. Since attorneys face more work and greater risk, it may be more expensive to file. Some lawyers no longer handle bankruptcy cases as a result of these provisions.

Think twice before financing your business with credit card debt!

- Under previous law, debtors were given 60 days to assume or reject a lease, but could ask for 60-day extensions as often as necessary. Under BAPCPA, the maximum period is 210 days, unless the landlord gives written consent to an extension.

### Protecting Yourself

There are several ways to protect yourself from bankruptcy:

- Avoid using credit-card debt for start-up or expansion funds
- Have an expert help you to choose a business entity that offers the maximum protection from personal liability
- Taking out a home loan to avoid bankruptcy could put your home at risk, because bankruptcy does not excuse you from paying your mortgage
- Medical expenses are the number-one cause of bankruptcy, so buy the best health insurance you can afford!
- Make sure your attorney and accountant understand BAPCPA, and can help you to avoid running afoul of it

### Warning Signs of Bankruptcy

How do you know when you're going bankrupt? If you know the warning signs, you might be able to avoid trouble, or at least minimize it when it hits. These signs often are linked—once one happens, the others may not be far behind.

- Lack of management control and accountability over finances
- Lack of inventory or supply to meet orders
- Lack of planning and documentation of major transactions
- Key people leave the company
- Business offers large discounts to customers who pay cash
- Bank requires subordination of its loans
- Payroll taxes are not paid
- Employee benefits are not funded
- Suppliers require cash payments
- Increase in customer complaints

### Coping With Bankruptcy

Your creditors are calling on the phone in a panic, your two largest customers just failed for the fourth time to pay off their accounts, and your banker is getting antsy. What should you do?

Contact your lawyer immediately. If he or she recommends filing for bankruptcy, you should seriously consider doing so. Your best strategy is to file before your creditors join together and force you into bankruptcy. A voluntary bankruptcy declaration will buy you time to submit a reorganization plan.

Afterwards, you have two courses of action: ensure that your plan to save your business works, or begin planning its liquidation.

During this process, stay in contact with customers to bolster their confidence. Keep creditors and stockholders informed about all developments. Your investors are probably more concerned than anyone about your business, so keep them apprised of the details through e-mails, or better yet, personal phone calls.

Last, but not least, be open with your employees, who more than anyone else feel the uncertainty of the business on a daily basis. Involve them in the reorganization plan, and keep them focused on the tasks at hand. After all, much of your business's future depends on them.

Keep your employees informed!

### Learning from Bankruptcy

After going through bankruptcy, you may feel worn-out, dispirited, and embarrassed. But keep in mind that bankruptcy doesn't necessarily mean the end for your career as an entrepreneur.

Bankruptcy is an opportunity for learning, so ask yourself these hard questions about what caused your failure:

- Was it caused by bad luck, or by a specific weakness?
- What new skills could help you to succeed next time?
- Did you create an exit strategy, and review it often?
- Did you stick to your core competencies?
- Did you grow too quickly? Too slowly?
- Did you have the management skills you needed to succeed?
- Were you undercapitalized?
- Did your business invest too much effort on new customers, and not enough on the ones it had?
- Did you file for bankruptcy protection too late?

Having failed once, you're likely to have a better grasp of market dynamics, and the correct mix needed to run a successful business: market research, capitalization, cash management, and personnel management. And your negotiating skills will almost certainly have improved.

*Anderson and Associates, a public relations firm located in a suburb of Washington, D.C., started up in 1995. Its owner, Dylan Anderson, had always planned to sell the business at some point, because she and her husband, who would retire in 2008, planned to relocate to the Maryland coast and build their dream house on the beach.*

*By late 2007, Anderson and Associates had become a very successful company. Clients included several national associations located in the Washington area, as well as some major corporations. Dylan had worked hard to establish her business, and all the key elements were there: attention to financial details, an energetic and creative staff, great customer service, and high profits. By mid-2008, Dylan had three serious bidders for her business.*

*Dylan and her husband ushered in the new year of 2009 in their new house overlooking the Atlantic Ocean. The new owner of Anderson and Associates celebrated the new year and his new venture in the company's office.*

## Business Continuity Planning

**Business continuity planning** means preparing your business for disasters and disruptions, in order to minimize downtime and restore critical business functions as soon as possible. The goal is to achieve a level of resilience and organization that can withstand common problems like fires, floods, earthquakes, tornadoes, and power outages, as well as more unusual threats like pandemic illness or terrorist attacks.

No business is too small to benefit from a continuity plan!

No business is too small to benefit from a continuity plan. Statistics show that many small businesses fail to survive relatively minor and common disasters like building fires and floods. Businesses that have a plan in place stand a much better chance of getting back on their feet when the smoke clears.

Here are the basic steps involved in continuity planning:

1. **List all necessary business functions, who performs them, and what equipment and supplies are required.** Compile contact information for key individuals (business and home phone, cellphone, business and personal e-mails, and so on), and make a detailed list of their responsibilities, both day to day and in the event of an emergency. Can any of these personnel telecommute, or perform key business tasks at another site? Do they have the equipment, hardware, and software they need? If so, make a note of it. Also, assign recovery tasks, and consider who should have authority and training to perform important business functions in the event that you are injured or otherwise unavailable.

2. **Identify threats, and the business functions they threaten.** Having done so, you can take steps to minimize the damage these threats can do to infrastructure, equipment, and data. For instance, you might back up essential data online, or on a remote computer, so that you won't lose it in the event of a fire or flood. If you have a fleet of delivery vehicles, you should know where to rent replacements in the event that they're damaged or otherwise unusable. List multiple replacement options wherever possible.
3. **Compile detailed contact information** for suppliers, key customers, insurance agents, equipment repair specialists, attorneys, Internet service providers, lenders and investors, and other essential outside partners. You should also include information on any hazardous materials or equipment in your facility, for the benefit of emergency responders and rescue teams.
4. **Identify and make copies of essential documents.** You should have duplicates made of all relevant business licenses, leases and contracts, tax documents, banking and accounting files, loan documents, personnel files, software documentation and licenses, and any other documents that you need to run your business. Where applicable, try to have legally valid copies made (i.e., by getting official or notarized duplicates). If you don't want to put all these documents in the plan, make sure that key employees understand how to find them at an offsite location. You should also store electronic versions at a secure location online.
5. **Designate a secondary work site** that can be used until your primary site is restored or replaced. This could be a hotel suite, a trailer, or even your garage. Whatever location you choose, make sure it's clearly identified in your plan, and include a map if necessary. When possible, list multiple, prioritized sites, as your first choice may not be available in the event of an actual emergency.
6. **Get employee input.** Before you finalize the plan, pass a draft version out to employees and hold a roundtable meeting to get their comments. People tend to take everyday things for granted, so it may take several passes to work through all the business implications of a disaster. You may find that you need to start over at Step One, because you overlooked something as simple as your need of an inkjet printer for specialty labels.
7. **Distribute the finished plan to employees.** Every member of your team should have a copy of the plan at work and at home. You should also consider storing a copy online in PDF format, so that your team can access it easily from a remote location.
8. **Revise the plan as necessary.** When things change, your plan needs to change too. Update your plan promptly to reflect new equipment and software, personnel changes, customer and vendor changes, and so forth. Clearly date each revision of the plan, collect and discard the outdated hard copies, and update any online versions. You don't want employees reading from two different plans!

Identify and make copies of the documents you need to run your business

9. **Test the plan regularly.** Even the most careful plan will overlook important details and logistical issues. It's better to learn about these mistakes during a practice run than in the middle of a crisis. To be effective, your test should assume the worst-case scenario in which your business location is destroyed. If your plan doesn't work as it should the first time, fine-tune it and try again within a month or two. Once you're satisfied with your plan, test it annually.

**NxLEVEL® GREEN TIP**

ENVIRONMENTAL BUSINESS RESOURCES

Preparing an inventory of the hazardous materials at your site is an essential step in continuity planning. Don't forget to include common chemicals like ammonia, bleach, paints, and solvents, which may be dangerous by themselves, or when mixed after a spill. Your inventory should identify these compounds by name, manufacturer, ID number (if any), amount, hazard class, and location. Take careful note of chemical concentrations, if they're listed; there's a big difference between a 3% hydrogen peroxide solution, and a 10% solution.

Chemicals that lack information (e.g., a unlabeled bottle of pickling acid) should be identified and labeled if possible, and brought to a waste-disposal facility if not.

Once you've prepared your inventory, you should gather the **Material Safety Data Sheets (MSDS)** for each chemical. Manufacturers can fax or e-mail you these documents, which should be added to your continuity plan, along with a map detailing where hazardous materials are stored.

Depending on the size of your facility, and the amount of hazardous materials you store, you may also want to apply radio frequency identification (RFID) tags to your chemical containers so that they can be tracked with an inventory-management system like **CISProMobile** (www.chemswlive.com). This will make them trackable in the event of a building collapse, fire, flood, hurricane, or tornado.

## Conclusion

Starting your own business gives you a priceless education. You learn about a particular industry, customer service, hiring and managing people, and keeping track of finances. You might even learn a few things about yourself.

With these insights in mind, you are uniquely equipped to set new goals and create the personal and professional life you desire. Creating a business continuity plan is an important part of this process, and can save your business from going under in a disaster.

Remember: The things that made you an entrepreneur—drive, fearlessness, and great ideas—will not disappear the day you cash out of your business. You might take some well-deserved time off, but before long, the wheels of your imagination will be churning out new concepts and opportunities for personal and professional growth.

# PART IV
# LEGAL ASPECTS OF YOUR BUSINESS

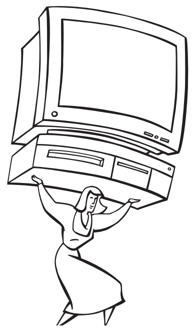
## Chapter 14
## LEGAL STRUCTURE OF THE BUSINESS

*About This Chapter:*
- *Common forms of business ownership*
- *How corporations work*
- *Mechanisms for raising capital*

## Introduction
This chapter discusses the advantages and disadvantages of the most common types of business ownership. In order to select the one that's right for you, you must consider liability, taxation, estate planning, and financing. The help of your attorney and accountant is invaluable when choosing the appropriate legal structure.

## Common Forms of Business Ownership
In most states, there are at least six business forms from which to choose:

- Sole proprietorship
- General partnership
- Limited partnership
- Corporation
- Limited liability company
- Limited liability partnership



Sole proprietorship is the most common form of business ownership in the Unites States

### Sole Proprietorship
The most common form of small business is the **sole proprietorship**, which is run by an individual, often under a trade name, with no outside owners or investors. Sole proprietorships are the easiest business entity to form. They're so easy, in fact, that you can form one without realizing it! For instance, if you're an freelance editor who doesn't appear on any employer's regular payroll, you are automatically a sole proprietor.

***Liability***
The chief danger of sole proprietorship is that it exposes you to personal liability for every act and debt of your business. In other words, if you fail to pay a business-related debt, your creditor can legally come after your home, car, and personal bank account, because the law says that you and your business are one and the same. This personal liability also extends to the actions of employees or agents acting on your behalf.

That being the case, if your business idea exposes you to considerable financial or legal risk, sole proprietorship is probably not for you; an S corporation or limited liability corporation is preferable. Also, bear in mind that the Bankruptcy Abuse Prevention and Consumer Protection Act may make it much more difficult for you to reorganize or discharge your debts through declaring bankruptcy.

*Tax considerations*

Sole proprietors record business income and expenses on their personal tax returns. They must also make contributions to Social Security and Medicare, and pay estimated income taxes throughout the year.

Also, many of the tax deductions available to other forms of business organizations—such as expenses for health benefits and defined benefit pension plans—are unavailable, or the expenses for them are only partially deductible.

If you decide to operate as a sole proprietorship, you must keep your business and personal finances and recordkeeping completely separate. Your business should have its own bank accounts, its own credit arrangements, and its own books and records. This is especially important when you have credit accounts, because interest payments are deductible for business debt, but not for personal debt.

*Estate planning*

Sole proprietorships terminate at the proprietor's death, so they're difficult to work into an estate plan. Your survivors must establish a new business if they wish the business to continue. Also, planning for the inheritance of business property and assets is a complex matter for which you'll need expert legal help.

*Financing*

Sole proprietorships have no ability to expand through new owners and their capital

Sole proprietorships are limited to their personal resources; they have no ability to expand through new owners and their capital. In addition, they may have limited access to debt financing, which must be secured by the proprietor's personal assets.

*How to form a sole proprietorship*

Generally, there are no costs involved in setting up a sole proprietorship. Most cities and many counties require sole proprietorships to register with them, and to pay some level of taxes.

If you have employees, a pension plan, or excise taxes, you must fill out Internal Revenue Service form SS-4 to obtain an Employer Identification Number (EIN). Otherwise, you can use your Social Security number for income tax, self-employment, and other tax purposes.

If you do business under a name other than your own, you will probably need to file a **fictitious business name** or **trade name affidavit** with the appropriate state, county, or city office.

*Will York enjoys carving wood. You name it, he can carve it! It wasn't too long ago that every time Will brought out his carving knife to whittle away at a block of wood, his friends and relatives frowned at him and said, "Will, you should be doing something more productive with your time!"*

*If you'd asked them about Will, they would have told you, "He's a good guy, but he wastes his free time whittling. He doesn't seem to have any ambition!"*

*Actually, Will was very ambitious. A great idea came to him one morning while he was carving a goose out of an old block of wood that he had found lying in a back corner of a friend's garage. Why not start an online woodcarver's community? He could trade tips with like-minded people, and perhaps also exchange photographs of carvings in different stages of development.*

*In fact, if he met the right people online, he would even be willing to trade carvings. The thought of placing the goose he was carving in the home of some appreciative hobbyist halfway around the world filled him with energy. Will couldn't decide whether to get on the computer or continue carving! In the end, he did neither, because it was time for him to go to his day job in the produce department at a local supermarket.*

### General Partnership

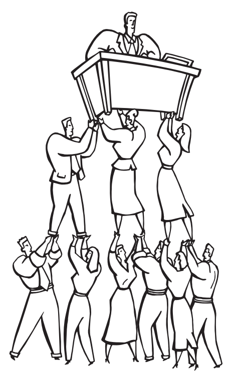
A **general partnership** forms when two or more persons enter an agreement (either written or oral) to operate a business together. The Uniform Partnership Act, which has been adopted by most states, sets forth the rights and duties of the partners to each other and to third parties. It also provides uniform procedures for dissolution and wind-up.

All of the following elements must be present to characterize a business as a partnership:

- A voluntary agreement to conduct an ongoing enterprise (a joint venture is similar to a partnership, but it is for one project only, rather than an ongoing business)
- Two or more owners ("partners") of the business
- An intent to make a profit
- Each owner has an inherent right to control the business
- The owners split the profits and losses from the business

You can customize your partnership agreement to deal with management issues, distribution of profits, and the authority to conduct business on behalf of the partnership.

Although a general partnership can be formed through a verbal agreement, it's wise to get the agreement in writing. Without a written agreement, the partnership will be governed by the law of the state where the partnership is primarily located.



Get your partnership agreement in writing!

Another risk of doing business without a written agreement is that you may find yourself in a general partnership without even knowing it! This could mean that you're jointly and severally liable for the debts of the business. It's crucial to specify in writing what each party's rights and obligations are; doing so may negate the implication that a partnership exists. (If you're truly acting and functioning like a general partnership, a written agreement cannot change that fact, but it can specify each partner's rights and obligations.)

You may think your "employee" or "consultant" is not a partner, but if you're splitting profits and making decisions together, a court may class your business as a partnership, even though the form of the business is "employer/employee" or "hiring party/independent contractor." This means that each partner has a continuing right to profits, a continuing right to control, and a continuing right to inspect the company's business records. It may also mean that upon dissolution and winding up of the partnership (the cessation of business, payment of debts, sale of assets, and distribution of whatever's left over), either or neither of you will have the right to use the company name.

### *Liability*

Partners are jointly and severally liable for all obligations of the partnership

Partners are jointly and severally liable for all obligations of the partnership, even if they have only a partial interest. This is the primary disadvantage of doing business as a partnership.

To understand what this means, let's assume that you started a business with three general partners. If the business failed and had $100,000 in debt, its creditors would seek first to recover that amount from the partnership's assets (e.g., emptying the partnership's bank account, and repossessing and selling its equipment and inventory). But if those assets are insufficient to pay the debts, joint and several liability states that the partners are collectively liable for the debt, *and* that each partner is individually liable for the full debt. If you were the only partner with sufficient personal assets to repay the creditors, those assets would be fair game.

If it were an equal four-way partnership, any partners paying more than their proportionate share would have a right of contribution against the others, but that's strictly between the partners. The creditors will seek payment from whomever has the assets.

### *Tax considerations*

A general partnership pays no federal income tax, but it must file an "informational" tax return. The partners report their share of the partnership's profit or loss on their individual tax returns. Note that fringe benefits packages for owner/employees are only partially deductible.

### *Estate planning*

General partnerships terminate upon one partner's death, so it's hard to use them in estate planning.

*Financing*
The general partnership provides flexibility in raising money to operate the business. Instead of merely being able to take out loans, you can sell a partnership interest to one or more people.

This purchaser of the partnership interest is making an investment that is at risk. While the partner hopes the investment will increase in value and generate a share of business profits, the fact is that the investment may never be paid back.

This is the essential difference between investment in a partnership (a capital contribution) and a loan: loans must be paid back, while investments in a business are at risk. If the business fails, the investor/partner loses that investment amount, and may recover nothing if a share of profits was never distributed to the partners.

A general partner's contribution can be monetary. It can also be property (such as equipment or a patent) or services. This brings us to another advantage of a general partnership: by bringing in a partner, you can bring new expertise to the business.

By bringing in a partner, you can bring new expertise to the business

*How to form a general partnership*
Generally, there are few costs involved in setting up a general partnership. As with a sole proprietorship, you'll need to register as a business, and to file an assumed business name.

The main concern is to draft a clear and comprehensive partnership agreement that specifies:

- The rights and duties of the partners
- Guidelines for bringing in additional partners
- How much capital each partner will contribute
- How disputes will be resolved
- How you will share profit and losses
- Who can authorize cash withdrawals and salaries
- How the partnership will be dissolved

*While he freshened lettuce leaves and arranged celery stalks, Will mulled over the possibilities of an online site for woodcarvers. By the time he got home, his path of action was clear. No sooner did he get online than he searched out the best host for the community he envisioned.*

*Three months later, thanks to some design help from his cousin, Will had set up a thriving site for the woodcarving community. Over 125 members from around the globe had signed up, and Will had gotten to know a core group of regulars who were in constant communication with one another.*

*Just as he'd imagined, he was able to exchange tips and photos. He'd even begun exchanging carvings and wood samples with members. Suppliers of carving hobbyists had gotten wind of* *the group and were beginning to make appearances in it as well, offering technical advice and discounts on their products. Will was in whittler's heaven!*

*Soon, he had another big idea. What if he could find a way to make money from his online community?*

### Limited Partnership

In a **limited partnership**, individuals or corporations operate as general partners, and are in charge of managing the day-to-day activities of the business.

Limited partners are silent investors, and are not jointly and severally liable for debts of the partnership. In return for this "limited liability," they give up the right to control the business. A limited partner's investment is all that is at risk. Tax considerations are similar to those of general partnerships, with a few exceptions that are beyond the scope of this book.

#### *Liability*

General partners remain jointly and severally liable for the company's debts. Limited partners are usually only liable for partnership debts to the extent of their investment, so if you invest $15,000 as a limited partner, you're exposed to no more than $15,000 in losses, regardless of the activities of that partnership or the extent of its obligations.

Limited partners must observe strict formalities to avoid joint and several liability

However, limited partners must observe strict formalities to avoid joint and several liability. Under most states' laws, if the limited partners cross the line between consulting and actual management of the limited partnership, the limited partners are jointly and severally liable.

#### *Estate planning*

Limited partnerships offer a bit more flexibility than general partnerships. If there are two general partners, the death of one does not terminate the partnership. And because a limited partner is similar to a shareholder, a limited partner's death doesn't legally affect business continuity.

#### *How to form a limited partnership*

In most states, the Uniform Limited Partnership Act addresses the partners' duties, liabilities, and rights in wind-up and dissolution. You must file a certificate of limited partnership (or a similar document) with your Department of Commerce or Secretary of State, and you'll also need to file to protect your trade name. Some states require the use of "Ltd." to accompany the trade name of a limited partnership.

### Limited Liability Partnership (LLP)

This is basically a general partnership, but with limited liability for all partners. If you're a partner in an LLP, you won't be liable for debts and obligations arising from the acts of other partners.

The LLP is formed by filing a Certificate of Partnership with the appropriate state body (usually the Secretary of State). LLPs are not recognized by all states, and some states restrict them to professional groups (e.g., accountants and lawyers). If you do business as an LLP in a state that doesn't recognize them, your business will probably be treated as a general partnership.

That said, if your operations are limited to a state that offers LLP registration, there's no reason not to take advantage of LLP protections.

*Tax considerations*
As with a general partnership, profits are taxed as personal income for each partner.

## Corporations

A **corporation** is a legal entity wholly separate from the shareholders who own it. All states have laws describing how corporations may operate within that state.

A corporation is a legal entity wholly separate from the shareholders who own it

One of the main reasons to do business as a corporation is the "corporate shield" doctrine, which limits personal liability as long as the corporation is properly organized and operated.

Corporations must strictly adhere to the laws that govern them. Otherwise, the corporate shield can be "pierced" by creditors. The most common reason for piercing is that the corporation did not have annual meeting minutes, or did not file its annual report. Courts also allow the shield to be pierced when the corporation is a sham, and the owners have depleted its assets for their own benefit.

A final thought on this topic: Operating in a limited liability corporate form does not absolve you from personal liability for unpaid taxes if you are in a position of authority in your business; the government will hold you personally liable!

*C corporations*
Most large businesses in the United States operate as **C corporations**. (The letter "C" refers to a subchapter of the Internal Revenue Code for corporate tax purposes.) These are usually large, publicly held companies, but they also include small and even single-owner companies. A C corporation may have a single shareholder who comprises the entire board of directors, holds all the corporate offices, and is the only employee.

The distinguishing characteristics of a C corporation are that it may have more than one class of stock (such as common stock and preferred stock) and an unlimited number of shareholders, and that the taxes on its profits are paid by the corporation.

When corporate income is passed to the shareholders as dividends, it's taxed again as personal income. This combination of a corporate income tax, followed by a personal income tax, is known as **double taxation**.

While no one likes the sound of "double taxation," it's not a serious problem for most small, closely held businesses. For one thing, it can often be avoided by careful year-end planning, since reasonable salaries and fringe benefits (medical and dental plans, insurance, and retirement plans) are deductible by the corporation (the operative word here is "reasonable"; if you pay yourself an inordinately high salary to avoid taxation, the IRS may challenge the deduction).

For larger corporations, the effect of double taxation is also mitigated by the Jobs and Growth Tax Relief Reconciliation Act of 2003, which reduced the maximum tax on dividends to 15 percent.

Another benefit of the C corporation is that it may allow you to deduct employee health insurance (note that shareholders are considered employees), as well as such fringe benefits as group term life insurance, company vehicles, and public transportation passes.

S corporations avoid the risk of double taxation

*S corporations*
**S corporations** are different from C corporations in that their profits and losses are not reported at the corporate level. Instead, they're reported on the owner's personal tax returns, in much the same way as partnerships. This avoids the risk of double taxation.

S corporations are limited to one class of stock, and must file their tax returns on a calendar year. They are restricted to 75 shareholders.

In order for your company to become an S corporation, you must file a special election with the Internal Revenue Service (within certain deadlines that depend on when you file your articles of incorporation with your state's Department of Commerce). You can switch from being an S corporation to a C corporation (or vice versa) only once during the existence of your company, so consider the change carefully!

The S corporation provides another substantial tax benefit, in that it may allow you to pass the losses of your business through to your personal tax return. This often has a significant benefit in the early years of a business, because the business may generate "paper losses," but still make enough money to pay a salary.

***Export corporations***
If your business is organized for import/export, you may want to form either a Foreign Sales Corporation, or an Interest Charge Domestic International Sales Corporation. These highly specialized corporations provide significant tax advantages. You may even want to set up a subsidiary export corporation that will run under your regular company. You should talk to your accountant and lawyer about this.

***Professional corporations***
Most entrepreneurs cannot operate as a professional corporation, because most states permit such corporations to be used only by doctors, lawyers, accountants, and other persons who are licensed by the state as professionals. Limitations on liability are discussed later in this chapter. For now, you should be aware that in most states, professional corporations offer shareholders no freedom from personal liability.

## Cooperatives

**Cooperatives** don't offer the tax benefits of a corporation, but they do have the unique feature of passing all profits through to its members (who are usually its employees). In essence, they combine the equal control of a partnership with the legal status of a corporation.

Members of a community may feel especially comfortable with the structure of a cooperative; communally run natural food stores often choose this form of operating entity. It's also common among smaller agricultural businesses in the Midwest and elsewhere.

Economic benefits are usually distributed to members according to their economic interest in the co-op. Many co-ops also stipulate common ownership and altruistic dissolution, which means that the co-op can't be wound up and have its assets distributed.

If you elect to do business as a cooperative, you'll need a written contract establishing the cooperative enterprise and describing how it will be managed on a day-to-day basis.

## Limited Liability Company (LLC)

The **limited liability company (LLC)** is a hybrid form of ownership established by an **operating agreement** that is similar to the bylaws of a corporation. The operating agreement is not a public record, and is not filed with a governmental agency.

LLCs combine the best attributes of partnerships and S corporations

LLCs combine the best attributes of partnerships and S corporations. They're taxed like a partnership (although they may have only one owner), but liability is limited like a corporation. Note, however, that the "shield" of an LLC can be pierced in some cases, as per corporate law).

An LLC is generally more flexible than an S corporation. There's usually no limit on the number or type of owners, and there can often be multiple classes of ownership interests.

In some states, a membership interest can be paid for with a promise of future services, or with an unsecured promissory note, in addition to the forms of payment authorized under corporate law (cash, property, services rendered, secured notes). However, if the LLC is capitalized solely with promises, it runs the risk of being deemed "undercapitalized," resulting in personal liability for LLC debts for the members.

You can form an LLC for any lawful business as long as the nature of the business is not banking, insurance, or certain professional service operations.

*Tax considerations*

One of the features of an LLC is that the parties may allocate in their operating agreement their shares of gain or loss, which do not have to be equal to the percentage of their investment. Therefore, if one party can utilize tax losses better than another due to his or her personal tax situation, the LLC allows beneficial allocation of that tax benefit.

### *Estate planning*

LLCs can also be used effectively in estate planning. Tax advantages and freedom from personal liability make the LLC an ideal business entity for joint ownership and operation of real estate. Note: Most states require you to file limited liability articles and annual reports with the Department of Commerce. Your lawyer can assist you in this process.

### *How to form an LLC*

Check with your lawyer or accountant about the advantages of the LLC in your particular state

Check with your lawyer or accountant about the advantages of the LLC in your particular state. Ask up front what it would cost to form a corporation versus the cost of forming an LLC.

In some states, forming an LLC involves nothing more than filing a simple, one-page document that lays out the Articles of Organization with the Secretary of State.

*Will checked with the ISP that hosted his carving community, and found that they were also suitable for his start-up needs.*

*He posted a market survey to his carving community. The survey asked a few short questions like "Do you know of any one-stop online stores where carving hobbyists can find all of the products they need?" and "What would be the most desirable characteristics of an online store devoted exclusively to carving hobbyists?"*

*Over 90 percent of the members of the carving community responded to Will's survey. Their responses confirmed assumptions Will had already made based on his own experience, and gave him new ideas about how to proceed. He began designing a site, working closely with his cousin and the technical advisors at the hosting service. To save on expenses, he and his cousin did most of the work themselves. It was very different from his day job, and it took a lot of commitment and concentration. But that was OK with Will, who really enjoyed learning new things.*

*Several weeks later, Will announced that in 30 days, he would open his new online store, WhittlersHeaven.com.*

## How Corporations Work

The closely held corporation is the form of entity most familiar to accountants and lawyers; the rules and tax code provisions that apply to them are well established. Shares in corporations are also easy to transfer for business and estate planning purposes. The following discusses in greater detail how corporations work, and what to do if you want to operate as a corporation.

### Forming a Corporation

You can form a corporation by filing **articles of incorporation** with your state's Department of Commerce (or your local equivalent). This document registers the corporate name and explains what type of business it will conduct. It also specifies its incorporators, its principal place of business, and the duration of its existence.

**Bylaws** are the operating guidelines for the company. They explain how the corporation will function; the rights and duties of the board of directors, shareholders, and officers; and how the corporation will wind up its business.

Once the articles have been filed, the corporation must have an organizational meeting to approve bylaws, issue stock, and elect the first board of directors. A corporation is not completely formed until all of these steps have been taken.

The organizational meeting is also a good time to adopt a formal **buy/sell agreement** and an employment agreement.

### Board of Directors

The **board of directors** manages the corporation's activities. It usually consists of five or fewer people. In the case of a closely held corporation with a single owner, the board often consists of the shareholder, one or two family members, and one or two trusted advisors.

When there are several owners, each usually has a seat on the board, at least initially. A chairperson is elected at the corporation's annual meeting, and runs the board meetings until replaced or voted against at the next annual meeting. The board sets the policies of the company, approves major expenditures (e.g., those that change the direction of the company), and elects certain officers to be in charge of specific aspects of the business.

### Officers

Typically, a corporation's officers include a president, a treasurer, and a secretary. The officers actually run the company; they hire and fire the employees and work to grow the business. Most states allow for a closely held corporation to elect one person to one or more offices, so you can be chairman of the board, president, treasurer, and CEO all at once.

### Shareholders

**Shareholders** are the people who own a corporation's stock. Their rights and duties are set forth in the bylaws. Ultimately, all power in the corporation rests with a majority of the shareholders, because they elect the board of directors. If the shareholders are dissatisfied with the management of the company, they may hold a special meeting and either elect a new board of directors, or require that the board replace the officers or other employees.

Shareholders are liable for the debts of the company only to the extent of their investment

Individual shareholders are liable for the debts of the company only to the extent of their investment in the shares.

### Annual Meeting

The board of directors and the shareholders must each have an annual meeting. However, most states allow for these meetings to be held jointly. The bylaws of the corporation state when the meetings are to be held, what type of notice must be given, and what activities may take place at the meetings. They should also specify the number of persons to be elected to the board of directors each year.

### Books and Records

To ensure that your business remains classified as a corporation, you must obey certain rules. As stated above, one of these is to hold an annual meeting. Another is to document the major activities of the corporation in the corporation's annual meeting minutes.

Most states require corporations to keep certain records, such as annual minutes and financial statements. The shareholders have a legal right to review these records. Your corporation should maintain a minute book containing the registry of shareholders, a copy of the articles of incorporation, the bylaws, the organizational minutes, and the minutes from each of your company's annual meetings.

The annual minutes should describe salaries paid to the principals; loans to and from the corporation; major purchases or sales of equipment; real estate and leases; and major policy decisions. The minutes should also describe employment agreements; pension or medical plans; reimbursement for vehicle expenses; authorizations for major travel or educational expenditures, and similar actions. This will assist your accountant in the preparation of the annual tax return, and serve as evidence to support that tax return if you are audited.

### Annual Reporting

Most states require corporations to file an annual report with the Department of Commerce. This may be a simple pre-printed form indicating that your corporation is still in business, and stating the location of your corporate office and the name of the person in charge. Other states have a more complicated form for annual reporting. In any event, it's important to file the annual report to prevent the Department of Commerce from terminating your corporate charter.

While all these formalities may sound complicated, your lawyer and accountant are there to help you; they can handle much of the paperwork.

## Mechanisms for Raising Capital

Most businesses will have to raise additional capital at some point. The rules governing that process differ depending on the type of corporate entity in place.

All states require businesses to have some amount of equity capital

### Equity Financing

All states require businesses to have some amount of **equity capital**. In other words, the owners must give some value to the company to give it life, and to support their possession of limited partnership shares, LLC memberships, or corporate stock.

Corporations, limited partnerships, and LLCs allow the organizers to finance the business through their own investments, as well as by seeking capital from outside investors. (Note that financing your business through the investment of third parties results in loss of control.)

Some corporations use **preferred stock** to raise capital from outside investors. This type of stock is often nonvoting, and usually has a set dividend payable to preferred shareholders before any dividends are payable to "common" shareholders. Remember that taxes must be paid on dividends received by preferred shareholders.

*Securities*
The federal government and all 50 states have adopted regulations that restrict the ways in which you can sell the investment opportunities known as **securities**. These laws apply to shares of stock in a corporation and memberships in an LLC, among other things.

Federal regulations may apply if you publicly offer a security for sale across state lines, if more than $5 million is involved, or if more than 35 investors are solicited. In these cases, your security sales will be regulated not only by federal law, but also by the Securities and Exchange Commission (SEC), with whom you will have to register your securities.

Many states have similar **blue sky provisions**, but their regulatory thresholds are lower to cover smaller businesses. Typically, states require registration if the solicitation is made to 25 or more persons, and over $1 million is sought. Even if state registration isn't required, your sale of securities is subject to disclosure laws aimed at preventing fraud. Disclosure laws require companies that offer securities to disclose detailed information, so that the public will have sufficient knowledge on which to base an investment decision.

Consult with your lawyer before making a public or private offering of a security, to make sure you comply with registration and disclosure requirements. Be aware that if you're considering a public offering that requires registration, you can expect a complicated, time-consuming, and expensive process.

Consult with your lawyer before making a public or private offering of a security

### Debt Financing
Another method of financing the business is through debt. This often takes place through the traditional relationship of a business and its bank. The bank typically requires shareholders to make a personal guaranty of the corporation's obligations, and will most likely want collateral to secure the debt. Thus, in order to get a loan of $50,000 for new equipment, you will probably have to sign the loan personally, and grant the bank a lien on the title to that equipment. You may even have to put up your personal assets as collateral. (As a side note, you may want to insist on the personal guaranty of the principal of a corporation to which you sell goods on credit. This gives you a guarantee on the debt, in case the corporation proves to be an empty shell with no real assets.)

A second method of debt financing for closely held businesses is for the principal shareholder to loan additional funds to the company for its operation. You should document these loan transactions in your annual minutes, and prepare a promissory note payable to the principal by the business.

The principal may also want to consider taking some collateral for the loan. This way, something of value remains if the business becomes insolvent. This is important because if the business fails, creditors can't attach the business's interest in assets that have been previously pledged as collateral to the principals.

*Bonds*

A **bond** is a cross between a stock and a loan; this instrument is a security too. The corporation sells bonds to a third party for a fixed price, and agrees to pay interest on that amount. The face amount of the bond is repaid from future profits on a certain date. The bond holder receives no collateral.

*Venture capital*

When a business is unable to acquire capital by borrowing money from the local bank, a common solution is to look to **venture capitalists**. These lenders often finance new businesses, but sometimes under onerous terms. They usually require the personal guaranty of the principals, together with a lien on all the assets of the business. And since they often demand a majority interest in the company through shares of its stock, you may find that your lender is also your majority shareholder.

Many owners get squeezed out of their businesses this way, so you should very thoroughly discuss this issue with your lawyer and accountant before agreeing to such terms.

## NxLEVEL® TECH TIP

### BUSINESS RESOURCES AND THE WEB

Here are some sites that will speed up the process of finding official information on state taxation, licensing, and legal structures:

- **Where To Get Business Licenses** (www.sba.gov/hotlist/license.html). This site offers links to business license resources for all 50 states.
- **State Tax Info and Forms** (www.business.gov/finance/taxes/state.html). This site provides access to key resources that will help you learn about your state tax obligations, including tax permits, state income taxes, and employment taxes.
- **State and Territory Business Resources** (www.usa.gov/Business/Business_Resources.shtml). This site compiles direct links to the official business portals of all 50 states, as well as Guam, Puerto Rico, American Samoa, Federated States of Micronesia, and the Midway Islands.

*Later, Will found out that he had inadvertently formed a partnership with his cousin, who'd helped him to design and maintain the Website. After talking to an accountant, he realized that this was not the best form of organization for his business, particularly from the taxation perspective.*

*It turned out that there were several advantages to forming an S corporation. The main issue was that Will was considering starting a new Website in order to sell finished work by whittlers from all over the world. He needed capital to do this, and it was easier to get financing as an S corporation. Accordingly, Will filed the appropriate special election with the IRS.*

*Six months later, the local supermarket had to hire a new worker in the produce department, because WhittlersHeaven.com was consuming all of Will's time! As demanding as it was, it was also beginning to pay off handsomely. The core group of the carving community had spread the word through their own networks. Carvers around the world recognized that for good quality, prices, and honest customer service, there were few operations—online or otherwise—that could surpass WhittlersHeaven.com.*

*Membership in his online community was continuing to grow, too, and was fueling sales at his online store. He was also steadily selling work by craftspeople from 13 countries, in part because he created a "whittler of the month" feature that used YouTube videos to introduce artists and demonstrate their techniques.*

*The upside was that Will was making more money than he could ever have dreamed of making in the produce department, and his friends and family had stopped worrying about his "lack of ambition."*

*The only downside was that because of his remarkable success, he now had to make quarterly payments to the IRS!*

### Government Financing Programs

Many states have created grants, loan programs, and other financing devices to assist small businesses. These programs constantly change in response to the political and economic climate.

Many states have created grants, loan programs, and other financing devices to assist small businesses

The most well-known program is the Small Business Administration, which cooperates with local lending institutions to make loans that might exceed the risk tolerance of the bank. The bank loans the funds, and the SBA guarantees a variable percentage of the loan.

There are many other programs unique to each state. Consult with your local economic development organization to determine which resources are available to your business.

## Conclusion

The type of business entity you choose determines:

- How easy it is to transfer your business to family members, employees, or a purchaser
- Your amount of personal liability
- How you and your business are taxed
- Your estate planning options
- Your options for generating capital

Therefore, you must consult with your lawyer and accountant before selecting an entity, so that you can make the best possible choice.

Remember to follow all the rules governing your type of entity. This will ensure that your business is able to continue in that form, and that you retain all your rights and benefits as the business owner.

Once again, always seek advice from your lawyer and accountant when considering the legal structure of your business!

# Chapter 15
# GOVERNMENT REGULATIONS AND TAXES

*About This Chapter:*
- *The American legal system*
- *Federal and state taxation*
- *Governmental regulations affecting businesses*

## Introduction

How does the legal system affect your business? How can you use it to protect your business interests and plan for your retirement? We will answer these and other questions by discussing the legal system, and some of the major areas of business regulation.

There's no way that we can discuss every law that might apply to your business. Laws vary from state to state, and change frequently. You should take this chapter as a jumping-off point for your own research, and seek help from trustworthy accountants and lawyers who have experience with the issues faced by businesses in your industry.

## The American Legal System

The American legal system consists of statutory laws, judicial interpretations, and administrative rules originating from the executive, legislative, and judicial branches of government. All of these can affect your business.

### Statutory Law

The US Congress comprises the Senate and the House of Representatives. In order for a bill to become law, it must be enacted by both chambers. Once enacted, it becomes part of the federal code. A similar procedure takes place in each of the 50 states.

The federal code is subject only to the US Constitution; state statutes are subject to their own state constitutional limitations, and must also conform to federal law and the US Constitution. Traditionally, states can regulate activities that take place within their borders (for instance, how businesses may incorporate, how pollution is controlled, or the requirements for obtaining a driver's license).

States can regulate how businesses operate within their borders

Since different statutes govern different aspects of business practice, it's a good idea to insist that your contracts with other parties include a statement by the other party that they are in compliance with all federal, state, and local laws. For example, if you're working with a toy manufacturer, you should ask the manufacturer to represent to you that they are in compliance with federal laws regarding child safety standards.

### Judicial Interpretation and Common Law

The federal court system consists of:

- United States Supreme Court
- Eleven appellate circuit courts
- Federal district courts
- Federal magistrates

In addition, there are federal courts established for:

- Bankruptcy
- Claims
- Taxes
- Customs
- Patent appeals

Federal courts hear cases of federal law, and those which involve the crossing of state lines or waterways. Each of the states has a supreme court, and most have an intermediate court of appeal. All the states also use local (appellate) trial courts, which are usually based upon county lines.

Common law is based on judicial interpretation of precedent

The courts hold trials, hear appeals from lower courts, and probate estates. They also review the decisions of administrative agencies, and the actions of state and federal legislatures, for conformity with federal law and constitutional requirements. In reviewing the actions of the other two branches of government, the courts establish law through their interpretations. This is called **common law**. The courts use decisions from previous, similar cases as a basis for their judgments.

### Administrative Rulemaking

The executive branches of the federal and state governments have established administrative agencies to implement federal codes and state statutes. These agencies create laws by way of administrative regulations. In many states, they've established a hearing process that enforces these regulations within the state.

Many laws affecting business originate from administrative rulemaking. One example is the worker safety regulations of the Occupational Safety and Health Administration (OSHA).

### Civil and Criminal Systems

There are two further divisions of the law: civil and criminal. A **tort** is a civil law action in which a plaintiff sues a defendant in order to be "made whole" after being injured by the defendant. Remedies are generally either money damages, or injunctions by which the court orders one party to cease injuring another party.

In cases of outrageous wrongdoing, punitive damages may be awarded by the court or jury to make an example of the wrongdoer, as happened in the famous case where McDonald's was forced by a jury to pay punitive damages to a woman who required multiple skin grafts after being scalded by coffee. The woman was awarded compensatory damages for her medical bills (which were reduced to $160,000, due to her share of responsibility for the injury), but the jury also decided that McDonald's should be fined for its conduct after the accident, through punitive damages.

A common example of a tort is a suit against a person who caused an automobile accident through negligence. The court can make the defendant pay money damages to the plaintiff; this may include compensation for any pain and suffering endured by the plaintiff.

Criminal law, on the other hand, concerns the rights of society as a whole versus the actions of individuals. Its purpose is to maintain public peace and safety. Criminal justice is enforced by the state or federal government, and penalties range from fines to jail terms.

The following story shows how one event can trigger various responses from the legal system.

*Al's Plating, your next-door neighbor, knowingly allowed toxic materials to leak onto your property, and one of your employees was injured as a result.*

*You have a statutory civil law remedy for the injury to your property, and you may be able to get an injunction against Al's to prohibit further dumping.*

*Your employee's family could bring a common law tort action for personal injury. Punitive damages would probably be in order, since Al had prior knowledge of his dumping. The state may also have a criminal complaint, and the state environmental regulating agency would bring an administrative action against Al's for violating environmental regulations.*

### Local Government

In addition to the state and federal legal systems described above, you should also be aware of local regulations, which are often called **ordinances**. These cover zoning and building codes, requirements for business licenses, signage regulations, solar-panel installation, graywater systems, the use of one's home for business purposes, and so forth.

## Federal and State Taxation

Federal, state, and local governments all have the power to collect taxes. In most states, taxation of personal and corporate income parallels the federal system.

As we saw in the last chapter, your choice of business entity has a great deal to do with how income tax regulations apply to your business.

### *Sales tax*

All but three states have enacted sales taxes, which affect businesses by taxing transactions. Some states tax nearly all transactions—including those for medical and legal services—while others exempt "necessity" items, like food and clothing.

States often attempt taxation of transient visitors through motel and occupancy taxes, gas taxes, and the like. States that use sales taxes usually require that you register your business with the state taxing authority; some even require a bond before they will issue you a tax identification number. In a few states, counties and cities have local taxing authority. Check with your accountant or state Department of Commerce to find out how your business will be taxed.

*Tom Davenport, the maker of a specialty microbrew called Brew-You Brew, was astonished to discover how much he had to pay in taxes once his business was operational.*

*Not only was he responsible for federal and state income taxes on his profits, but he also had to pay sales and use taxes to each state for which he needed a business permit; bi-monthly sales taxes to the Bureau of Alcohol, Tobacco, and Firearms (BATF) for his shipments of beer to wholesale distributors; and state alcohol beverage control agency taxes in forty states. The fines for missed or late payments to the BATF were enormous!*

*After four years of dutifully paying all these taxes, Tom decided to name his latest flavored ale Tax-You Brew, and to introduce the beer to the public on April 15!*

### *Property tax*

Siting your business in an enterprise zone can bring significant tax benefits

Most states assess taxes against real estate as a means of funding state government. The property tax structure can have interesting twists, such as your equipment being taxed as real estate or personal property. Depending on its location, your business may have unique tax benefits or burdens. Many states have adopted enterprise zones or similar devices whereby businesses are given tax breaks for locating in certain areas. Urban renewal districts can also result in favorable real property taxation assessments.

Discuss your state's tax structure with your accountant and lawyer before starting a business, or making any major changes to an existing business.

*Business license fees*
Many local jurisdictions can tax your business under a system of business license fees. Before you choose a business location, you should consult the city finance department to determine what, if any, local business fees they assess.

Some states also assess special fees for regulated professions and industries (such as beer, wine, and spirit manufacturers), so check with your state Department of Commerce.

*Payroll/withholding taxes*
The federal government has a standard system for requiring employers to deduct and pay various payroll taxes on their employees. These include the **Federal Insurance Contributions Act (FICA)**, which is the Social Security tax, and the **Federal Unemployment Tax Act (FUTA)**.

Employers are also required to withhold sums from employees for state unemployment compensation, and injured worker compensation. In large metropolitan areas, city taxes are often withheld. As an employer, you must make quarterly (sometimes monthly) payments of income tax withholdings to the government. Incorrect or late payments can result in severe penalties! Anyone who has observed an IRS lock-out has seen the devastating effect of the failure to pay withholdings.

Some employers avoid federal withholding requirements by calling their workers **independent contractors**. Before attempting this, you should carefully review IRS regulations and state laws regarding independent contractors. In most states, persons or businesses performing labor or services for others (called the owner in this example) are considered independent contractors only if they:

Carefully review IRS regulations and state laws regarding independent contractors

- Are free from the direction and control of the owner, except that the owner specifies the desired results
- Are responsible for obtaining their own licenses and business regulations
- Provide their own tools or equipment
- Have the authority to hire employees to assist them
- Are paid upon completion of specific portions of the project
- File tax returns as a business, rather than as a W-2 wage earner from the owner's business
- Advertise to the public as an independent business through business cards, advertisements, telephone listings, and the like
- Perform work for more than two owners in a year
- Have a place of business outside that of the owner

## NxLEVEL® TECH TIP

BUSINESS RESOURCES AND THE WEB

There are hundreds of tax software applications on the market, to say nothing of programs designed to aid you with government compliance. Some of these programs are quite expensive, others can be difficult to use, and still others may squander most of their functionality on capabilities that are unnecessary for your business. You can save time and money—and spare yourself a lot of frustration—by using the following checklist every time you consider a software purchase:

- Seek out software that is designed to serve the needs of small-business users. Many of the popular business applications on the market today are designed for use by enormous companies with in-house support teams. If you lack these resources, you should choose software that avoids technical language, operates intuitively, and is scaled to the size of your enterprise.
- Make sure the program is relatively easy to learn and use. Look for on-screen tutorials, complete printed and on-screen documentation, CD-ROM training courses, and the like. Along the same lines, many companies offer free technical phone or instant-message support (for a limited time), advanced documentation by fax or Internet, and/or a money-back guarantee.
- Choose software with ready-to-use templates that allow you to create professionally formatted documents right away.
- Select a software program that can serve your needs today and in years to come. Perhaps a simple program is sufficient for your current needs, but it may become inadequate as your customer base and business expand.
- Make sure your computer is powerful enough to run the program you're considering. Most programs state minimum system requirements on the box. If you're unsure, ask the salesperson whether the software in question is compatible with your hardware.
- When purchasing any system, be sure to go through the usual budgeting, bidding, and purchasing reviews.

## Government Regulations Affecting Business

No one could hope to list or explain all the laws and regulations that can affect your business, not least because each state and city has its own set of rules. Following is a discussion of some of the regulations you may encounter.

### Employee Regulations

Under civil law, the employer is generally held responsible for any injurious act of its employees that occurs within the scope of employment. Thus, if your delivery person hits a child in a crosswalk while running a business errand, your business is probably liable. This is why many businesses buy liability insurance, and incorporate to avoid personal liability.

Here are some other laws affecting employment.

*Wage and hour regulations*

The federal government has established a minimum wage under the Fair Labor Standards Act. Most states have also adopted such requirements. There are additional state and federal laws regulating child labor, overtime, provision for periodic breaks, consecutive hours worked, and related employment practices.

You should familiarize yourself with these laws, and stay abreast of all proposed changes.

*OSHA*

The Occupational Safety and Health Administration (OSHA) sets guidelines for worker safety. Governing the guidelines are a complex series of regulations by both federal and state agencies. There are severe financial penalties for failure to comply with these regulations, but what's more important is that it makes sense to provide a safe and healthy workplace for your employees!

It makes good business sense to provide a safe and healthy workplace for your employees!

*The hiring process*

Under Title VII of the Civil Rights Act of 1964, your business is prohibited from discriminating against anyone on the basis of race, color, sex, national origin, or age. Consequently, there are a number of federal and state codes and regulations that affect your hiring process. For instance, you may not inquire about a person's age, religion, or sexual preference. It's a good rule of thumb not to ask *any* interview questions that are not job-related. (We recommend that you establish a standard set of questions for your interviews. This will be discussed in more detail in Chapter 23 *Managing Human Resources*.)

*Harassment*

The government has also enacted antidiscrimination laws to discourage harassment in the workplace. Harassment can take many forms, from unfair job placement and promotion to permitting sexual harassment to occur in the office. The best way to avoid these problems is to adopt and enforce an employee policy manual specifying conduct your company does not tolerate.

*Organized labor laws*

The National Labor Relations Board has adopted a number of statutes and administrative regulations relating to unfair labor practices and collective bargaining with labor organizations. Some states require union employment or its equivalent in public projects. If you're going to have a manual labor force or bid on public projects, you may want to consult with the state Department of Labor for the applicable regulations.

Employers cannot discriminate against people with disabilities

### *Americans with Disabilities Act (ADA)*

Employers cannot discriminate against people with disabilities, whether in the work force or in facilities that are open to the public. These extremely broad regulations include the size of restroom doors, the height of keyboards, the type of door handles used, and so forth. Be aware of these regulations, and familiarize yourself with the sections that apply to your business.

### *Family and medical leave*

The Family and Medical Leave Act applies to employers of 50 or more people. It entitles workers to a maximum of 12 weeks of unpaid leave in cases of pregnancy, adoption, family or personal illness, and elder care. Employers who do not comply with the requirements of this law may be subject to serious penalties.

Also, state or local laws that provide greater family and medical leave rights than the federal act does are not superseded by it, which means that your employees may have a choice of whether to request such leave under federal or state law. Your state Department of Labor will be able to help you understand how these laws affect your business.

## Consumer Protection

There are a number of federal and state consumer protection regulations affecting everything from consumer credit to warranties. Your local chamber of commerce can help you understand and comply with consumer protection regulations.

### *False advertising*

The Federal Trade Commission (FTC) Act states that advertisements must be truthful, fair, and non-deceptive, and requires advertisers to back up their claims with evidence. In deciding whether ads are false, deceptive, or unfair, the FTC looks at both express and implied claims. Thus, in the case of a company that makes a "100%-natural" product, it might look at the express claim that the product is natural, and the implied claim that being "natural" confers some heath benefit.

It also looks at what the ads *don't* say. For instance, if a company advertised a "solar lamp," without revealing that the lamp needed to be plugged in to work, that would almost certainly be considered deceptive.

What evidence is needed to back up advertised claims? It depends on the product and the claim being made. A claim like "Kids love Abner's Ice Cream" is unlikely to require evidence. But statements that make express or implied claims about a product's health and safety benefits, or the conditions under which the product was manufactured (e.g., organic cotton, free-range eggs, or US-made goods) must have a reasonable basis in fact.

The explosion in green, sustainable, organic, and energy-saving products has raised many concerns about deceptive advertising. If you intend to advertise such products, you should consult the FTC's ***Guides for the Use of Environmental Claims,*** which can be downloaded from **www.ftc.gov.** In the case of energy-saving appliances and insulation, note that under the Appliance Labeling Rule, your product must undergo standardized testing before you can make any claims as to its energy efficiency.

*Warranties*
The federal government has established an "anti-lemon" law providing minimum requirements for written warranties in consumer transactions. This is in the nature of a disclosure requirement; it is not a requirement that you provide a warranty. Using the sale of a used car as an example, the seller is required to disclose any defects in the car to a prospective buyer, but doesn't have to provide any type of warranty that the car will work next month.

*Uniform Consumer Credit Code*
Many states have adopted the Uniform Consumer Credit Code, which establishes a uniform system of regulations for consumer credit contracts and usury, which is the legal rate of interest.

*Department of Commerce*
Most states have a Department of Commerce or similar state agency that regulates specific businesses. For example, the state's real estate division regulates licenses for sales, property management, and escrow; while the insurance division regulates the types of policies that can be sold and who can sell them. A number of other divisions regulate persons engaged in specific business activities. A call to the Department of Commerce or its equivalent can often save you a great deal of frustration later.

*Selling internationally*
If you sell to foreign consumers, you will be subject to US export regulations, domestic and international shipping regulations, as well as the laws that applies in your target country, and any international treaties to which the United States is party (e.g., intellectual property treaties). International trade is a complicated issue, and it's wise to seek out experts in this field before undertaking it. See Chapter 9 *Export and Import* for more information.

*Telephone solicitation*
There are strict federal regulations governing telemarketing, which all businesses must observe. Applicable laws include the Telephone Consumer Protection Act of 1991 (TCPA) and the FTC's Telemarketing Sales Rule (TSR). Here are some important provisions of these laws:

There are strict federal regulations governing telemarketing

- Telemarketers may not call residences before 8am or after 9pm, local time.
- Telemarketers must provide their name, the name of the person or business on whose behalf the call is being made, and a telephone number or address at which that person or business may be reached.
- Telemarketers cannot use artificial voices or recordings.
- Sales calls cannot be made with artificial voices or recordings to cellphones, or to any service in which the recipient is charged for the call.
- Telemarketers cannot send unsolicited advertising faxes.

In addition, the Do-Not-Call Implementation Act of 2003 created a National Do Not Call Registry for residential phone lines, and stipulated that firms engaged in telemarketing must:

- Pay a subscription fee for online access to the Do Not Call Registry
- Scrub their call lists every 31 days, in order to remove the phone numbers of consumers listed in the Do Not Call Registry
- Remove consumers from their internal call lists when asked to do so, whether or not that consumer is listed in the Do Not Call Registry

Telemarketing abusers may be subject to a fine of up to $11,000 for each infraction. In one high-profile case, a telemarketer was fined $500,000 for breaking federal rules.

The Act has an exception for calls relating to an "established business relationship," which means you may contact anyone with whom your company has done business in the last 18 months, even if that person is listed on the Registry. It's also permissible to conduct surveys. However, if the person you contact asks to be put on your "do not call" list, you must honor the request.

Seek legal advice before engaging in telemarketing

In addition, most states restrict telephone solicitations in a variety of ways. And of course, every state prohibits dishonesty or fraud in telephonic sales. Seek legal advice before engaging in telemarketing.

*Commercial e-mails*
The Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003 (CAN-SPAM) sets forth legal requirements for businesses that send e-mail for the purpose of advertising, and specifies penalties for firms that violate the law. CAN-SPAM applies primarily to spammers, most of whom have no prior relationship with the recipient, but it also specifies that an e-mail's header and routing information must not hide or misrepresent the source of the e-mail.

Here are some of CAN-SPAM's most important provisions:

- **The subject line cannot mislead the recipient about the content of the message.** For example, if you're selling novelty paperweights, your e-mail's subject line can't represent it as a personal message from a friend or co-worker.
- **The e-mail must be clearly identified as an advertisement**. It also must include your valid physical postal address.
- **Recipients must be able to opt out of receiving future e-mails.** The e-mail must explain how to unsubscribe from the mailing list, and the specified method must actually work within ten days. In addition, the opt-out method must be functional for at least 30 days after you send the initial e-mail.
- **Once a recipient has opted out of receiving e-mail from you, you cannot sell or transfer that person's address to another entity.** This rule applies whether that entity intends to send the recipient e-mail on your behalf or not.

As of this writing, each violation of these provisions is subject to fines of up to $11,000 per incident. In addition, additional penalties—including imprisonment—may apply to the following activities:

- Using another computer without authorization, in order to send commercial e-mail from or through it.
- Using a computer to relay or retransmit multiple commercial e-mails, in order to deceive or mislead recipients or service providers about the origin of the message.
- Registering for multiple e-mail accounts or domain names, using information that falsifies the identity of the actual registrant.
- Falsely representing oneself as the owner of multiple Internet Protocol addresses that are used to send commercial e-mails.

***Privacy of consumer information***

The prevalence of e-commerce has led to concern over the use and misuse of personal data submitted online. Since e-commerce typically happens across state lines, the laws regarding data collection in a customer's state can affect your business.

Online privacy laws are getting tougher!

California has passed two laws that are a good example of this. The Online Privacy Protection Act of 2003 requires commercial Websites that collect personal data from consumers in California to post a conspicuous, accurate privacy policy. This policy must fully describe your business practices regarding private data. In addition to the legal remedies for violating this law, violations of online consumer privacy tend to bring a great deal of negative publicity.

The increasing attention that consumers and lawmakers are paying to privacy policies is typified by the FTC's complaint against Gateway Learning Corporation, which was punished in 2003 for changing certain details of its privacy policy without notifying its customers. You should seek legal counsel when devising privacy policies, and when changing them.

Another law, which took effect in January of 2005, states that you may need to provide California consumers with information on your sharing of their personal data with third parties for direct marketing purposes.

Under recent federal legislation, firms that provide financial services are required to provide written notices to certain clients regarding disclosure of nonpublic personal information. Every such firm is now required to explain how and when nonpublic information may be disclosed, and whether the firm maintains safeguards complying with federal regulations to guard their client's information. A sample privacy disclosure statement appears below. This is just a sample; your attorney can tailor it to your business if you provide financial services.

**Sample Privacy Disclosure Statement**

Pursuant to the Gramm-Leach-Bliley Act, Public Law Number 106-012, and the rule issued by the Federal Trade Commission regarding the Privacy of Consumer Financial Information, 16 Code of Federal Regulations Part 313, firms which provide financial services are required to provide written notices to certain clients regarding disclosure of nonpublic personal information.

We may collect nonpublic information about you from you, and with your authorization, from third parties such as accountants, attorneys, financial advisors, insurance agents, banking institutions, and other advisors. We do not disclose any nonpublic personal information about our clients or former clients to anyone except as permitted by law, or as authorized by that client. If we are authorized by you, we may disclose nonpublic personal information to unrelated third parties. Such unrelated third parties would include accountants, attorneys, financial advisors, insurance agents, or government authorities in connection with work we are doing for you. We restrict access to nonpublic personal information about you to those employees of our firm who need to know the information in order to provide services to you. We maintain physical, electronic, and procedural safeguards that comply with the Federal Regulations to guard your non-public personal information.

You must obtain verifiable parental consent before collecting, using, or disclosing personal information from children under 13

### *The Children's Online Privacy Protection Act*

This is a federal law that requires commercial Websites and online services to obtain verifiable parental consent before collecting, using, or disclosing personal information from children under 13. This law applies to sites and services that specifically target children, and also to general audience sites that may be visited by children.

The FTC offers compliance guidelines at **www.ftc.gov/privacy/privacyinitiatives/childrens.html**.

## Uniform Commercial Code

The **Uniform Commercial Code (UCC)** was drafted in response to the need for uniform regulations covering such business contracts as invoices, bills of lading, warehouse receipts, and letters of credit. The UCC also regulates bank interactions, such as checks passing through interstate streams of commerce. The scope of the UCC is staggering; there are literally thousands of pages of written commentary on the UCC and each of its nine articles.

The UCC is broken down into chapters dealing with checks and promissory notes, contracts between businesses, security interests and liens on personal property, and maintenance of security investment accounts. The UCC also requires manufacturers to protect the users of their products through product liability standards. A few states' commercial codes also regulate bulk sales, which is the sale of substantially all of a business's assets.

Article 9 of the UCC is very important in establishing rights to collateral. It provides for liens (comparable to mortgages on real estate) on personal property—such as inventory, equipment, or accounts receivable—and establishes a uniform system for filing these liens. In 2001, major changes to Article 9 were adopted throughout the country. These changes are far too detailed to discuss here. The major impact of this legislation was on lien interests that cross state lines. If your business assets move between state lines, or you take collateral on assets that move between state lines, you should consult your lawyer regarding these laws. This law is also important when you borrow money and the bank wants your assets as collateral.

### Laws Affecting Transportation and Shipping

There are numerous restrictions on what you can transport, how you can transport it, and where it can go. Some of these have to do with national security concerns, and may have been created or strengthened in the wake of the terrorist attacks of September 11, 2001. Other laws have to do with protecting regional agriculture; ensuring the safe transport of hazardous materials; regulating alcohol, tobacco, and firearms; and so forth.

Many laws affect transportation and shipping

The USPS has rules with which you should become familiar, as do commercial carriers like UPS and FedEx. If you're shipping or receiving goods internationally, you're subject to additional regulations from air, land and sea carriers and foreign governments.

*In 2006, Roger Zwicki bought the Morris Paint Company through a bankruptcy sale. He thought he was getting a bargain. Roger wanted to open his own specialty paint factory after having worked at a major paint company for over 20 years.*

*However, in his eagerness to buy, he neglected to investigate the history of the property on which the factory was located. Three months into production of his specialty paint line, Roger was visited by federal officials who informed him that he was standing on a Superfund-targeted site. Four years later, he had to declare personal bankruptcy himself, due to the high cost of cleanup!*

*Today, Roger wishes he'd listened to his attorney, who recommended that he do more due diligence on the Morris Paint Company's environmental issues.*

### Environmental Laws

Many environmental rules are up for review or renegotiation at the time of this writing. Major lawsuits are pending, and major legislation is winding its way through Congress. Thus, this section will provide a brief overview of basic environmental regulations, with the caveat that things may change dramatically in coming years, and create both risks and opportunities for entrepreneurs.

*Clean Air Act (CAA)*
The CAA gives the EPA authority to regulate air emissions from various sources in order to meet National Ambient Air Quality Standards (NAAQS). Although the EPA oversees this effort, most of its rules are enforced by state and local governments, who are required by law to provide small businesses with a Technical and Environmental Compliance Assistance Program.

Whether the CAA affects your business depends on a number of factors, including the size of your business, the amount of your emissions, and the air quality in your region. Businesses that are traditionally regulated under CAA include body shops and garages, installers and servicers of air conditioning systems, and any business that operates a large, centrally fueled fleet in an urban area.

However, the rules may be changing. In 2007, the US Supreme Court ruled that that the EPA was required to determine whether or not there is sufficient scientific evidence to demonstrate "that emissions of greenhouse gases from new motor vehicles cause or contribute to air pollution which may reasonably be anticipated to endanger public health or welfare." After many political battles over this issue, the EPA determined in 2009 that there is such evidence, which will affect emissions of carbon dioxide (CO2), methane, nitrous oxides, hydrofluorocarbons, perfluorocarbons, and sulfur hexafluoride. This is expected to have a monumental effect on American business activities.

Regulation of greenhouse gases offers risks and rewards for businesses nationwide

In the case of carbon dioxide, the determination is not that CO2 itself is a health hazard—although it *is* toxic, as coal miners and other workers in confined spaces know very well—but that it contributes to global warming and the acidification of oceans and lakes. While climate variation can occur naturally, the EPA's finding acknowledges the scientific consensus that the current *rate* of temperature change is unprecedented. Although it's not yet known what regulations will follow, it seems safe to say that this ruling could affect most industrial activity in the United States, and offer risks and rewards for small businesses nationwide.

Some costs of addressing this problem will likely be passed on to consumers, in the form of an indirect energy tax; the precise amount will depend on such variables as the amount of cost savings businesses achieve through compliance; the amount of carbon fees that are spent on efficiency improvements that reduce consumer costs; and the availability of innovative, lower-cost green technology in a competitive marketplace.

In the meantime, the CAA requires certain types of businesses to obtain operating permits, and to prepare and submit a Risk Management Plan (RMP). As of 2009, RMPs can be submitted electronically. Go to **www.epa.gov/oem/content/rmp/rmp_esubmit.htm** for more details.

*Clean Water Act (CWA)*
Under the authority of the CWA, the Army Corps of Engineers and various state environmental agencies have adopted regulations that identify and protect **wetlands**. Primarily, these rules prohibit filling or other disruption of wetlands, and mandate mitigation of any injury to wetland areas. The regulations go far beyond riparian areas

that lay along streams and lakes; they also extend to areas that are seasonally inundated with groundwater. Before you start a cut or fill project, you should check state and local regulations, which may be more stringent than federal rules.

In addition, the CWA makes it unlawful to discharge pollutants (including waste water and storm water) without a special permit from the EPA.

### *The Safe Drinking Water Act (SDWA)*

The SDWA authorizes the EPA (in cooperation with state governments) to establish purity standards for aboveground and underground sources—or potential sources—of drinking water. SDWA's standards include health issues like bacteria and industrial pollution, as well as quality issues like smell, taste, and turbidity.

### *Water rights*

Depending on where you live, you may be subject to laws that regulate access to and use of water. In Nevada, for instance, you may face stiff penalties for violating any provision of Nevada Water Law that relates to the appropriation of surface or underground water rights. Check with local government officials to see what water permits you need, what rights they provide, and what restrictions are in effect.

Check with local government to see what water permits you need and what restrictions are in effect

## NxLEVEL® GREEN TIP
ENVIRONMENTAL BUSINESS RESOURCES

There are many online resources that can help you to understand and monitor current and upcoming environmental regulations. Here are a few of the best:

- **EPA Newsroom** (www.epa.gov/newsroom) has up-to-date news on agency research, rulemaking, and enforcement, as well as programs to help small business with compliance.
- **EPA Compliance Assistance Centers** (www.epa.gov/compliance/assistance/centers/index.html) help businesses to understand and comply with federal environmental requirements.
- **ChemAlliance Virtual Plant Tour** (www.chemalliance.org/Tools/plant/index.asp) lets you click on different areas of an online chemical plant in order to get relevant safety and regulatory information.
- **Environmental Law Net** (www.lawvianet.com) has a daily news feed and an online forum, which allow users to track developments in environmental law and interact with environmental professionals from all over the world.

Conduct a facility inspection and site search before you buy or lease property

***Comprehensive Environmental Response, Compensation and Liability Act (CERCLA)***
CERCLA and its equivalent state laws create a method for cleaning up releases of hazardous substances. Under CERCLA, responsible parties are identified in any cleanup activity, and are required to pay for cleanup costs. In addition, the Act created a federal "Superfund" that allows the EPA to clean up abandoned hazardous waste sites and to collect reimbursement from responsible parties.

As of 2002, certain small businesses may be exempt from certain CERCLA requirements under the Small Business Liability Relief and Brownfields Revitalization Act. As a general rule, though, it's very wise to conduct a facility inspection and site search before you buy or lease property. These issues are discussed at greater length in Chapter 16 *Business and Environmental Ethics*.

***Resource Conservation and Recovery Act (RCRA)***
Under RCRA, the handling of hazardous materials is regulated from creation to disposal. The Act complements CERCLA; together, they affect almost every business and real estate transaction. RCRA regulates active and planned sites, while CERCLA deals with abandoned sites and spills. Most states have laws and regulations parallel to RCRA and CERCLA.

All facilities that treat, store or dispose of hazardous wastes are subject to the RCRA permitting process. The EPA has an e-permitting site at **www.epa.gov/osw/hazard/tsd/permit/epmt/**.

As of 1986, RCRA also regulates the underground storage of petroleum and related products. Many businesses use petroleum products in the operation of vehicles and machinery, or as heating oil for furnaces and boilers. Most states regulate the use of storage tanks for these products, as well as the cleanup of any petroleum products that may have leaked from tanks in the past. These cleanups, for which the small-business owner may be held financially responsible, can be very expensive. If you buy a business with an existing storage tank, be sure to check your state's rules; you may be required to purchase a new tank.

***Emergency Planning & Community Right-to-Know Act (EPCRA)***
EPCRA requires each state to create and maintain a State Emergency Response Commission (SERC) to provide citizens with information on local chemical hazards, and prepare local communities for spills, terrorist attacks, and other disasters. EPCRA also requires businesses to have emergency plans, report on the quantity and type of chemicals they store, and notify authorities in the event of a toxic release.

***Federal Insecticide, Fungicide & Rodenticide Act (FIFRA)***
FIFRA gives the EPA authority to regulate the sale, distribution, and use of pesticides. It specifies that large-scale pesticide users (e.g., farmers) must be certified and registered in order to apply or store pesticides.

*National Environmental Policy Act (NEPA)*
NEPA requires the government to research the potential environmental effects of federal activities, such as construction of a new highway or military base. Before embarking on such projects, the government is usually required to conduct Environmental Assessments (EAs) and Environmental Impact Statements (EISs). If you are counting on a government or private contract for a new construction project, be aware that these assessments can be time-consuming, and may even derail the project entirely.

*Pollution Prevention Act*
The Pollution Prevention Act of 1990 encourages businesses and governments to change the way they produce, use, store, and dispose of raw materials, in order to reduce pollution. Recommended practices include reuse, recycling, conservation, and **Environmentally Preferable Purchasing (EPP)**. You can learn more at **www.epa.gov/p2/index.htm**.

*Toxic Substances Control Act (TSCA)*
TSCA mandates the testing and regulation of all chemicals produced or imported into the United States, and regulates the manufacture or importation of chemicals that are not on the TSCA Inventory, which comprises "existing chemicals." Chemicals that are not on the TSCA Inventory are considered to be "new chemicals." Businesses that intend to manufacture or import such chemicals for commercial use normally have to notify the EPA before proceeding.

In addition, TSCA regulates such high-profile toxic materials as asbestos, indoor radon, lead, and polychlorinated biphenyls (PCBs).

*Endangered Species Act (ESA)*
The ESA regulates activities that affect threatened or endangered species (e.g., species that are near extinction). It protects not just individual animals and plants, but also the health of the ecosystems upon which they depend for survival. Penalties for violating the ESA can be very serious, and may include jail time.

Penalties for violating the Endangered Species Act can be very serious, and may include jail time.

The ESA is enforced by the United States Fish and Wildlife Service (FWS) and the National Oceanic and Atmospheric Administration (NOAA). Individual states also maintain their own ESA lists.

Possible updates to the ESA include federal grants or tax incentives to landowners who maintain habitat for protected species. In some cases, **mitigation banking** and **conservation banking** may make it possible to develop one's land while abiding by the requirements of the ESA and CWA. If you decide to go this route, due diligence is essential; handled improperly, these schemes can cause more problems than they solve for you, your neighbors, and the environment.

*Extended producer responsibility laws*
An increasing number of cities and states are developing mandatory takeback requirements for certain types of products and packaging. Contact your local waste management authority for more information.

### Zoning

**Zoning** divides the community into districts or zones, and zoning laws regulate the use of land and the structures thereon in order to protect public health, safety, and general welfare. For information about zoning laws in your area, check with your local building or zoning department.

## Conclusion

The size of local, state, and federal government continues to grow in scope and complexity. Virtually every aspect of business faces regulation to some extent. Therefore, it's essential to educate yourself about the regulations that apply to your business. Although laws and regulations may seem to be a maze, there are plenty of people who can help you to comply and prosper.

There are also ways of avoiding certain regulations altogether. In the chapters that follow, we'll discuss these strategies in greater detail.

# Chapter 16
# BUSINESS AND ENVIRONMENTAL ETHICS

*About This Chapter:*
- *Defining values*
- *Treating customers ethically*
- *Treating employees ethically*
- *Environmental ethics*

## Introduction

Entrepreneurs face many ethical tests as they struggle to get their businesses off the ground. They may be tempted to lower their taxes by understating revenues, to pay employees less than the fair market rate, to issue misleading advertisements, or to engage in manipulative selling practices.

Although many of these actions are illegal, business ethics go beyond what is legal or illegal. When we feel tempted to compromise our principles for the sake of business or personal advantage, adherence to ethics is a measure of our integrity and sense of responsibility. It's very easy to proclaim one's strong ethical beliefs to the world. It's more difficult to behave ethically when times are tough and the survival of your business is on the line. But ultimately, a business has the same responsibility to be honest, fair, and socially responsible that an individual does.

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## Defining Values

Throughout history, all societies have defined the following traits as the best and most fundamental human virtues:

- Fairness
- Fidelity
- Honesty
- Integrity
- Respect for others
- Responsible citizenship

You undoubtedly look for these qualities in yourself and others, so it's only natural that you should strive to build a business that displays the same values. That being the case, there will almost invariably be an ethical dimension to your business decisions.

You should regularly ask yourself these questions when making decisions:

- Is this decision consistent with my personal and organizational values and ethics?
- Will anyone be hurt by this decision?
- Would I want to be treated the way I'm treating someone else?
- Will this decision increase employee and customer trust?

### Ethical Dilemmas

Being ethical means choosing the right over the wrong, the fair over the unfair. In many cases, the proper course of action is perfectly clear. In others, it seems we must compromise one or more of our values no matter which alternative we select. When this happens, we find ourselves in an ethical dilemma.

People compromise their ethics for many reasons, including financial worries, peer pressure, and deadlines. When you're operating under stresses like these, such compromises may seem justifiable. That's why it's important to ask yourself the following "mirror test" questions:

- Does the decision make you feel guilty, disappointed in yourself, or anxious about what someone else might think?
- If your child, spouse, or friend were in a similar situation and came to you for advice, would you recommend the same course of action you're choosing?
- Would you feel comfortable if your decision received public scrutiny?
- If someone injured you through a conscious action and invoked one of your justifications in defense, would you accept it as a legitimate excuse?

These questions can help you pinpoint ethical dilemmas, confront them without illusions, and resolve them. One of the hardest tasks in ethical decision-making is looking at a problem from someone else's point of view; always ask yourself how you'd want to be treated if you were in the other person's shoes.

## Treating Customers Ethically

Customer loyalty is the result of trust, and trust is the result of fair dealing

Customer loyalty is the result of trust, and trust is the result of fair dealing. A customer considers a transaction to be fair when it satisfies his or her expectations (i.e., an excellent product, delivered on time, at a reasonable price).

However, it takes more than meeting expectations to build customer loyalty. The customer must consistently receive service above and beyond his or her expectations, resulting in a cycle of ever-increased and ever-exceeded expectations.

Therefore, you must empower your employees by giving them the freedom and tools to add value to each transaction. Above all, when conflicts or disagreements arise, your employees must try to see things from the customer's point of view, and bend over backwards to reach an equitable agreement.

Your commitment to treating customers ethically can help to distinguish you from your competitors, and give you a competitive advantage.

### Ethics Training for Employees

As the leader of your business, you represent the values by which your employees will operate. For this reason, you must handle ethical dilemmas precisely as you want your employees to handle them. If there's a double standard, they won't take your ethics program seriously.

You must handle ethical dilemmas precisely as you want your employees to handle them

There must be perfect congruence between what you ask of your employees, the values that guide your own behavior, and the type of behavior you reward. The consequence of ethical congruence is employees who consistently act in accordance with the organization's guiding principles, even in the absence of specific policy or direction.

You can best communicate your ethical expectations through daily interaction. Let your employees know what's important to you: if safety, quality, and customer service come first in your business, make sure your employees know what you expect them to do when conflicts arise between any of these values. They must understand that you'll reward those who uphold your ethical code, and remove those who don't.

### Your Statement of Ethics

Once you've quantified the ethical ideals that will guide your employee's interactions with customers, management, and one another, it's time to draft a statement of ethics. Post the statement prominently, and explain that all your employees must adhere to the values it expresses. To be most effective, a statement of ethics should contain more than vague aspirations; it should also include explicit rules or principles that must be followed, and be backed up by some mechanism for reporting and enforcement.

Remember that the most eloquent statement of ethics is worthless unless the code of conduct it dictates is an obvious, measurable force in your day-to-day business! If your employees, partners, and customers, see that compromises are often made and rules often broken, for the sake either of convenience or personal gain, they'll form their own opinions about what your business really values.

### Codes of Conduct

Effective codes of conduct must give your employees the desire to make ethical business decisions. They should also address practical issues, so that your employees can easily act on that desire during their daily routines. It's impossible to have a specific policy for every situation that might occur, so you must clearly define what steps your employees should take when confronted with a dilemma.

Encourage your employees to discuss ethical situations or decision-making dilemmas as they arise, and create an ethics "chain of command," so your employees can always get the answers they need. This might comprise written guidelines, or a standard procedure.

**NxLEVEL® TECH TIP**
BUSINESS RESOURCES AND THE WEB

**Need help complying with state and federal advertising laws?**
**Business.gov** maintains a very useful list of legal advertising guidelines, organized by type of product. You can access it at **www.business.gov/business-law/advertising-law/specific-products**.

**The Better Business Bureau's National Advertising Council** offers guidelines for self-regulation, as well as advertising review and monitoring services. Memebership is available to "National Companies based in the United States who want to show the public their dedication to the principles of industry self-regulation and ethical business practices; both in the traditional marketplace and on the Internet." Visit **www.bbb.org/us/advertising-review-services** for more details.

You can also get compliance help by contacting your regional FTC office. For contact information, visit **www.ftc.gov/ro/index.shtml**.

### The Law and Your Customers

The Federal Trade Commission's Bureau of Consumer Protection works to protect consumers against unfair, deceptive, and fraudulent business practices. It has seven divisions:

- **The Division of Advertising Practices** is the nation's enforcer of federal truth-in-advertising laws. Its primary areas of concern include foods, drugs, dietary supplements, and other products that promise health benefits; advertising and marketing that targets children; and claims about product performance (including products that promise environmental benefits).
- **The Division of Consumer and Business Education** develops and implements educational campaigns that encourage informed consumer choice and competitive business practices in the marketplace.
- **The Division of Enforcement** investigates and prosecutes businesses that engage in fraudulent, unfair, or deceptive marketing and advertising practices, and monitors compliance with administrative and federal court orders entered in consumer protection cases.
- **The Division of Financial Practices** develops policy and enforces laws relating to lending practices and consumer privacy.
- **The Division of Marketing Practices** investigates and takes action against false and misleading marketing practices, online and off.

- **The Division of Planning and Information** provides consumers and law-enforcement agencies with information on scams, frauds, and identity theft.
- **The Division of Privacy and Identity Protection** oversees issues related to consumer privacy, credit reporting, identity theft, and information security.

You can learn more about the Bureau of Consumer Protection at **www.ftc.gov/bcp**. Individual states have their own laws, some of which may be more stringent than federal laws. Contact your state Department of Consumer Affairs for more information.

*Chris Hendrickson is the owner of Bull's Eye Graphics, a successful graphic design and printing shop in the Hunter's Point area of San Francisco.*

*One day, she noticed that her head printer, Ed Apperson, was pouring fixer and developer waste into the sink. Ed is an expert at offset printing. In fact, Chris feels that she couldn't run her business without him.*

*Unfortunately, Ed learned the trade when he was considerably younger, and has become a bit set in his ways. When Chris asked him to stop pouring the waste into the sink, Ed replied that he'd been pouring wastes down the drain since his high school print shop class, and saw no reason to stop now. When Chris insisted, however, he agreed to dispose of the waste properly, and she thought no more about the matter.*

*As it happened, Ed disposed of the waste properly only when Chris was on the shop floor. Most of the time, he felt he was too busy to do anything more than dump the waste in the sink. He figured what she didn't know wouldn't hurt her. Besides, he was saving time and money!*

## Treating Employees Ethically

Mutual trust and respect are prerequisites for running an ethical organization. In some businesses, employees feel pressured, unappreciated, and mistrusted. Often, unethical employee behavior comes from a perception that the employer's behavior is itself unfair or unethical. The resulting anger and disillusionment can lead to poor performance, low morale, and indifference to the well-being of the business.

What earns employees' trust and loyalty? In a word, fairness. Being fair requires first that you be honest with yourself, and second that you be honest with employees and customers. Without honesty, there can be no ethical management.

Without honesty, there can be no ethical management!

Your employees want an opportunity to succeed, and a reputable product to sell. They want to fulfill the promises that they make to your customers. If they work hard and do what is required, they should have a reasonable expectation of reward.

Note that what gets rewarded gets repeated. The distribution of rewards communicates what is most highly valued by an organization. For example, if you reward people for great customer service, then great customer service becomes a priority, rather than mere organizational rhetoric.

### The Law and Your Employees

The main law affecting workers' pay is the Fair Labor Standards Act (FLSA), which was passed in 1938. The FLSA mandates a minimum wage, premium pay for overtime work, and equal pay for men and women performing equal work.

The FLSA applies to almost all small businesses, excepting those of which the owner is the sole employee. (Even if your business is covered by the FLSA, some administrative and professional employees may be exempt, provided they meet certain criteria. Check with the Wages and Hours Division of the U.S. Department of Labor, or with your state Department of Labor, for more information.)

Here's a partial list of rules mandated by FLSA:

- **Minimum wage.** Some states have a higher minimum wage than the federal rate. Check with your state Department of Labor for the most current information.
- **Recordkeeping.** Records you must keep include employee's full name, social security number, address, sex, and occupation; total hours worked each day and week; basis on which wages are paid; overtime hours worked; and so forth.
- **Overtime.** It's illegal to change the start of the work week to avoid paying overtime.
- **Deductions.** Deductions from wages for such items as uniforms and tools are illegal if they reduce the wages of employees below the minimum wage, or reduce the amount of overtime pay due.
- **Posting.** Employers must display an official poster outlining the provisions of the Act (you can get free posters by calling 1-866-4US-WAGE).
- **Equal work.** Jobs don't have to be identical to be considered "equal work." They meet the definition of the Equal Pay Act when they require identical levels of skill, effort, and responsibility.
- **Pay interval.** Pay periods must be one month or less. Certain states require a shorter interval. Call your state Department of Labor for more information.
- **Time off.** Although the FLSA doesn't require you to grant paid vacation days, holidays, or sick days, be aware that if you promise such days off in an employee handbook or other written form, or have paid these days in the past, you may be legally required to give these benefits to all employees. Some states mandate paid time off for voting, military service, and school conferences.
- **Breaks.** Nearly half the states have regulations on the frequency of breaks and the minimum length of these breaks.

*Bending the rules*
Some employers try to avoid minimum wage and overtime requirements by labeling all entry-level employees "assistant managers," and then forcing them to work over 40 hours per week with no further compensation.

The Department of Labor works to uncover such abuses, and the employers they catch face severe penalties. Most investigations occur after a disgruntled employee complains (note that it's illegal to fire or harass an employee for complaints of this type).

If you're found to have violated the FLSA, you usually have to pay the employee all unpaid wages (including overtime). You may also be fined or penalized. Serious abuses may result in fines of up to ten thousand dollars; a second offense may lead to jail time.

Also, these proceedings can result in a loss of morale among your other employees, who are likely to side with the unhappy employee.

## Worker Safety and Health

There are many good reasons to create a safe and healthy workplace for your employees. First, and most important, is your humane concern for their well-being. Next, there are pragmatic reasons: healthy workers are happier, more productive, and less prone to absenteeism, and they can lower your health insurance and workers' compensation costs.

Healthy workers are happier, more productive, and less prone to absenteeism

Last, there are legal obligations. The average worker is knowledgeable about workplace health and safety issues, and will not hesitate to make legal claims against employers who fail to rectify unsafe conditions.

The best way to meet your legal responsibilities for keeping your workplace safe is to involve your workers. Schedule regular safety meetings at which you ask your employees to identify problems and suggest solutions. If workers can voice their safety concerns to you, they're less likely to complain to the authorities. (Organizing a worker's safety committee can also earn you a break on workers' compensation premiums.) Safety codes are another good way to let employees know you take their safety seriously.

*Occupational Health and Safety Act*
The Occupational Health and Safety Act states that as an employer, you must provide a workplace "free from recognized hazards that are causing or are likely to cause death or serious physical harm to employees."

To administer these regulations, Congress created the Occupational Safety and Health Administration (OSHA). OSHA oversees exposure to hazardous chemicals; first aid and medical treatment; noise levels; protective gear; fire protection; worker safety training; workplace temperatures, and ventilation (among other things).

Workers have two basic rights under OSHA. First, they can complain to OSHA about safety or health violations without being penalized for doing so. Second, they can refuse to work if they have a reasonable belief that by working they face an immediate risk of serious injury or death.

OSHA inspectors can enter your workplace at any time—with no warning—and can issue citations or impose penalties if unsafe or unhealthy conditions exist. If you have ten employees or fewer, and are in a business with a low injury rate—a shoe store, for instance—you may be exempt from these inspections.

Certain businesses with ten or fewer employees may also be partially exempt from OSHA recordkeeping requirements. To see if your business is exempt, contact your state OSHA office. If you're not exempt, note that you're required to provide records to an OSHA compliance officer within four hours of being requested to do so.

Penalties imposed by OSHA depend on the seriousness of the violation. For willful or repeated violations, your business may be fined thousands of dollars. If a worker dies because you ignored OSHA standards, you could even be sent to prison.

In assessing penalties, OSHA looks at several factors, including the size of your business; the seriousness of the hazard; and whether you've made a good-faith effort at compliance.

*Safety training*
Under OSHA, you're responsible for safety training. Make sure that all employees know about the hazards of the materials and equipment with which they'll be working, and that you have Material Safety Data Sheets (MSDS) for any chemicals they work with.

Make sure that all employees know about the materials and equipment with which they'll be working

Don't let an employee begin a job until he or she has been instructed in how to do it safely. You must maintain records of your safety training procedures; it's a good idea to have employees sign a form each time they receive training. Be prepared to show these records to OSHA inspectors.

Remember: even if no accidents ever occur, a noncompliant workplace provides disgruntled workers with a means of causing you considerable trouble.

Under recently passed regulations, you're also required to establish procedures for reporting injuries and illnesses, and to train employees in how to use it. If your state has a health and safety law that meets or exceeds federal OSHA standards, the state OSHA can take over enforcement of these standards from its federal counterpart. State standards and enforcement actions may be more strict than federal standards, and the requirements for posting notices and recordkeeping may be different.

If your business operates in a state that has an OSHA law, contact the appropriate agency for the standards that are applicable to your business. For more information on OSHA regulations, visit **www.osha.gov**.

*Business was booming at Bull's Eye Graphics. Chris needed to hire a few more employees, so she interviewed an applicant named Peggy Bennett. She asked Peggy if she'd worked in a busy print shop before; Peggy said she had, but not for some time.*

*Chris was disappointed. She'd really wanted a worker with years of experience in high-volume, fast-turnaround printing, but none of the applicants fit the bill perfectly.*

*On the other hand, Peggy seemed enthusiastic and confident, so Chris decided to hire her on the understanding that she would undergo a three-month trial period, during which she could be dismissed for any reason.*

## Environmental Ethics

In the past, businesses tended to ignore or downplay the environmental consequences of their actions. Today, things are changing. For many businesses, it's no longer socially, legally, or economically feasible to ignore environmental problems.

For many businesses, it's no longer socially, legally, or economically feasible to ignore environmental problems

In fact, the money one can make by cleaning up the environment rivals the money one can make by polluting it, and many entrepreneurs are finding highly profitable niches in fields related to environmental clean-up. Other businesses are finding that redesigning their products can reduce costs, enhance brand identity and competitiveness, and lessen regulatory burdens.

One reason for these new opportunities is that environmentalists and businesses have been more willing in recent years to look at their interests, instead of their positions. While there's still considerable tension between business advocates and old-school environmental activists, a younger generation of science-minded environmentalists is taking a more business-friendly approach that relies on technological innovation, product and process redesign, and other free-market solutions that can deliver savings and other competitive advantages to business owners.

Where earlier activists attempted to restrict or stop business activity and development, these environmental advocates are more likely to act as collaborative partners and consultants who show businesses how to save money, reduce their vulnerability to regulation and lawsuits, and improve their public image. Perhaps the most famous example of this trend is Ford Motor Company's hiring of architect William McDonough to redesign its Rouge Truck Plant in Dearborn, Michigan. The new plant features a "fumes to fuel" system that converts paint fumes into electrical power; a storm-water management system that collects water and reuses it throughout the plant complex; and plants that break down polluting compounds naturally.

### Intergenerational Equity

There are two main currents in environmental ethics. The first, which is often referred to as **deep ecology**, argues that the environment and the creatures that live in it have an intrinsic value, simply by virtue of the fact that they exist. The practical side of this stance is summed up in the famous "Land Ethic" formulated by the American naturalist Aldo Leopold: "A thing is right when it tends to preserve the integrity, stability and beauty of the biotic community. It is wrong when it tends otherwise."

The second, which is sometimes called **conservation ethics**, argues that the environment must be protected because it's necessary to ensure human welfare, now and in the future. In terms of public policy, this is a more influential approach, not least because it appeals more directly to human self-interest, as well as to traditional religious conceptions of human beings as the "stewards" of the earth.

Human welfare in this sense is not simply physical or economic. It can also be psychological and emotional. Many people would object to damming the Grand Canyon, even if doing so would create jobs and lower their electric bills, because they believe that the aesthetic or spiritual value of the existing landscape outweighs these advantages.

Even someone whose only interest in the Grand Canyon was economic might argue that current and future tourism creates more jobs and wealth than a dam would. After all, there's only one Grand Canyon, but there are many possible ways of creating jobs and generating power.

The state of Nebraska came to a similar conclusion in regards to wetlands that are an important stopping-point for migrating sandhill cranes. Instead of replacing its remaining wetlands with shopping malls, it has increasingly focused on promoting the migration as a spectacle for birdwatchers worldwide. Today, birdwatchers bring millions of dollars into Nebraska communities every year. The growing trend of **eco-tourism** has allowed communities all over the nation to capitalize on their natural assets, while providing a strong economic incentive to protect them for future generations.

We have a moral obligation to maintain the integrity of the earth for the generations that will come after us

Conservation's focus on future generations is based on the idea of **intergenerational equity**, which states that we have certain moral obligations to maintain the integrity of the earth for the generations that will come after us. Therefore, it counsels sustainable use and management of resources, much as an accountant might counsel careful budgeting and cash flow analysis.

A common approach to conservation ethics is the valuation of **ecosystem services**. These are the things plants and animals and ecosystems do that benefit us. Bats that eat crop pests are a fairly straightforward example: if a healthy population of bats reduces the need for pesticides on a given farm, then the value of this ecosystem service is equal to the money the farmer saves on pesticides (which includes the costs associated with storage and use). This provides a useful starting point for weighing the economic effect of decisions that might harm the bat population. Note that there are also opportunity costs to consider: if running a pesticide-free farm, and being seen as a eco-friendly business, will provide a competitive advantage, then there's an additional economic benefit to relying on natural pest control.

This is a somewhat controversial approach in environmental circles, and even its advocates acknowledge that it can be difficult to value certain ecosystem services (those that actually make human life *possible*, for instance). Still, it does provide a preliminary basis for assessing the economic value of natural processes, and debating how to preserve that value from one generation to the next.

### The Triple Bottom Line

Valuing ecosystem services is one aspect of **true cost accounting**, which is also known as **full cost accounting**. This is an attempt to arrive at a more realistic assessment of the costs and benefits of business decisions, by taking social and environmental issues into account.

Businesses that favor this approach measure their business success in terms of a **triple bottom line**, which is usually summed up as "people, planet, profit."

At a minimum, a business that's committed to the triple bottom line will treat customers, employees, and partners ethically; work to minimize or offset its use of natural resources; take steps to reduce or eliminate waste; and avoid as many external costs as possible.

When implemented wisely, these measures can boost profitability by improving efficiency and employee morale, avoiding regulations, and generating consumer goodwill.

### Product Stewardship

In order to calculate the triple bottom line, it's necessary to look at every stage in the life cycle of your products and services, from "cradle to grave" (i.e., from the sourcing of raw materials to disposal).

Product stewardship reduces environmental impact at every stage of the life cycle

**Product stewardship** is an increasingly common methodology for reducing environmental impact at every stage of the life cycle. Businesses that take this approach seek to reduce the environmental impacts of their products by greening their products and their supply chain, and educating their customers on environmental responsibilities.

For manufacturers, strategies include sourcing sustainably harvested materials, reducing the use of toxic substances, designing for reuse and recyclability, and creating takeback programs.

For retailers, product stewardship strategies might include stocking environmentally preferable products and supplies (e.g., resuable shopping bags instead of disposable plastic bags); allowing customers to return products for recycling or safe disposal; choosing greener delivery methods; and using renewable power, natural lighting, and green building practices.

Remember that to succeed, these policies have to be profitable, which means that customers have to accept and value them. Don't make the mistake of looking at stewardship measures in isolation, or assuming that once you've made an effort, your customer will too. Customer education, incentives, and rewards are central to product stewardship. It's acceptable—and in some cases, preferable—to work towards that goal gradually, but you can't lose sight of it.

For specific examples of product stewardship, visit **www.epa.gov/epawaste/partnerships/stewardship/products/index.htm**.

### Greenwashing

Companies that make false or misleading environmental claims for their products, or launch a high-profile green product while continuing to profit from environmentally destructive policies, are frequently accused of **greenwashing**.

According to the green marketing firm TerraChoice (www.terrachoice.com), there are six basic types of greenwashing:

- **Hidden trade-offs.** A company trumpets a product's environmental benefits while downplaying its problems. For instance, a bottled water company might call attention to its sustainable sourcing policies, while ignoring the environmental impact of making and discarding plastic bottles.
- **No proof.** Claims are made without any supporting evidence, as when a manufacturer claims a product is "organic," even though it doesn't have organic certification.
- **Vagueness.** The classic example is a product that claims to be "100% natural." Obviously, there are plenty of "natural" things that none of us would want to eat, buy, wear, or have in the house. Water from a spring that's high in naturally occurring arsenic would be 100-percent natural, but that's not really a selling point.
- **Irrelevance.** TerraChoice's example is a product that claims to be free of chlorofluorcarbons (CFCs). Since CFCs were phased out years ago, the claim is basically meaningless in that it doesn't distinguish the product in question from any other product that's currently on the market.
- **Fibbing.** Making false claims that a product meets a specific standard, has received a specific certification, or enjoys some sort of third-party endorsement. This form of greenwashing is relatively rare, perhaps because it's clearly illegal.
- **Lesser of two evils.** This refers to environmental claims that are applied to an inherently non-green product (e.g., "eco-friendly" gasoline).

As of this writing, the FTC is working on tightening its legal standards for green marketing claims, and the penalties for certain types of greenwashing are likely to be substantial.

But the main reason to avoid greenwashing is that it's unethical, and it's almost certain to bring you negative PR, which will ultimately affect your sales. Always assume that green-oriented customers and advocacy groups will evaluate your claims skeptically, and don't make claims you can't back up with facts.

### Environmental Regulations

For many businesses, the idea of escaping regulation through redesign is appealing not so much because of the social benefits, but because federal and state environmental laws are confusing at best and nightmarish at worst.

The following brief summary of these laws is not intended as a substitute for expert legal advice. These laws change often, and this text may be outdated by the time you read it! We strongly encourage you to do your own homework on these issues.

The U.S. Department of Transportation (DOT), the Occupational Safety and Health Administration (OSHA), the Environmental Protection Agency (EPA), and the National Fire Protection Association (or National Fire Code) all have regulations pertaining to hazardous materials. Each agency has its own definition of which materials qualify for regulation, and its own specific handling requirements.

To further complicate matters, while each agency concentrates on its own specific area, the regulations and areas of concern overlap. For example, both DOT and OSHA have communication and training standards that you must meet.

The EPA's list of hazardous substances is based primarily on environmental impact and persistence. OSHA, meanwhile, simply defines a hazardous chemical as something that "may be considered explosive, flammable, poisonous, corrosive, oxidizing, irritating or otherwise harmful, and is likely to cause death or injury."

It may seem impossible to keep track of all these regulations, but you can do it by focusing on one area at a time. For instance, many organizations offer hazardous materials (or hazmat) shipping and handling seminars to help you comply with DOT regulations. It's a legal requirement that all hazmat shippers undergo this training or its equivalent, so you may wish to sign one of your employees up and make him or her the company hazmat expert. Storage and handling within your workplace are regulated mainly by OSHA, which has plenty of compliance information available. Emissions, spills, contamination, disposal, and the like are the primary concern of the EPA. Check their Website for help with compliance.

*How the laws are enforced*

Because environmental problems often require special understanding of local issues, responsibility for implementing federal environmental laws rests largely with state and local governments. In fact, many states have enacted—or are enacting—local laws that are more stringent than federal laws.

To find out who's obeying the law, the EPA generally relies on the following methods:

- **Self-monitoring.** Most US environmental laws require regulated facilities to keep track of their own compliance status and report all or part of the resulting data to the responsible agency. This not only gives the agency data it needs, but also helps the company's senior management to obey the law. Fraudulent reporting is a serious offense.
- **Inspections.** This is the EPA's primary means of officially assessing compliance.
- **Area monitoring.** Area monitoring looks at environmental conditions in the vicinity of a facility, or over a larger area. Methods used for area monitoring include ambient monitoring, remote sensing, and overflights.

*Penalties*
It's impossible to predict how the EPA will deal with a particular violation of environmental law. Its response usually depends on your willingness to cooperate, the severity of the situation, and any unusual or mitigating factors. Possibilities include:

- **Civil actions.** Most environmental laws authorize the EPA to obtain civil penalties and/or injunctions against violators. Typically, your permit can be suspended or revoked, you'll be required to take steps to correct the violation, and you'll be subject to penalties that are at least equal to the costs your company saved by not complying. Penalties may also be imposed as a per-day charge, or per violation.
- **Criminal action.** Criminal prosecution is usually reserved for flagrant violations, such as illegal dumping of hazardous waste, or deliberate falsification of records. Criminal violations may be either misdemeanors or felonies, punishable by substantial fines. Jail terms for corporate executives are less common, but not unheard of.
- **Administrative enforcement action.** This involves only the administrative agency, not the courts, and can range from informal advisory notices or warning letters—advising the manager of a facility what violation was found, what should be done to correct it, and by what date—to a more formal legal order compelling the recipient to take corrective action within a certain time.

Note that state and local governments may assess additional civil penalties.

## NxLEVEL® GREEN TIP
ENVIRONMENTAL BUSINESS RESOURCES

**How can you get a copy of an EPA publication that you're interested in?**
First, look at the **EPA Small Business Ombudsman's** list of publications, which can be accessed from EPA SBO's home page at **www.epa.gov/sbo/pubs.htm**. Second, the National Center for Environmental Publications and Information (NCEPI), a free repository for EPA documents in paper and/or electronic format, can be accessed at **www.epa.gov/ncepihom**, or call 1-800-490-9198. Other sources of EPA technical and public information can be found at **www.epa.gov/epahome/publications.htm**.

Finally, you can search a database for federal, state, and other publications and fact sheets on the **Small Business Environmental Home Page**. The database can be accessed at **www.smallbiz-enviroweb.org**.

*The weeks went by, and Peggy didn't seem to be working out. When her second inking mistake in two months caused Bull's Eye to miss an important deadline, Chris suspected that Peggy had exaggerated her qualifications and fired her.*

*Peggy was angry and disappointed. She felt that she hadn't been given a fair chance to prove herself. On a couple of occasions, she'd seen Ed pouring developer down the sink. Thinking back on this, she became convinced that Bull's Eye was an unethical company. She considered it her duty to notify the CalEPA.*

*The Inspectors looked into the matter, and found grounds for a criminal complaint. Bull's Eye was fined $4,000 and placed on two years' probation after pleading no contest to two violations of the state's waste disposal laws.*

*Chris wasn't happy about paying the fine, but she was well aware that it could have been worse. She signed Ed up for a city-sponsored training program, and used P2 processes to reduce wastes. After that, no more chemicals went down the drain, and neither did Bull's Eye Graphics!*

### It Pays to Cooperate!

The EPA's Small Business Compliance Policy offers a waiver of penalties for environmental violations to encourage small businesses to participate in onsite compliance assistance programs, and to conduct voluntary environmental audits. The policy applies to small businesses that employ 100 or fewer individuals.

Making compliance efforts now can protect you from penalties later!

The EPA will waive civil penalties if your business:

- Detected the violation through onsite compliance assistance; or conducted a voluntary audit and disclosed the violation(s) to the appropriate regulatory agency in writing and within 21 days.
- Has not used the Small Business Compliance Policy for a similar violation in the past three years, and has not been subject to two or more enforcement actions for environmental violations in the past five years.
- Fixes the violation and any harm associated with it within six months of discovery. (Businesses that use pollution prevention technologies to fix the violation receive an additional six months to comply.)
- Did not cause serious harm or present a significant threat to public health, safety, or the environment; and is not guilty of criminal conduct.

If your business meets these criteria, the EPA will waive up to 100 percent of the gravity component of the penalty. However, in the unlikely event that your business obtained a significant economic benefit from the violation, such that you put your competitors at a serious marketplace disadvantage, the EPA may fine you the full amount of this benefit.

For more information on the EPA's Small Business Compliance Policy, visit **www.epa.gov/compliance/incentives/smallbusiness**.

### Who Pays the Costs of Clean-Up?

Clean-up of environmental contamination is supposed to be paid for by all those who are responsible for the contamination. If many parties are responsible, they bear a proportionate share of the costs. If negotiations fail or responsibility is disputed, the EPA can either require "potentially responsible parties" (PRPs) to clean up the contamination, or conduct the clean-up itself and then sue those responsible to recover its costs (and up to three times that amount). The state also can sue those responsible by filing a separate action.

Get legal help when dealing with potentially contaminated property!

PRPs can be current and previous owners of a property, and the EPA holds them jointly and severally liable. Therefore, if you unwittingly buy contaminated property, it's essential that you consult with an attorney immediately. You can be held liable for clean-up even if you had no knowledge of the contamination at the time of your purchase!

Under the Small Business Liability Relief and Brownfields Revitalization Act of 2002, you can avoid this liability if:

- You bought the property after enactment of the Brownfields Act
- You conducted an "all appropriate inquiry" (i.e., made an diligent attempt to research the prior use and owners of the property)
- Contamination occurred before you bought the property
- You have not tried to impede clean-up efforts

It's not quite that simple, of course. There are other strictures, and narrow definitions of terms. Further, if the EPA remediates the site without recovering clean-up costs, it can put a lien on the property. And if remediation increases the fair market value of the property, the EPA may put a lien on it for the amount of that increase.

The lesson here is that you'll definitely need a lawyer's help when dealing with potentially contaminated property.

## Conclusion

Entrepreneurs are members of their communities. People who value their communities naturally feel a responsibility to make positive contributions to those communities, and to adhere to local, state, and federal laws. By acting ethically, you establish a valuable reputation for fair dealing. Not only is this good for your conscience, it's good for your business!

Whether we're talking about customers, employees, stockholders, suppliers, or regulatory agencies, the benefits of ethical business practices are obvious. From referrals by loyal customers to the favorable credit terms offered by vendors, the rewards for doing business ethically are real, measurable, and personally rewarding.

# Chapter 17
# MANAGING RISK

*About This Chapter:*
- *Seek the help of qualified advisors*
- *Business protection strategies*
- *Squeeze-outs*
- *Dissolution*
- *Insurance*
- *Types of insurance*

## Introduction

This chapter explains precautions you can take to protect your business from **internal risks**, such as your fellow investors forcing you out of your position because you no longer agree on the company's direction; and **external risks**, such as a customer suing you for damages. In addition to being necessary for the survival of your business, good risk management can improve your odds of obtaining capital from lenders and investors, and will help you to sleep better at night.

This chapter also discusses the importance of insurance, which reduces the financial impact of the risks under which your business operates. As a business owner, it's your responsibility to find out what coverage you need before you're faced with a claim. Trying to save money by keeping coverage to a minimum is false economy, and can have disastrous results!

Find advisors you can really rely on!

## Seek the Help of Qualified Advisors

It's essential that you find qualified advisors to help you with the legal aspects of protecting your business. You should interview prospective advisors to find a fit in personality, objectives, and business philosophy. Ask for recommendations from fellow entrepreneurs and business leaders in your community, Look for someone experienced and efficient, who will remain in his or her career during your business's future. The hourly rate your advisor charges is another consideration. Last, always ask for references, and check them.

### Accountant

A qualified accountant is probably the most important advisor you can have. Apart from organizing your books, an accountant can help you with business management, tax reporting, and strategic planning.

A business that starts without the help of an accountant may later find that the accounting system isn't set up properly, that tax reporting hasn't been done accurately or on time, or that the accounting system isn't set up to expand as the business grows. Performing daily bookkeeping chores in-house or through a bookkeeping service will save money, and your accountant can then concentrate on more complex planning and organizational issues.

### Insurance Agent

We recommend that you establish a good relationship with a qualified business insurance agent. Later in this chapter, we will discuss the need to insure against various risks as a means of avoiding disastrous consequences.

### Banker

You'll probably need outside capital during the course of your business, either for major improvements—such as buying a new computer system or a new building—or for cash flow management and operating funds.

It's difficult for a banker to respond quickly to a loan request without having had the opportunity to review your business plan and tax returns, and to visit your facilities, so it's a good idea to establish a relationship with a banker well in advance. A periodic lunch meeting with your banker and accountant is a great way of protecting your business.

### Lawyer

The most practical way of selecting a business lawyer is through a referral from your accountant, who will be familiar with the business law firms in your area. Another person to ask is your banker. You might also place a call to the president of the local county bar association, or the director of your Chamber of Commerce. Keep in mind that you will need someone with experience in legal issues that pertain to small business.

## Business Protection Strategies

Protect your business from internal and external threats!

Once you have your professional advisors on board, you should plan for some of the difficult situations you may have to confront in the future, and devise strategies to protect your business from internal and external threats. (Note: The rest of this section assumes that you will be in business with someone else.)

### Participate Prior to Purchase

If you're buying an ongoing business, you can learn more from the former owner than you could ever learn from a textbook, or from talking to dozens of professional advisors. Keep your eyes and ears open, and you'll see firsthand what works and what doesn't.

### Retain the Prior Owner in an Advisory Capacity

If you haven't worked directly with the former owner prior to purchase, you should consider retaining that person as a consultant. The business contacts and practical experience of the former owner are invaluable assets.

### Participate in Management

If you're one of several owners in a business, don't overlook your role in management. You may be in charge of only one department, but that doesn't mean you can ignore the big picture. Take the time to review management reports, and talk with other executive staff members to make sure that all business functions are functioning smoothly.

### Maintain a Majority Position

When you're doing business with other co-owners, it's easy to forget that the majority owners ultimately control the business. If you must take a minority position, try to have all other owners have equal minority interests (i.e., all of you hold one-third interest).

### Importance of Bylaws and Operating Agreement

One of the first things you can do to protect your business from internal threats is to draft corporate **bylaws**, or an **operating agreement**. (Remember that bylaws are adopted by a corporation, while an operating agreement refers to the contract between partners or limited liability company members.)

Here are some things you should consider in your bylaws:

- Location and timing of meetings
- What percentage of ownership is required to call a meeting?
- What sort of business can be conducted by what percentage of the ownership interests?
- How are the officers and members of the board of directors elected and compensated?
- Who has the authority to enter into contracts, sign checks, and bind the business to other obligations?
- How is employment handled?
- What method is in place for terminating the employment of personnel who have ownership interest?

### Buy/Sell Agreements

A properly drafted **buy/sell agreement** is one of the most important business-protection devices you can have. It's crucial to the success of your business, regardless of whether there are two or twenty owners. The issues it should address are:

Your buy/sell agreement is crucial to the success of your business

- How can an owner be expelled from employment or ownership?
- How do you terminate the business relationship and get your money out?
- What happens upon divorce or death?
- Do you fund the buy-out upon death or disability with an insurance policy?
- Will relatives inherit the interest of a deceased or retiring owner?

Your business advisors can help you resolve these questions.

### How to Deal with the Vocal Minority

Some owners attempt to dominate all of your business's operations, regardless of their percentage of interest. It's important to recognize these individuals early on. You may have to rely on the terms of your buy/sell agreement to buy out the disruptive minority owner. (Of course, it's preferable to avoid getting into business with these individuals.)

### Avoiding Problems with Inactive Shareholders

Certain owners always remain inactive. Others are content to be a "silent investor" until things go bad, at which point they take the opportunity to question everything you've ever done. The best way of handling such people is to keep them advised of business operations through regular reports, and inviting their participation at annual meetings.

An inactive owner who is expected to be an active participant requires a totally different approach. For example, if three partners agree to contribute equally to the duties of the business, and one is not pulling his or her weight, you must take appropriate action.

If there's a personal problem, counseling may be effective. If the problem persists, you may need to terminate the inactive owner's interest. Your professional advisors can be of great assistance in dealing with problems relating to inactive owners.

*Sally's Sodas was a successful natural beverage company operating in Austin, Texas. In 2009, it merged with Just Juice Company, a subsidiary of a major food and beverage manufacturer.*

*At first, Sally's shareholders were excited by the increase in their share price due to the merger.*

*The excitement didn't last, though. Before long, the shareholders were dismayed to find that instead of having a 10% share of the small but profitable start-up, they now owned less than one-tenth of one percent of a major corporation! This severely curtailed their ability to exercise control over corporate decision-making.*

## Squeeze-Outs

Business **squeeze-outs** typically happen for one of three reasons: the company is merged into or taken over by another business; the owners have a divergence of business interests; or one of the owners has wrongfully taken business opportunities for private benefit.

A **merger** is a blending of two businesses. They most often happen because two businesses have compatible opportunities. Potential negative consequences include loss of opportunity for former owners, and dilution of their ownership interest.

Divergence of business interests takes place when some of the owners see the business going in one direction, and others see it going elsewhere.

*Misappropriation of opportunities*
Of the three most common reasons for squeeze-out, misappropriation of the business's opportunities is the most problematic.

Sometimes, individuals take advantage of the business's opportunities because they don't feel the company is qualified to handle them. For instance, a partner in a construction company might refer a project to his cousin's construction company for a commission if he believes that his own company can't handle the assignment.

But more often, it's the result of one owner attempting to better his or her position at the expense of the others. Your buy/sell agreement should address whether opportunities belong to the business, or each owner can seek out and exploit these opportunities for personal gain.

### Protecting Yourself from Squeeze-Out

An owner who actively participates in management will usually be able to detect the warning signs of a squeeze-out well in advance. The best way to protect yourself against squeeze-out is to have provided for a fair way of treating each other in your bylaws or operating agreement. If the rules for termination are well defined in your buy/sell agreement, and the method of valuing the business interests is clearly set forth, the disputes may not go away, but they certainly will be less adversarial.

A good operating agreement can help to prevent squeeze-out

## Dissolution

There are three phases to the **dissolution** of a business:

- **Windup** occurs when the owners decide that the business should stop functioning, rather than have one owner's interest bought out by the other owners, or by a third party.
- **Liquidation.** After the affairs of the business have been wound up, the outstanding contracts performed, all debts paid, and the various entanglements separated, you must liquidate the assets of the company and distribute the funds (or the assets themselves) to the owners, based on their percentage of interest.
- **Reorganization.** Once the old company has been dissolved, many owners take the opportunity to reorganize.

## Insurance

Lawsuits abound in our society, and virtually all businesses are at risk. (In fact, over 90 percent of the world's lawyers practice in the United States, which is one of the main reasons that we live in such a litigious society.) It's estimated that 80 percent of small businesses are not properly insured.

Remember, you may be legally liable for damages even in cases where you exercised reasonable care. Similarly, you may be liable for acts of employees or persons under contract with you, and for any property of others placed in your care.

### Choosing an Agent

People buy insurance in two ways: through an agent or through a broker.

- **Agents** work for one or more insurance companies and receive a commission for each policy they sell. They tend to offer standardized coverage.
- **Brokers** are hired by their customers for a fee. They generally do business with large companies that want customized insurance packages.

There are two types of insurance agents:

- **Direct writers** represent one insurance company, so they tend to be quite familiar with the policies they offer.
- **Independent agents** represent multiple insurance companies, which means that they may offer more competitive prices.

Personal referrals are the best way to find a good agent. Ask your banker, accountant, or other businesses for a recommendation. You may need several agents for the various types of insurance your business requires.

You should always get at least three bids, and check references carefully. You should understand exactly how your premium is calculated, and make sure the agent's estimate is correct. A good insurance agent will ask enough questions about your business to identify all potential areas for loss and liability. For your part, you need to be honest with your insurance agent, who can only give good advice on complete information.

Insure whatever you can't afford to lose!

Your agent should pick the policy that is in your best interest, and sell it at a competitive price. Since your agent is your contact with the insurance company, you'll need to have confidence in him or her should a claim arise.

### What Kind of Coverage Do I Need?

There's no specific answer to this question. The rule of thumb is to insure whatever you can't afford to lose. In other words, if you can't afford to pay 100 percent of a given business loss, you need insurance.

Some kinds of insurance are mandatory, such as workers' compensation or auto insurance. Beyond that, the type of insurance you need depends on the nature of your business. An engineering firm might need errors and omissions insurance, while an e-commerce company may need Website insurance.

Remember: even if you're operating a business from home, your household insurance will probably not cover your business venture. Buying a separate policy, or upgrading existing insurance, is a necessary cost of doing business.

It's also worth mentioning that insurance is often a necessary condition for a bank loan. And if you run a sole proprietorship, adequate insurance is crucial, because you are personally liable for all business debts.

The basic steps to developing your insurance program are:

1. Go over the coverage you already have
2. Check with local and state government offices to find out whether they mandate specific forms of insurance
3. Obtain professional advice
4. Determine what further insurance you need, and where to buy it economically

Your agent should look at your present coverage to identify uninsured risks, and recommend the amount of additional insurance you require. Most businesses should have fire, automobile, liability, and workers' compensation insurance. Insurance firms offer free risk analysis, so it's wise to have several agents who are experienced with businesses of your type assess the level of coverage you need.

Your agent should identify uninsured risks, and recommend the amount of additional insurance you need

Although insurance is a necessary cost of doing business, what you actually pay can vary greatly depending on your situation. If you belong to an industry group or a professional association, they may offer discounted insurance. You may also be able to reduce your exposure to risk by changing how you do business. For instance, if you're facing high premiums because of a specific risk, you may wish to consider outsourcing that business function to another company. That way, you get the work done, and the outside firm takes on the risks.

## NxLEVEL® GREEN TIP

ENVIRONMENTAL BUSINESS RESOURCES

**Greening Your Insurance**

One way that going green can affect your bottom line is by reducing your insurance costs. If you work with hazardous materials, for instance, finding a nontoxic or nonflammable substitute could reduce the risks you face at your facility, and therefore lower your insurance rates.

In addition, many insurers are offering premium credits and discounts for owners of green commercial buildings, and for driving hybrids and other fuel-efficient vehicles. This is partially because smart, careful, responsible businesses are less risky overall, and partially because the insurance industry is worried about future losses related to climate change, and therefore has a strong economic interest in providing incentives for environmentally responsible behavior.

Ask your insurance agent what credits and discounts are available for green policies or improvements.

## Types of Insurance

The insurance industry divides coverage into two categories: property and liability, and life and health.

### Property and Liability Insurance

Property and liability are the most important types of insurance for business. A property policy provides insurance on your building and other physical assets. Liability protects you against claims of injury or property loss resulting from negligence on your part.

Don't assume that a package policy covers all your insurance needs!

Property and liability coverage is often offered to businesses as a package policy covering a number of risks at once. You should be careful with these plans. Don't assume that a package policy covers all your insurance needs.

Property losses must be reported within 60 days, unless an extension is granted. Liability policies generally require immediate notification. There must be proof of loss. Insurance companies compensate your losses in four ways:

- By paying cash for the actual cash value of the loss
- By repairing the insured item
- By replacing the insured item
- In liability cases, by paying court costs, legal fees, and interest on judgments in addition to the liability judgments themselves

There are other specialized types of property and liability insurance your firm may need. Insurance companies have developed coverage for almost everything. In most cases, all are written as separate policies, or as separate riders.

If you need specialized insurance, your agent can tell you about coverage available. The plans most businesses should consider are as follows:

*Liability insurance*
Liability insurance protects your business if, for example, someone suffers a bodily injury while on your site and sues you for damages. Your insurance policy should cover your costs for these damages. Many liability policies also cover injuries like libel and slander (if you're in the publishing business, for instance).

The cost of liability insurance is generally related to the risk of your industry. Thus, if your company deals with toxic waste disposal, the cost of your liability insurance will be much greater than it would be for a florist shop.

*Product liability*
Product liability insurance protects you against claims of injury or property loss due to your product's defects or design flaws.

*Professional liability*
Professional liability insurance protects people who are self-employed in such fields as law, engineering, and accounting from being sued for malpractice by their clients.

*Completed operations insurance*
CPAs and other licensed professionals need this type of insurance to protect themselves against errors or omissions in the services they provide to their clients. For example, suppose you asked an accounting firm to value a company you were thinking of investing in, and after investing, you learned that the valuation was highly inflated. If you chose to sue the accounting firm, their completed operations insurance would help cover any damages they had to pay you.

*Commercial property insurance*
Most businesses need business property insurance to protect company equipment and assets that are stolen, or damaged by fire, flood, vandalism, or other unfortunate incidents. Other hazards, such as windstorms, hail, smoke, and explosion can also be covered. The coverage is written for a specific value, such as the cost of replacing a building or its market value. Premiums are based on the insurable value.

Most businesses need business property insurance to protect their equipment and assets

*Business interruption insurance*
This type of insurance protects against lost business due to disasters such as fire or weather damage. It's particularly important for businesses with a high risk of fire damage, like restaurants.

*Gus Rizzo was confident that his low-cost package insurance policy would cover any risks that his restaurant, La Dolce, might face.*

*Unfortunately, in February of 2009, a cooking-oil fire ruined some of his kitchen appliances, and caused considerable smoke damage to the rest of the building.*

*As it happened, Gus's policy did cover the cost of restoring the restaurant. But it didn't cover his loss of income due to closure. Because he was unable to serve lunch or dinner for four weeks, Gus's losses mounted, even as his restaurant was being refurbished.*

*Needless to say, Gus made sure that his next insurance policy included coverage for business interruption!*

*Commercial auto insurance*
Commercial auto insurance is not much different from the automobile insurance on our personal cars. Most commercial auto policies include property coverage for the vehicle itself, and liability coverage for damage to other vehicles and persons, and the cost of injuries to the driver and passengers of the insured vehicle.

If your company has more than five vehicles, **fleet insurance** will cover them all on one policy. If you're transporting people for a fee, you need a special type of endorsement or policy.

*Electronic data processing (EDP)*
EDP policies protect you against damage to your computers and loss of data resulting from mechanical failures, power surges, and viruses. A good EDP policy will cover costs associated with business interruption and data recovery.

*Website insurance*
This protects you against loss of money, libel, and copyright infringement arising from your Website, as well as damage to computers and data resulting from vandalism and viruses.

*Surety or fidelity bonds*
Bonds are similar to insurance. You can buy a bond to guarantee that you will perform some specific action for a customer. Bonding is very important in the construction industry, where the bond guarantees that you have the financial capacity to perform. If you fail to perform as agreed, the client can get a settlement to cover their losses.

You can also buy fidelity bonds for employees to protect the business against employee dishonesty and theft. Fidelity bonds should be used to cover both cash and merchandise losses.

*Key-person insurance*
Key-person insurance protects the company against financial loss caused by the death or disability of a key employee or partner. The key person is covered by life and disability insurance, and the business is usually the policy owner and beneficiary. This insurance is particularly important for closely held business.

*Home office insurance*
If you're working from home, you should contact your homeowners' insurance company and update your policy to include coverage for office equipment. This coverage is not automatically included in a standard homeowner's policy. For more information, see Chapter 7 *Home-Based Business*.

*Henry Corbin runs a small but thriving Web design firm in Ames, Iowa. When he started his company, he bought an EDP policy that included coverage of such hazards as virus attacks and power surges.*

*In 2009, he was very glad he'd paid for EDP insurance! A client inadvertently e-mailed him an file that contained a virus, and it infected his entire network.*

*The EDP policy paid to repair Henry's corrupted server, and its business interruption components covered the money Henry lost while his network was being restored.*

## NxLEVEL® TECH TIP
BUSINESS RESOURCES AND THE WEB

**Protect one of your most important assets—your computer.**

The business information stored on your computer system is one of your most important—and most vulnerable—assets, but if you're like many companies, your insurance doesn't cover its loss. (For example, a theft policy may cover some or all of the replacement cost of a computer, but does not address the loss of the data stored on the computer, which are often infinitely more valuable than the hardware itself.) Loss of important computer data—such as accounting information, employee records, crucial work-in-progress, or a customer database—can deal just as crippling a blow to your business as a fire or flood, yet this risk is seldom adequately addressed by conventional policies. That's why you should consult your insurance agent about **Electronic Data Processing (EDP) insurance**, which covers theft, loss, and costs incurred when computers break down. If you're considering EDP coverage, look for coverage of losses due to virus attacks; utility-based damage (e.g., voltage spikes and blackouts); lightning strikes; and fire or water damage. It may also be possible to get coverage of damage to peripheral systems that are an integral part of your computer network. This is a relatively new (and often confusing) form of insurance, but its popularity and importance are likely to grow as computers assume an even more central role in business.

A basic first step is to make sure that all your sensitive electronic equipment (e.g., computers, printers, fax and copy machine, etc.) have a proper surge protector (not a cheap "outlet strip") between the equipment and the wall outlet. Additionally, many firms also use a back-up power supply that provides enough power—and time— for you to save and back up your computer files when the power goes off.

### Life and Health Insurance
Life and health coverage is usually part of employee benefit packages, but it may also insure the owner and partners. In some cases, benefits are required by state or federal law.

Employee benefits—such as group life, health coverage, and pension plans—are commonly offered as additional compensation in lieu of salaries or wages. Not surprisingly, healthcare is the fastest-growing component of employee benefits, but the high costs make it a major investment for small businesses.

The reasons most companies provide employee benefits include:

- Attracting and retaining good employees
- Improving morale and worker satisfaction
- Helping employees stay healthy and productive

Healthcare is the fastest-growing component of employee benefits

*Workers' Compensation*
Workers' compensation covers employees who are injured on the job. It's required by law, but specific rules vary by state. Most states require that workers' compensation benefits cover medical and rehabilitation costs, and lost wages for employees hurt on the job.

Workers' compensation has two components: the first covers medical bills and lost wages for the injured employee; and the second encompasses employers' liability, which covers the business owner against lawsuits by the spouse or children of a worker who was permanently disabled or killed. In some states, a third optional element has been added to protect the business against employment practices liability, such as claims from sexual harassment, discrimination, and the like.

Requirements and laws regarding workers' comp vary quite a bit, so you should check with your state insurance commissioner's office to find out what coverage you need.

*Life insurance*
Life insurance often comes as part of a health insurance package. Otherwise, term life insurance can be purchased for your employees at a reasonable cost.

*Group health/medical insurance*
Healthcare is designed to cover the cost of care associated with a serious illness or accident. Many plans now include "wellness" programs, which include screenings for breast or colon cancer, and high blood pressure. Most plans are either comprehensive or scheduled. Comprehensive plans provide full coverage to an employee after a deductible has been paid. Scheduled plans specify the amount they'll pay for each healthcare item.

The cost of any healthcare plan is determined by the work done by the employees. The riskier the occupation, the higher the cost of coverage. Choosing the most economical and effective health insurance plan can be difficult. Your agent can be invaluable in finding the best coverage.

A pension plan is one of the best incentives a business can offer to recruit and retain good employees

*Pension plans*
This is one of the best incentives a business can offer to recruit and retain good employees. However, because of the costs involved, only 20 percent of companies with less than 20 employees have an employee-based pension plan.

Generally, there are two types of plans. A **defined plan**—the best example of which is the public employee retirement plan—pays a set amount, and guarantees a certain level of income at retirement, based on length of service and wage level. A **contribution plan** promises, but does not guarantee, a set amount. Profit sharing, in which a company makes an undefined contribution based on a profitability formula that changes from year to year, is a good example of this type of plan.

*Self-insurance*
Many small firms are looking at **self-insurance** as a way to cover the medical needs of their employees. Essentially, they establish a savings plan so that money is available in the event of a claim. The business only purchases **stop-loss insurance**, which protects it against major catastrophic illness/accidents and expenses.

A self-insurance plan may help you to manage costs and save money. In addition, benefit laws and premium taxes do not apply to self-insurers. On the other hand, self-insurance costs are not tax deductible, unlike the cost of providing health insurance for your employees. You should get plenty of expert help before choosing self-insurance.

Get plenty of expert help before choosing self-insurance

*Social Security*
The social insurance provisions of Social Security cover certain types of long-term disability that make work impossible. The amount of the disability benefit depends on your age at the time of the disabling sickness or injury, and your record of covered earnings. Social Security may also provide survivors' benefits to your spouse or children in the event of your death.

### Insurance Checklist

| Types of Insurance | Required | Type/Coverage | Annual Cost |
|---|---|---|---|
| **Protecting Your Business** | | | |
| General Liability | | | |
| Product Liability | | | |
| Completed Operations | | | |
| Errors/Omissions | | | |
| Professional Liability | | | |
| Automobile Liability | | | |
| Electronic Data | | | |
| Fire and Theft | | | |
| Business Interruption | | | |
| Fidelity Bonds | | | |
| Surety Bonds | | | |
| **Protecting Yourself** | | | |
| Personal Disability | | | |
| Key-Person | | | |
| Life Insurance | | | |
| Medical | | | |
| **Protecting Your Employees** | | | |
| Group Health | | | |
| Life | | | |
| Pension Plan | | | |
| Workers' Compensation | | | |

## Conclusion

You must work hard to establish a business, so it stands to reason that you'll want to protect your investment of time, money, and effort by taking precautions right from the beginning.

Seeking out the advice of accounting, insurance, banking, and law professionals enables you to make informed decisions about protection techniques. Developing lasting relationships with your advisors will help you manage such business risks as partnership or shareholder problems, squeeze-outs, and insurance coverage. Take the time now to begin a program that will protect your business. You'll be glad you did!

# Chapter 18
# INTELLECTUAL PROPERTY RIGHTS

*About This Chapter:*
- *Why protect your ideas?*
- *Business names*
- *Trademarks*
- *Copyrights and copyright law*
- *Patents and patent law*
- *Trade secrets*

## Introduction
Understanding intellectual property rights is one of the most important things you can do as a small-business owner. Globalization and e-commerce have dramatically elevated the importance of intellectual property protection for small business, and the coming years will undoubtedly bring new challenges for businesses that want to protect their ideas, brands, and business methods in the global marketplace.

This chapter will help you to become familiar with the basic protections available to you, so that you'll be better able to seek professional help from experts in this constantly changing field.

## Why Protect Your Ideas?
The most obvious reason to protect your intellectual property is that if you don't, you can lose it to dishonest employees, or to competitors.

Your ideas are one of your business's most important assets!

Further, if you create ideas while employed by your own corporation, and you don't reserve the rights to them, the corporation may own those ideas. This means that if the corporation sells its assets to a third party, or its assets are seized by the court or creditors, you may find that your copyrights, patents, trade secrets, and other intellectual property belong to a third party.

This is another reason to identify the ownership of the intellectual property in your employment agreement, even if you're a single-shareholder corporation.

## Business Names

Most businesses operate under an assumed business name, sometimes signified by the phrase, "Doing Business As" or "DBA" for short.

Generally, courts rule that the first business to use or register a name has the right to continue using it, so it is important that you register your business name as soon as possible. Most states provide for the registration of an **assumed business name**, either statewide or by county. Usually, you must file the assumed business name as soon as you begin using it.

### County Versus State Registration

If your music store is named "Sax and Violins," and you reserve this name in your county, it may be available for use by a business in another county. But even if you register your name statewide, the court may allow another business to use it, provided the competing business operates in a different area and/or industry.

*A few years ago, Scott Engel was working as an electrician in Stony Brook, New York. On weekends, he liked to go on long bike rides. He always brought his cellphone with him, but he was often absentminded about charging it. This was irritating to his wife Sarah, who sometimes couldn't get in touch with him when she wanted to.*

*Scott had never been the type to remember things like charging cell phones. His logic was that if he had to remember to charge his cell phone before long bike rides, there was something wrong with its design.*

*"If there's something wrong with it," said Sarah, "why don't you fix it?"*

*That's when Scott hit on the idea of creating a cell-phone charger that would be powered by his spinning bicycle wheels.*

## Trademarks

A trademark is a word, phrase, symbol or design (or a combination of words, phrases, symbols or designs) that identifies and distinguishes the source of consumer goods.

The more distinctive your trademark is, the more legal protection it has

Trademarks are categorized by how distinctive they are. The more distinctive your trademark is, the more legal protection it has.

- **Fanciful marks** comprise abstract, made-up words or designs. An example of a fanciful mark is "Xerox." This is the strongest type of trademark.

- **Arbitrary marks** consist of actual words or designs that do not relate to the product or service being sold. "Grey Goose Vodka" is a good example.
- **Suggestive marks** suggest what the product or service is. "Comedy Dungeon" would be a suggestive mark for a comedy club.
- **Descriptive marks** are not entitled to protection under trademark law. If a mark merely describes the good or service, the mark is not distinctive. An exception, however, involves the concept of secondary meaning. If a descriptive mark has acquired secondary meaning, the mark is entitled to trademark protection. Secondary meaning is proven by showing that the mark is now identified not just as a description of the product, but as indicative of its source.
- **Generic marks** are never entitled to trademark protection. A generic mark does not describe the product or service; it *is* the product or service. For instance, "aspirin" is a generic mark.
- **Trade dress** refers to the overall packaging and appearance of a product or business, insofar as they communicate the source of the product to the public. Coca-Cola's fluted bottle is one example of trade dress; the distinctive architectural style of a fast-food restaurant is another. Trade dress can be a combination of many elements—from colors to fonts to shapes and sizes—that work together to create customer recognition and goodwill.

Trademark protection is a constantly evolving field of law, and companies are defending trademarks more aggressively than ever before. Product colors, sounds, and scents have all been registered as trademarks in recent years. Consider, for example, Apple's trademark of the three-dimensional shape of its iPod, and T-Mobile's trademark of the specific shade of magenta it uses in its logo. The upside of this trend is that it may be easier to create and defend a unique brand identity, and keep copycats at bay. The downside is that you might conceivably find that your product infringes a larger company's trademark simply because it's a certain shade of green.

### Registering Your Trademark

You don't need to register your trademark to own exclusive rights to it; the commercial use of a trademark establishes your rights under common law. Unfortunately, these rights are often regional. Common law may recognize your exclusive right to a trademark within the state of Rhode Island, but allow its simultaneous use by a business in Oregon. This is why it's wise to seek federal registration of your trademark, which gives you:

It's a good idea to seek federal registration of your trademark

- Legal presumption of your ownership of the mark, and your exclusive right to use it nationwide
- The right to have federal courts (rather than state courts) hear claims of infringement, unfair competition, and counterfeiting
- The ability to record your trademark with US Customs, which will forbid the importation of infringing goods into the United States
- A basis for obtaining registration in foreign countries

To qualify for registration, a trademark must be unique. Therefore, when you apply for a trademark, an examining attorney searches the records of the United States Patent and Trademark Office (USPTO) for conflicting marks. This may take several months.

That's why it's a good idea to do your own search before submitting your trademark. You can access the USPTO database by visiting **www.uspto.gov**. Alternatively, you can visit a Patent and Trademark Depository Library (PTDL); the USPTO Website has a list of addresses around the country.

If this sounds like too much work, you can hire a private firm to do the search. Check your Yellow Pages, or look online.

### Protecting Your Trademark

You can only register a trademark federally if you're using it in interstate commerce

Many trademark owners prefer federal to state registration. Note, however, that you can only register a trademark federally if you're using the mark in interstate commerce.

Trademark registration lasts for ten years, and can renewed for an indefinite number of ten-year periods. Every five years, the registrant must file an declaration that the mark is still being used in interstate commerce, or the registration will be canceled.

*Trademark symbols*

Once a trademark is registered, the symbol ® must follow the trademark (usually in superscript). Failure to use the ® after a registered trademark may cost you your ability to seek damages from an infringer.

If you wish to assert exclusive rights to a trademark that you haven't yet registered with the federal government, or to a trademark whose registration application is pending, you may use the symbol ™ after the mark. This symbol has no legal effect, but it may warn other businesses to choose another mark.

*Maintaining your trademark*

Your trademark is a central part of your brand identity. Its value increases each time it's presented properly. And it decreases—literally!—when it's used carelessly.

Unless you carefully monitor the use of your mark, the mark may lose its distinctiveness and become generic. That's why the Xerox Corporation doesn't want you to say you're making a "xerox copy" if you're using a Sharp photocopy machine. Xerox is not generic; it is synonymous neither with the verb "to copy," nor with the noun "copy." Instead, it's an adjective that describes a brand of photocopiers and related products.

Also, if a mark becomes associated not with the source of the product, but merely with the product itself, it becomes generic.

*Intent to use*

Small local firms and start-ups that haven't yet used a mark in interstate commerce often worry that another company will begin using the mark, or file a federal registration application.

**How to Protect Your Trademark**

- **Always** use the mark as an adjective, and follow it with the generic name of the product (e.g., Grey Goose Vodka)
- **Always** set the mark apart from surrounding words by using italics, capital letters, or different colors or fonts
- **Always** use a trademark symbol: "TM" and "SM" for unregistered trademarks or service marks; ® for federally registered marks
- **Never** use the trademark as a noun

Federal trademark law includes an "intent to use" provision that allows a six-month presumptive period of nationwide exclusivity. To enjoy this protection, you must file an "intent to use" application asserting your good-faith intent to use the mark. Once this is approved, you have six months to use the mark.

If you need more time, you may file for a number of extensions by reasserting your intent to use the mark. But if you do not use the mark within three years of filing the initial intent-to-use application, the USPTO will decline to register your mark.

*Protecting trade dress*

To receive legal protection, trade dress must be nonfunctional. In other words, it must exist solely to communicate the company's identity to consumers. As a simple example, the shape of your sign, and the fonts and colors used on it, could be protected as trade dress. But the bracket that holds it to the wall could not, because it's a functional element of the sign.

Trade dress must also be distinctive, either in and of itself (e.g., the Coke bottle) or because it has acquired a strong association with your company over time.

Like trademarks, trade dress doesn't have to be registered with the USPTO to enjoy legal protection, but there are benefits to registration. Among other things, trade dress registration gives your business a presumption of legal right that other businesses will probably find it difficult to challenge in court. After five years, this right becomes incontestable.

Note that this is an evolving area of law, and standards may not be applied consistently by different courts. The application of trade dress protections to Websites and other electronic interfaces is an especially murky area of IP law that is likely to increase in importance in coming years.

*The principle was simple. Scott already had a headlight that was powered by the rotary motion of his wheels. So why not a cell-phone charger?*

*Scott knew a lot about electricity, so he had no problem drawing up a circuit diagram for his device. But he knew nothing at all about prototypes, and manufacturing, and patents, and design, and marketing...there seemed to be no end to the things he didn't know about!*

*Scott called up an acquaintance of his named John Franz, who was a mechanical engineer. After asking John to sign a nondisclosure agreement, Scott explained what he wanted to do.*

*John liked the idea, and couldn't see any reason why it wouldn't work. They'd need a small dynamo unit, like the one that powered Scott's headlight. There'd also have to be a cord that would fit a cell phone's charging port. It was pretty straightforward. They messed around in John's garage for a few weeks, and—after destroying several cell phones they'd bought cheap on eBay—finally made a working charger.*

*The next step was to build a prototype.*

## Copyrights and Copyright Law

Copyright protection applies to original works of authorship in tangible form. "Tangible" means that it can't simply be in your head; it must be physically accessible to other people.

"Originality," in this context, means that the work of authorship was created by the author, and is the author's own work. It doesn't necessarily mean the *idea* behind that work is original. Ideas aren't protected by copyright law. What's protected is a specific expression of the idea.

To put it another way, the authors of this book couldn't use copyright law to stop another author from writing a book about entrepreneurship, but they could stop another author from publishing the text in this book as his or her own work.

Like ideas, objects that are "intrinsically utilitarian" can't be copyrighted. For instance, a lamp with a base in the shape of a great blue heron is not copyrightable, although the base itself may, when separated from the lamp, be copyrightable as a work of visual art.

If an object's shape is utilitarian, that shape is not copyrightable. A good example is a bottle, which must be shaped so as to allow pouring and drinking of its contents. The shape of the bottle may be protected under trademark law if the shape is distinctive (like the Coca-Cola bottle), but not under copyright law.

### Works Made for Hire

If a copyrighted work is a **work made for hire**, then the hiring party is considered to be the author of the work, and owns the copyright to it.

The Copyright Act of 1976 provides specific circumstances under which works made for hire are created. Absent these circumstances, the copyright to the work is owned by the person who actually created the work.

The first way of creating a work made for hire is through an employer/employee relationship. The person hired to do the work must legally be an employee, and the work must be created during the scope of the person's employment.

The second way is through a commission, or special order for a work. It's important to note, though, that only certain types of commissions qualify for work made for hire status (and then only if the parties agree in writing that the work is a work made for hire).

As we discuss elsewhere in this book, it can be difficult to determine whether a worker is an employee or an independent contractor. Generally speaking, if a worker is an independent contractor, then he or she will own the copyright to a commissioned work unless there is a written agreement to the contrary.

### Registering Copyrights

Copyright registration, while important, is not necessary to create a copyright. A copyright exists from the moment an original work of authorship is created and put in tangible form. No other formalities are required.

Still, there are several important advantages to registering your copyrights. First, if you wish to sue someone for copyright infringement, you must have a registered copyright. Second, registration proves that the copyright is valid, and that the facts stated in the registration certificate are true. Last, registration gives you more flexibility in seeking monetary damages from the infringer, and gives you the right to seek an award of attorney's fees if you win your case.

If you wish to sue someone for copyright infringement, you must have a registered copyright

You can register your copyright with the Register of Copyrights in Washington, DC. Copyright notices and registration are both very inexpensive and remain in force for up to 50 years after your death.

### Notice of Copyright Ownership

Notice of copyright ownership makes the public aware that a copyright exists in the work, and that the copyright owner has exclusive rights to the work. The copyright notice has three elements:

- The symbol ©, the word "Copyright," or the abbreviation "Copr."
- The year of first publication of the work (when copies were first offered for distribution to the public by sale, rental, lease or lending)
- The name of the copyright owner

*John knew a machine shop in Bridgeport, Connecticut that he figured could handle the production of a prototype. Scott was feeling a little more confident. He had a workable idea, and an engineer he liked and respected for the design and drafting, and now he had a machinist, too.*

*Still, he was worried. He knew his idea was a good one, and that it could end up in a manufacturing venture and a lot of money for everyone. At the same time, he knew that it wasn't a stroke of genius. If he'd had the idea, maybe someone else had, too.*

*All the same, there was nothing he could do but wait for John to finish up his drafting. A few weeks later, Scott and John met with Walt Kelly at Bridgeport Tool and Die, and presented him with the plans.*

## Patents and Patent Law

Let's say you just invented a great new way to remove wine stains from fabrics, and you want to make sure your competitors won't copy your product's ingredients. How do you do this? By obtaining patent protection.

Anyone, regardless of age or citizenship, may obtain and legally protect a US patent

A patent grants its owner the right to exclude others from making, using, offering for sale, importing, or selling the invention in the United States. Anyone, regardless of age or citizenship, may obtain and legally protect a US patent.

There are two main types of patents:

- **Utility patents** may be granted to anyone who invents or discovers any new and useful process, machine, article of manufacture, or composition of matter; or who makes any new and useful improvement to any of these. Utility patents are good for 20 years.
- **Design patents** may be granted to anyone who invents a new, original, and purely ornamental design for an article of manufacture (e.g., the external appearance of the iBook computer). Design patents are good for 14 years.

### Usefulness, Functionality, and Novelty

Patent law specifies that the device or process must be "useful." This means that it must have a useful purpose, and that it must function for that purpose. A machine that doesn't operate properly isn't useful, and therefore wouldn't be granted a patent.

In order for an invention to be patentable, it must be new as defined by patent law. This means an invention is not patentable if it was described in a printed publication anywhere in the world, or was in public use or on sale in the United States, prior to the applicant's "discovery" of it.

## NxLEVEL® TECH TIP
BUSINESS RESOURCES AND THE WEB

If you have an idea for a new product, but you're not sure that it's really marketable, you might wish to consult an independent product developer (IPD). For a fee (usually less than $1,000), IPDs will objectively evaluate your product's potential, so that you can decide whether to pursue further development. Here are three very reputable IPDs to consider:

The **Wisconsin Innovation Service Center** at the University of Wisconsin, Whitewater, will send you an evaluation of your product with regard to competition and technical feasibility in about 30 days. It will also conduct a preliminary patent search. Call (262) 472-1365 for more information.

The **Washington Innovation Assessment Center (WIAC)** will identify the positive and negative characteristics of your idea, and provide a quantitative measure of its potential for commercial success. For an additional fee, they'll also conduct a preliminary patent or trademark search. For more information, call (509) 335-8842.

The **Wal-Mart Innovation Network (WIN)** is another option. For $200, the students at Southwest Missouri State University in Springfield will evaluate and score your idea for market potential. If your score is high enough, Wal-Mart buyers may consider your product for placement in their stores. However, WIN should be looked at primarily as a source for product evaluation. To find out more, call (417) 836-5671.

Note: All three of these IPDs will sign confidentiality agreements, so you don't have to worry that sharing your idea with them will release it to the public domain.

Also, a patent cannot be obtained upon a mere idea or suggestion. There must be a complete description of the actual device or process for which a patent is sought.

It also means that if the inventor herself described the invention in a printed publication, used it publicly, or placed it on sale, she must apply for a patent before one year has gone by, or lose her right to patent protection.

### Obtaining a Patent
Filing patents is the most difficult, time-consuming, and costly aspect of IPR protection. Patents don't come cheap; they can cost thousands of dollars each because of research and attorneys' fees. You'll need legal help to determine if your invention is patentable, and successful filing requires the services of a patent attorney who is registered to practice before the USPTO.

You'll need legal help to determine if your invention is patentable

Once you receive your patent, you have the right to exclude others from using, selling, or manufacturing your product. To retain this right, you must mark your product with its patent number.

***Patent pending***

The phrase "Patent Pending" serves as a warning that a patent application is in process, and that copycats should be careful because they might infringe if the patent issues. Applying the phrase "Patent Pending" to an item for which no patent application has been made is illegal, and can result in a fine.

*As they moved forward, Scott and John realized that no matter how many precautions they'd been able to take, there was still no substitute for patent protection. They hired a patent attorney to begin the necessary research, so that they'd be ready to file when the prototype was done.*

*Since the prototype was already in production, all of this seemed a little premature to Sarah, who thought Scott was getting paranoid. But Scott explained that in business a little paranoia can be very useful. When the prototype was finished, he wanted everything in place so he could move quickly.*

*Even with this head start, the patent process was long and hard and cost a good deal of money. But after 18 months, they did get it. Now, Scott and John had the sole rights to the charger. But they still had to find a way to manufacture it, market it, sell it, and protect the patent against infringement.*

## Protecting Your Patents

Monitoring patent infringement is your responsibility, not the government's!

You need to understand that although the government registers your patent, it doesn't enforce it. It's up to you to monitor the marketplace for infringers, because the government will not lift a finger to stop infringement until you prove the case in court. On the other hand, if you allow infringement to go unchallenged, you lose your patent protection. Be aware that it can be extremely complicated and expensive to launch a legal defense of a patent!

One solution to this problem is licensing your product to a manufacturer, and specifying in the contract that the licensee will enforce the patent, and that there will be legal penalties for failing to do so. Usually, only exclusive licensees will agree to this provision.

Another possible option is to keep your invention or process to yourself, and protect it as a **trade secret**.

## NxLEVEL® GREEN TIP

ENVIRONMENTAL BUSINESS RESOURCES

The explosion in green design and technology has made intellectual property a central issue in the green economy. Here are some sites that can help you to learn more about emerging green products and processes, and the legal aspects of innovation and collaboration.

**Eco-Patent Commons** (accessible through **www.wbcsd.org)** is a sustainable design initiative spearheaded by the World Business Council for Sustainable Development (WBCSD), in collaboration with IBM, Nokia, Pitney Bowes, and Sony. It offers patents pledged by businesses, which can be freely used for projects that will benefit the environment. As WBCSD says, the goal is "to promote and encourage cooperation and collaboration between businesses that pledge patents and potential users to foster further joint innovations and the advancement and development of solutions that benefit the environment."

**Green Patent Blog** (www.greenpatentblog.com) is a fascinating site "dedicated to discussion and analysis of intellectual property issues in clean technology and renewable energy." This is a great place to learn about the legal aspects of new technology, as well as interesting topical items like green patent auctions.

**GreenXchange** (sciencecommons.org/projects/greenxchange) is a project launched by Nike, Creative Commons, and Best Buy. It invites open collaboration in developing new ways to promote efficient resource use and green manufacturing techniques. Strategies include patent pools, research non-assertions, and technologies that support networked and community-based knowledge transfer and sharing.

## Trade Secrets

Trade secrets are the primary intellectual property of most small businesses. They comprise the confidential business information, methods, and processes used in your business. To qualify as a trade secret, information has to meet the following criteria:

- It is not generally known to the public
- The secrecy of the information confers some sort of economic benefit (e.g., it gives you a competitive advantage that you would lose if the information were no longer secret)
- Your firm has made a reasonable effort to keep the information out of the hands of competitors

Trade secrets are the primary intellectual property of most small businesses.

One advantage of trade secret protection is that unlike patent protection, it's not subject to a time limit. As long as it remains secret, it's protected. On the other hand, it doesn't offer a minimum period of protection wherein you have exclusive rights. Also, patent protection gives you legal recourse if a competitor reverse-engineers your product. Trade-secret protection usually does not.

In most states, trade secrets and customer lists are protected against theft or misuse under the Uniform Trade Secrets Act, as long as you take reasonable steps to maintain their secrecy. Even if an invention or process is not eligible for patent registration, it may still be a protected trade secret under state law, provided it meets the criteria above. In addition, the Economic Espionage Act of 1996 makes the theft or misappropriation of a trade secret a federal crime.

Misappropriation of trade secrets typically occurs when an employee has left your employment and attempts to use your secrets to compete against you. The remedies against such acts are often injunctions; the court requires the offending party to stop using the information and to return it to the owner. Monetary damages may also be awarded against the offending party, since in many instances you cannot undo the harm done to your business.

One of the best things you can do to protect your trade secrets is secure your computer network and files. If you are on a network, make sure that you have password protection for files that should only be seen by you, and be careful about e-mailing them. A document shredder can also prevent information from getting into the wrong hands.

Last, many entrepreneurs find it useful to operate under the "need to know" principle. If people inside or outside your company don't need to know a trade secret in order to do their jobs, don't tell them about it.

### Noncompetition and Nondisclosure Agreements

**Noncompetition agreements** are intended to restrain a person from competing with your business. They're typically used when an employer does not want employees to leave with unique knowledge developed by the company. Noncompetition agreements are also used when a business is acquired by a new owner who doesn't want the former owner to start another business in the area, contact all his or her old customers, and compete against the very business he or she just sold.

Most states regulate noncompetition agreements, and some also address the content of trade secret agreements. You should have your lawyer check into this, and help you draft these agreements so they will be enforceable.

Nondisclosure agreements are useful when you must give outsiders nonpublic information about your business

A **nondisclosure agreement** typically requires that parties receiving information about your business can't disclose it to any third party or use it for themselves. These agreements are useful when you must allow another company to acquire nonpublic information about your business, such as when a company reviews your operations, books, and records for purposes of an acquisition or merger; or when you retain a consultant to assist you in the management of your enterprise.

You should have such an agreement in place before you allow an outsider to have access to any of your books or records, trade secrets, ideas, customer lists, or even to inspect your premises. Your lawyer will be able to advise you on this matter.

*Twenty-three months, and thousands of dollars, had bought Scott and John one working charger. Now, they had a hard decision: Should they try to scrape together the money they'd need to manufacture it? And even if they managed it, could they handle the marketing? The distribution? The patent monitoring and enforcement?*

*The more they thought about it, the more they realized they simply couldn't do it. They'd have to try and license the charger instead. By searching online, they found a few sites dedicated to similar products. Scott made some phone calls, and got a good response. As he'd suspected, people were excited about it.*

*In the end, Scott and John licensed the charger to Solarise, a small but very successful firm in Cleveland, Ohio that manufactured and sold energy-efficient products all over the world via its Website. They negotiated a 15% royalty rate, and agreed that it was Solarise's responsibility to enforce the patent.*

*Solarise put the charger on its Website, and consumer response was enormous. Orders flooded in not just from the United States, but from Europe, South America, Australia...almost everywhere.*

*Scott hadn't just solved his own problem. He'd made life easier for everyone who rode a bike and owned a cellphone. And he'd helped to solve an environmental problem, too!*

## Conclusion

It's impossible to overstate the importance of intellectual property laws to businesses of every type. If you learn nothing else about law, you should understand the basic issues covered in this chapter, and be able to apply them to your business.

You don't have to be engaged in biotech or computer research to have methods or processes that are not commonly known. Who your customers are, and what and how often they order, is vital information that you should seek to protect.

IPR is an extremely complicated subject, and it's in a continual state of flux. As we've said so many times, the services of an IPR attorney are essential, and well worth paying for. And now, more than ever, you will want an attorney who makes a point of keeping up with the latest domestic and international developments in this evolving field.

# Chapter 19
# CONTRACTS AND LEASES

*About This Chapter:*
- *What makes a contract legal?*
- *Types of contracts*
- *Common contract issues and terms*
- *Breach of contract and its remedies*
- *Contracts on the internet*
- *Leases*
- *Consignments*

## Introduction

A contract is a voluntary agreement between two or more parties that creates a binding legal obligation between those parties.

No matter what type of business you run, you need a basic understanding of contract law. You'll also need expert legal help to ensure that your contracts are intelligent, safe, complete, and legally enforceable.

No matter what type of business you run, you need a basic understanding of contract law, and access to expert legal help!

## What Makes a Contract Legal?

Most contracts are governed and enforced under one of two laws.

- **Common law** governs such business contracts as employment agreements, leases, and partnerships. Common law is derived from the precedent set by judges' decisions over the years. Thus, it's based on tradition, but also evolving.
- **The Uniform Commercial Code (UCC)** was drafted in response to the need for uniform regulations covering the sale of goods, particularly in interstate commerce. It was drafted by private organizations, so it's not a law in and of itself. But it has the force of law when enacted by states. The UCC articles dealing with contract law are Articles 1, 2, and 9. Your lawyer can help you understand how these Articles affect your business.

Common law recognizes four elements to an enforceable contract:

- Mutual assent
- Consideration
- Capacity
- Legality

Suppose you walk into the corner grocery store where you've been shopping for 15 years, and pick up a bottle of milk. At the counter, you realize that you forgot your wallet. The grocer makes a note that you'll pay for it the next time you come in, and lets you leave with the milk.

Although this is an informal transaction, it has all the elements of a contract. There's mutual assent, because the grocer offered the milk for sale, and you agreed to buy it at a specific price. There's consideration, because value was exchanged when you got the milk and the grocer recorded an account receivable. There's capacity, because both of you had the mental capacity to understand the terms of your agreement. And there's legality, because the sale of milk is legal.

Let's look at each of these elements in a little more detail.

## Mutual Assent

Have both parties agreed to the same thing?

In order to determine whether you have a deal, the first question is, have both parties agreed to the same thing? Suppose a car salesman points to a new Maserati and says, "Wouldn't you like to have one of these?" The fact that you answer "Yes" doesn't mean you've reached mutual assent.

Under common law, there must be a valid offer for goods or services, and an acceptance of this offer at an agreed-upon price. Also, the offer must set forth the essential terms of the contract: price, date of performance or delivery, and place of performance or delivery.

Under common law, a contract offer is only open for a reasonable amount of time, or until the seller withdraws it. The UCC allows the parties to agree to leave the offer open for a stated period of time. This agreement is itself a contract.

The UCC also recognizes contracts established by the conduct described in the milk-buying scenario above, even in the absence of a written document between the parties.

### *Counteroffers*

If the buyer proposes an adjustment to the contract terms, this becomes a **counteroffer** from the buyer to the seller. The counteroffer terminates the original offer, and is then subject to the seller's acceptance or rejection. At this point, the seller isn't required to agree to the counteroffer *or* the original offer.

### *Standardizing contract terms*

Common law rules on mutual assent caused problems in the modern business world, because so much of our business dealings use preprinted forms with conflicting terms.

Thus, the UCC includes a provision under which the identical terms of different forms are deemed the contract terms. Terms that disagree, and are not material to the transaction, are thrown out and replaced by the standard "gap filler" terms of the UCC.

However, if the terms in the differing forms are so much at variance that the parties in effect don't have an agreement, then the UCC states that no legal contract exists.

### Consideration

In an enforceable contract, **consideration** must pass between the two parties. In our grocery store example, you received the milk as consideration, and the grocer received your promise to pay.

In an enforceable contract, consideration must pass between the two parties

Consideration can consist of many other kinds of value. For example, if you promise to design computer software for a company within six months, and they promise to ship you a new laptop two months after delivery, this constitutes an enforceable contract.

*Forbearance*

**Forbearance**, or giving up a right, can also be a form of consideration. For instance, if you had the right to buy shares of stock under an option (as we'll discuss in a later chapter), you could agree to give up that right as consideration for the company performing some other duty, such as agreeing to ship you two boxes of parts you need.

Bear in mind that forbearance is valid as consideration only if the party is forbearing from something he or she has a legal right to do. For instance, a 15-year-old who agreed not to smoke cigarettes or drink alcohol in return for $1,000 from his uncle would not be offering valid consideration.

### Capacity

Both parties must have the mental capacity to enter into a contract. For that reason, most states rule that contracts with minors for unessential goods or services are unenforceable against the minor. Likewise, you cannot enter into a contract with a person who lacks the mental capacity to understand the transaction, regardless of his or her age (e.g., someone with Alzheimer's disease). Another example of lack of capacity is being intoxicated or under the influence of drugs, prescribed or otherwise.

### Legality

The terms of a contract must be legal. In most states, for example, one could not enforce a contract based upon prostitution, drug trafficking, child labor, or other illegal transactions.

## Types of Contracts

A contract can either be either express or implied. An **express contract** is stated in words (preferably in writing), while an **implied contract** is manifested by conduct.

### Implied Contracts

Suppose you call your box supplier and ask for 500 variable-depth mailers, and hang up without making any verbal commitment to pay for the boxes. Despite the lack of a verbal commitment, your promise to pay is implied by the fact of your order, which is why such contracts are referred to as **implied-in-fact**.

If your supplier mailed you an extra 500 mailers by mistake, and you used them but refused to pay for them, a court might find that a contract was **implied-in-law**; though you didn't order the boxes, the court recognizes that if you use them, you should pay for them, and thus finds that an implied-in-law contract exists. As such, contracts implied-in-law are actually a form of restitution.

Implied contracts are a frequent source of trouble in employment law, where such things as orientation materials, verbal assurances, and standard procedures may imply a contract. Be careful about making any employment promises, or statements that can be interpreted as being promises! Many employment contracts specifically state that employees may be fired at will, and that nothing in employee manuals or other materials constitutes a contract of employment.

Put your contracts in writing!

### Oral Contracts

Oral contracts are valid and binding, but their terms can be very hard to prove in court in the event of a dispute. Of course, it's possible to come up with a very specific and detailed oral contract...but if you're going to go to that much trouble, you may as well take the additional step of putting the terms in writing!

*The Bon Larvis Band is recording its first CD. They know that the silkscreen artist Ramiro Gonzalez has designed several CD covers for groups around their hometown of Avenal, California.*

*The band members see Ramiro at one of their shows, and they make their pitch, shouting to be heard over the club's sound system. "Will you do our CD cover? We want guitars, clouds, skulls, and a lightning bolt on it." Ramiro responds, "Sure, I'll do it for $500.00." They agree on a due date. The band members tell Ramiro that they'll press 1000 CDs, but put nothing in writing.*

*Ramiro delivers the original art to the band, and they pay him. A week later, Ramiro discovers that The Bon Larvis Band is also using his artwork on its posters and t-shirts. He asks them to stop using the artwork on anything but the CD cover. The band tells Ramiro, "Look...we hired you and paid you, so we own all rights to the art and we can do whatever we want with it. Plus, we got the original, so you're out of luck."*

*Who's right? Ramiro's art is probably not a work made for hire. The Bon Larvis Band exercised very little control over his work. Ramiro used his own workspace and tools, set his own hours, and had other clients. Thus, Ramiro owns the copyright. At most, The Bon Larvis Band has nonexclusive rights as a licensee of Ramiro's art.*

*But how long does the license last? Can it be terminated? Did it include the right to reproduce and distribute copies of the artwork on posters and t-shirts? How much, if any, additional compensation should Ramiro receive for these additional uses? The only way to settle these issues is to analyze the parties' oral agreement, which consisted of a few shouted words in a noisy nightclub. Ultimately, it's the band's word against Ramiro's, and that's not a good way to conduct business! An agreement in writing would've prevented these problems from arising.*

### Written Contracts

Some types of contracts must be in writing. Examples include:

- Contracts for the sale of goods (tangible, movable personal property) for $500 or more
- Contracts for the sale of real estate
- Contracts that, by their terms, cannot be performed within one year (such as an employment agreement with a three-year term)

The law that requires a written contract in these and other circumstances is known as the **Statute of Frauds**. Like every general rule of law, the Statute of Frauds is different in every state, and there are many exceptions to it.

The UCC allows the contract to be any type of written communication between the parties, such as a series of e-mails that can collectively be construed to represent the contract terms. The UCC specifically excludes specially manufactured goods from the Statute of Frauds, because the existence of goods made to the specifications of the buyer is evidence enough that the parties had an agreement.

By committing your agreement to writing, you lessen the chance of fraud occurring, and eliminate the risk of protracted or undecidable legal disputes over who said what when.

### Get Legal Advice!

If you ask your lawyer to draft a contract for you, outlining the basic terms ahead of time will save money. Look at other agreements that people in your industry have used. Your Chamber of Commerce may be able to put you in contact with someone in your business, or you might find relevant information at the library or on the Web.

You may want your lawyer to prepare a blank contract that you can use again and again. There are even contracts available on computer software, or through online downloads. However, the circumstances surrounding every contract are unique, so your lawyer should always review the agreement before you finalize it.

Your lawyer should always review agreements before you finalize them

## Common Contract Issues and Terms

When you receive a contract, make sure you understand all its terms and conditions. Bear in mind that the **boilerplate** (also known as fine print, or standard clauses) found in most business agreements is extremely important. In the event of a dispute, every term in that contract will be reviewed and utilized by one party or the other.

Don't assume that a printed form can't be modified. If a contract contains unacceptable boilerplate, you can cross out or change a term, initial the change, and have the other party initial it too. Remember that small print can have huge consequences!

A good contract should be written so that a third person who is not in your industry can understand its terms. (If you have to submit this contract to arbitration or litigation, it's very helpful if the judge is able to understand it.)

Most business contracts include the following terms.

### Parties

With whom are you dealing? Is it the parent corporation, or a shell with no assets? You may wish to consider the requirement of a personal guaranty if the party turns out to be Blue's, Inc., rather than the financially secure Ms. Blue. A guaranty by Ms. Blue places her in the position of responsibility if her corporation defaults.

### Performance

Performance means the actions you must complete under the contract. For instance, you might be required to deliver ten desks to an office by a particular date.

### Delegation and Assignment

You can normally delegate your contractual duties to someone else, unless the contract terms specifically forbid it. However, an obligation to perform certain personal services can't be delegated to someone else without the other contracting party's consent, because the obligation is personal: the other contracting party bargained for that particular person's services.

It's a good idea to include this restriction in a contract, in order to avoid any disputes as to whether the services were "personal" or merely "ministerial" (requiring no special skill).

A transfer of contractual rights is called an **assignment**. If you're expecting $5,000 from a contract partner, you can normally assign your right to receive that payment to someone else, as long as the contract terms don't forbid it. But if doing so would lead to unexpected burdens, hardships, or risks for your contract partner, the contract may not be assignable.

Review the delivery terms of the agreement carefully!

### Place of Delivery

Where are the goods to be delivered? Who pays for shipment? Who bears the risk of loss while the goods are in transit? Does training on how to use the item take place in your office or theirs? Are your travel time and expenses covered?

Failure to review the delivery terms of the agreement carefully can result in your profits being used to pay for these costs. You should also consider when payment is due and what, if any, **carrying charges** apply.

### Time to Perform

If the parties fail to identify the time for performance, the UCC implies that a "reasonable time" must be allowed. Of course, what's reasonable to you and what's reasonable to the other party may be different, so you should clearly specify when performance is due, both from the delivery and payment sides of the transaction.

### Notice

Are you required to provide notice under the agreement when you've reached a certain production level, or prior to beginning your performance? Whom do you notify, and what constitutes legal notification (e.g., written, verbal, in person)? Don't ignore these questions!

### Price

The UCC will fill a nonexistent price term in a contract if the parties' actions indicate there is a contract. However, you should understand the price term of your agreement *before* you start performance. Your contract should also establish how many units you're to deliver, at what price, and whether the price is in US dollars, Euros, or some other funds. In the case of barter arrangements, the form of consideration should be clearly specified.

### Warranty

A **warranty** is a promise or representation about the goods, which creates an expectation that the goods will conform to the promise. It can be created by a description of the goods, a sample or model, or a verbal or written statement.

Obviously, it's best to deal with warranties in writing so there's no confusion. Note that you may have made a warranty by sending a sample unless you disclaim any implied warranties.

The UCC provides for implied warranties of "fitness for particular purpose" and **merchantability**, as does most state warranty legislation. The shorthand definition of merchantability is that the goods are fit for their normal use, and are equal in quality with similar items manufactured by others. "Fitness for particular purpose" means that the seller has reason to know of a particular purpose for which the goods are required, and that the buyer is relying on the seller's skill or judgment in furnishing suitable goods. You can avoid both of these implied warranties if you expressly disclaim them in bold print, by name, in your written contract. We recommend that you consult your lawyer before offering any warranty, or disclaiming the UCC-implied warranties.

### Quality Control

Does your contract require international standards (ISO) certification, or **total quality management (TQM)** reporting? Do you need to deliver a sample before the contract takes effect? Are you manufacturing the product to the buyer's specifications? Are any tolerances allowed? Does "class A goods" mean the same thing to the buyer and the seller? Have you done business with this party before, so that prior performance establishes these standards?

What quality standards apply?

### Nonconforming Goods

Under common law, the seller must deliver exactly what the contract specifies or the buyer doesn't have to accept the goods. However, if the seller ships goods reasonably believed to be acceptable to the buyer—even though they do not exactly match the terms of the agreement—and the buyer doesn't reject those goods within a reasonable amount of time, the UCC recognizes the deal as complete.

### Good Faith

The UCC specifically provides that every contract, including those between businesses, has an implied obligation of good faith in its performance or enforcement. Many courts are now enforcing these requirements. (This doesn't mean, however, that the court will allow you to escape a bad deal just because you entered into it foolishly.)

The UCC also provides that if the court finds any clause of a contract to be "unconscionable," it may refuse to enforce the contract, or it may enforce the contract minus the unconscionable clause. The UCC doesn't define the term "unconscionable"; rather, it looks to the prevention of oppression and unfair surprise. It's not intended to disturb the allocation of risk because of superior bargaining power, so once again, don't think this rule will allow you to get out of a bad agreement.

### Right to Inspect Books and Records

Either party may desire the right to inspect the other party's business records, as they apply to the contract.

### Bailout

Does the agreement allow for an escape? Are you bound to deliver goods in the future? Or is this a single-delivery agreement, so that once you have performed you can bail out?

### Renewal Options

Renewal options, which give one party the right to renew the contract after it expires, can be dangerous unless they are negotiated carefully and fairly.

### Early Termination Clause

The parties to a contract may agree that, given a certain amount of advance notice, either party can terminate the agreement. This is especially important to consider in exclusive arrangements, when one or both parties are not allowed to work with other parties on the same subject matter covered by the contract.

### Merger Clause

Don't sign a contract with a merger clause unless you're certain that it's accurate and complete!

This clause nullifies any and all existing agreements between the two parties, and affirms that the contract terms constitute the only valid description of the agreement. This clause ensures that the parties will commit their agreements and understandings to writing, rather than relying on something outside of the agreement to make their case.

Before signing a contract that contains this clause (which is also known as an **integration clause**), you must be absolutely certain that the contract is accurate and complete!

### Modifications

Does the contract require that any modifications be in writing, and does it exclude all other prior agreements? These terms can have very serious consequences! Both common law and the UCC state that if the parties intend the written contract to be their final agreement, it cannot be contradicted by oral terms. This is known as the **parol evidence rule**. There are exceptions to this rule and it's different in each state. However, the courts are much more likely to enforce it when the contract contains a clause requiring all changes to be in writing.

### Estoppel

Generally, a party to a contract may not deny the existence of that contract, or a change to the performance under the contract, when the other party has begun performing under the agreement and the first party knowingly allows the other party to continue. Therefore, even if the other party's performance is not identical to the terms of the original contract, the doctrine of **estoppel** can modify the written contract.

The following story explains how this might happen.

*Let's say your greeting card design business contracts with a large greeting card supplier, Sentimental Thoughts, Inc., to deliver 15 birthday card designs on a monthly basis. For the first three months, you deliver exactly 15 birthday card designs to Sentimental Thoughts per month.*

*Suddenly, you get writer's block. For the next year, you deliver only seven birthday card designs per month, and make up the shortfall with anniversary and "bon voyage" card designs.*

*If Sentimental Thoughts doesn't complain about this, the doctrine of estoppel states that you have effectively changed the terms of your agreement. However, in order to protect yourself, you should document any changes by way of letters or other written memoranda.*

### Partial Invalidity

If for some reason a judge or arbitrator decides that a contractual clause is invalid, a **partial invalidity** clause provides that, if only part of the contract is invalid, that part can be excised from the contract, without invalidating the entire agreement.

### Choice of Law/Choice of Forum

A contractual clause specifying which state's law will govern the contract is known as a **choice of law** provision. In most cases, you want the law of your home state to govern the contract, provided you know that the law has provisions favorable to you.

In most cases, you will want the law of your home state to govern your contracts

If the parties have to litigate a dispute, the contract can specify the locale of the lawsuit. This is known as a **choice of forum** clause. This can be a contentious point to negotiate if the contracting parties are from different states, because one party will have to travel to another state to bring or defend the lawsuit. Your lawyer may not mind handling the arbitration in Hawaii, but you may not be able to afford it if you live in Colorado!

Note that choice of law and choice of forum clauses must bear a reasonable relationship to the parties to the contract. For instance, an Illinois business and a Florida customer could not choose Colorado law to govern the contract, or as the forum to resolve a dispute; the appropriate choices would be either Illinois or Florida.

Many small businesses prefer arbitration or mediation because of the high cost of trying to pursue a lawsuit

### Alternative Dispute Resolution

More and more people today are using **alternative dispute resolution (ADR)** to handle disputes. There are three types of ADR:

- **Negotiation** is simply the contracting parties trying to work out their differences between themselves
- **Mediation** involves a neutral third-party mediator who doesn't decide which party is right or wrong, but helps the parties to communicate and arrive at a mutually agreeable settlement
- **Arbitration** involves a neutral third-party arbitrator who decides which party is right and determines a legally binding remedy

All three types of ADR are generally faster and less expensive than court proceedings, and the mediator or arbitrator may be an expert in the field, as opposed to a judge who may be a generalist in legal matters. Many contracts provide for mediation or arbitration in place of a party's right to bring a lawsuit to enforce the agreement. You should consider whether this is beneficial to you before entering that term into the agreement. Many small businesses prefer to use arbitration or mediation because of the high cost of trying to pursue a lawsuit in court.

*Mike Laughton, a farmer from Gilroy, California, was having problems getting his distributor, Sun Products, to comply with their contractual obligation to distribute Mike's organic fruits and vegetables to chain stores throughout California. Over the course of one year, Mike saw his customer base slide from ten chain stores to three!*

*He asked around and discovered that Sun Products was marketing other growers' produce in the same area. Mike was furious, and immediately telephoned Sun Products to complain. Sun Products claimed that their agreement with Mike was not exclusive.*

*Because there was an arbitration clause in the contract, Mike called in an arbitrator to settle the dispute. The arbitrator ruled that Sun should pay Mike $100,000 for lost business and agreed that the two firms could terminate their working relationship. Mike was happy because he was compensated for his losses and he was free to find another exclusive distributor. The cost of taking Sun Products to court would have been prohibitive, so arbitration was a great solution for Mike.*

### Professional Fees and Expenses

Most well-drafted contracts provide for the winning party to recover attorney and other expert's fees (for appraisers, accountants, and the like), and all court costs from the losing party. You should make sure that this term also covers arbitration, defense of your position if the other party goes bankrupt, and other such fees and costs in any appeal.

Generally, in the absence of a statute or a contractual provision, attorney fees aren't recoverable in litigation or ADR. The inability to recover attorney fees makes going to court economically unfeasible for many small-business owners. An attorney fees clause stating that the winner is entitled to an award of reasonable attorney fees in the event of litigation or arbitration is therefore often advisable.

### Limitation of Damages

Parties to a contract may agree to limit the amount and types of losses the wronged party can recover in the event the contract is breached. Contracts frequently limit the amount of damages either party has to pay (e.g., a contract for the sale of goods could limit damages to the cost of replacing the goods).

## NxLEVEL® TECH TIP

BUSINESS RESOURCES AND THE WEB

Hiring a lawyer can be quite expensive, running $200 per hour or more, yet much of what lawyers do is routine. Many legal documents are simply templates that can be filled in with basic information, so why not fill them in yourself and save some money? That's the premise behind legal software, which provides templates for a wide range of commonly used legal documents. Users fill in blanks with the appropriate information, aided by pop-up windows describing the type of information that should go in each blank. Popular providers include **LegalZoom** (www.legalzoom.com) and **Nolo** (www.nolo.com).

The templates offered by these providers packages vary. Typical documents include estate planning; finance; power of attorney; consumer credit; wills and gifts; buying and selling real estate, goods, or a business; borrowing and lending money; operating a corporation; and general contract clauses. Remember: Legal software programs simply help you produce legal documents more quickly. Like accounting or tax software, they can reduce the cost of legal services, and they also give you a better grasp of the legal documents your business deals with. However, you'll still need to have the documents reviewed by a lawyer specializing in that issue, or in your particular business.

## Breach of Contract and Its Remedies

A **breach of contract** occurs if either party fails to perform as promised, makes it impossible for the other party to perform, or refuses to perform.

Failure to comply with contractual obligations should always be defined in the contract

Failure to comply with contractual obligations should always be defined in the contract, even if it's a general statement like "a default shall occur in the event that either party fails to comply with any provision of this contract."

Remedies in the event of default should be clearly specified.

- Can the non-breaching party terminate the agreement and avoid its obligations, or is the only remedy payment of monetary damages?
- If a copyright assignment has been made, must the defaulting party return all rights to the party who made the transfer?
- If the contract involves sales of goods, must any remaining inventory be returned? At whose expense?

There are several common legal remedies for breach of contract.

### Damages

If you lose money or property because someone breaches a contract, you're usually entitled to **compensatory damages**. These may include money or property, as well as the actual value of any services you rendered, any business you lost, and so forth.

Two other forms of damages are less commonly awarded in breach of contract cases.

- **Consequential damages.** These are damages for expenses incurred as a direct result of a breached contract. For instance, suppose you're a caterer, and you contract with a baker to have a certain number of individual dessert servings made and delivered. The baker calls the night before you need the desserts, and says that they won't be ready. As a result, you're forced to find another bakery, and buy a sufficient number of desserts at a much higher retail price. In this situation, you may be entitled to the difference between the amount you contracted to pay, and the amount you were forced to pay when the deal fell through.
- **Liquidated damages.** Sometimes the parties to a contract provide for specific consequences if one party breaches the agreement. This is generally referred to as liquidated damages. The courts do not allow the recovery of liquidated damages if they are really a penalty rather than an accurate forecast of the reasonable cost of obtaining the goods or services elsewhere. Nevertheless, you should review these provisions very carefully. If enforceable, they can be quite severe.

Note that the amount of damages you can receive may be limited by law. For instance, the concept of **substantial performance** means that you can't consider a contract breached if the other party falls slightly short of his or her obligations. In other words, if you order

500 desserts from a baker, and you get 497, you can't consider it a breach of contract (though you *can* seek compensation for three missing desserts).

Also, when someone breaches a contract with you, you're obligated to try to mitigate the damages you suffer. Suppose you've paid a bakery $1,500 for 500 desserts, to be delivered in one month's time, and the baker informs you two weeks in advance that the desserts won't be ready on the specified day. If you wait until the last minute to find another source, and end up paying $2,500 to a gourmet food store, you're not entitled to the extra $1,000, because you didn't seek out another baker who could do the job in advance at a lower price.

### Specific Performance

Another remedy sometimes available for a breach of contract is **specific performance**, where the court orders the breaching party to perform as promised. Courts are generally reluctant to order specific performance, because it's difficult for the court to enforce, but courts will order specific performance if there is no other remedy available.

### Indemnification Clause

An **indemnification clause** transfers the risk of damages or loss from one party to another. If that sounds serious, it is. Certain types of indemnification clauses can make you financially responsible for damages you didn't cause!

Indemnification clauses can make you financially responsible for damages you didn't cause

In a typical indemnification clause, you agree to indemnify, defend, and hold harmless the other party against damages caused by your own negligent acts, errors, and omissions.

- **Indemnifying** the other party means you agree to reimburse him or her for losses, as specified by litigation, arbitration, or settlement.
- **Defending** the other party means you agree to pay for his or her legal expenses in the event that a claim is brought by some third party.
- **Hold harmless** means you agree to protect the other party from harm from any lawsuits brought by third parties or yourself.

Your lawyer can and should help you to understand indemnification.

### Rescission and Reform

In some cases, a court may rescind a contract. This dissolves the contract, making it a legal nullity. **Rescission** often happens because of mistakes in the contract, but it may also come about through one party's breach of contract or a finding of fraud.

Alternatively, a court may choose to **reform** a contract, by rewriting it to reflect the court's understanding of what the parties actually intended.

## Contracts on the Internet

E-commerce contracts raise some interesting problems. Usually, consumers indicate their acceptance of e-commerce contract terms by visiting a page that lists the terms, and clicking on a button that says "I accept" or "I decline."

But what if the user clicks on the wrong button? The merchant would read this as acceptance, and start performing according to the contract terms.

To avoid this, online merchants often require their customers to confirm their acceptance by clicking on a second button, or by agreeing to a charge on their credit card after placing the order. Online acceptance forms should be clear and complete, and contain standard terms and conditions.

### E-mail and Contracts

Save all e-mails to and from your customers!

E-mail exchanges between a business and its customer can constitute a contract, so you should save all e-mails to and from your customers and suppliers.

By law, it's the final e-mail offer that, when accepted, creates a binding contract. Therefore, your final communication should set forth all the terms of the agreement. A court may look at the entire e-mail exchange in order to divine both parties' intent, but if it finds there was no "meeting of the minds," it will rule that no contract was formed.

Obviously, it's supremely important to be able to generate hard copies of e-mails in the event of litigation. Anyone engaged in e-commerce should keep printable electronic records of online orders and e-mail communications. Hard copies will carry more evidenciary weight if the data are stored by a third party and physically protected from alteration.

**A Checklist for E-Commerce Contracts**

- All terms and conditions should be clear, simple, and straightforward.
- State as a term of the agreement that the online display is the sole, exclusive, and final agreement between the parties.
- Put a system in place for capturing complete, accurate, printable records of all negotiations and agreements.
- For agreements that involve transactions in goods in excess of $500, or that cannot be performed within one year, obtain a fax-back or digital signature.

### Electronic and Digital Signatures

There are a number of ways of "signing" an electronic document. One familiar method is the "I Accept" button that you must press to use software or an online service, in order to affirm that you understand and agree to the terms of use. Signing a credit slip with a digital pen at a supermarket checkout counter is another common method.

Digital signatures are electronic signatures that are cryptographically protected. **Public Key Infrastructure (PKI)** is a cryptographic system that allows authorized parties to share and sign documents online. To put it very simply, the signing software uses an algorithm to generate a "signature" that's unique to the user and to the document being signed, which can be verified by the other party on receipt. If the document is subsequently amended or altered, the algorithm will automatically invalidate the signature. Digital signature systems often include time stamps as well, to certify the precise moment at which the document was signed. DocuSign (www.docusign.com) is one example of a PKI-based digital signature service.

A related trend is the advent of **mobile signatures**, which allow you to sign documents from a cellphone or PDA after entering a secret code that enables the algorithm to generate a signature. This feature can also be used to confirm your identity during phone conversations. This will be an increasingly common capability in coming years.

Note that certain types of documents require traditional pen-and-ink signatures. These include wills, foreclosure and eviction notices, and hazmat shipping documents. Electronically signed versions of such documents will not be legally enforceable.

### Uniform Electronic Transactions Act (UETA)

The UETA gives electronic signatures and records the same validity and enforceability as paper-based transactions. As of 2009, 46 states have enacted it, usually without making significant changes.

The key provision of UETA is that records, signatures and contracts "may not be denied legal affect or enforceability" solely because they are created electronically. For more information, visit **www.nccusl.org**.

The Uniform Electronic Transactions Act gives electronic signatures and records the same validity and as paper-based transactions

### Electronic Signatures in Global and National Commerce Act (E-Sign)

In 2000, Congress enacted the **E-Sign Act**, which comprises a universal standard for transactions involving electronic contracts, signatures, and records. Because E-Sign is a federal law, its scope is limited to electronic transactions occurring in interstate commerce. E-Sign governs electronic contracts in the absence of a state law, or where states have made modifications to UETA that are inconsistent with E-Sign. You should research the terms of this Act thoroughly before engaging in e-commerce.

## Leases

A **lease** is an agreement giving one party possession of another party's land or personal property (e.g., equipment) for a stated period of time. A lease differs from a sale, in that a lease transfers possession of property, while a sale transfers both possession and ownership.

There are two main types of leases that you might have to sign: real estate leases, and equipment leases.

## Real Estate Leases

Real estate leases—which include leases for warehouses, workspaces, studios, offices, retail spaces, and the like—are the most common type of lease. Here are some things to think about when leasing business premises.


- **Area.** What space are you actually renting? If you're in a shopping center or office complex, a suite map is helpful. This map should also indicate common areas (see below).
- **Rent escalators.** How does the rent change over time? Is it based on a consumer price index adjustment, appraisal, or the landlord's whim?
- **Triple net.** This is a shorthand expression for requiring the tenant to pay the insurance, maintenance, and taxes on the property. These payments are in addition to your regular lease payments. There are many variants of these provisions, and you must review them very carefully to understand the full cost of the lease.
- **Common areas.** Are you sharing any space with other tenants? If so, how are the costs for those spaces allotted between you? Who takes care of it? Who pays for insurance on those areas? Examples of common areas include lobbies, restrooms, elevators, parking lots and lawns.
- **Parking.** Is there enough? Is it conveniently located? Are any spaces reserved for you or your customers? Can the landlord later develop an additional building in what was formerly your parking area, leaving you with inadequate parking?
- **Renewal.** Is your right to renew the lease clearly stated, and is the mechanism for renewal clearly defined?
- **Purchase rights.** Do you have an option to buy the property, and if so, under what terms? Do you have a first right of refusal to buy the property under the terms offered to a third party by your landlord?
- **Exclusivity.** Does your lease state that yours will be the only paint store in the complex, or can other paint stores come in and compete against you? Can the landlord lease the parking lot to a Christmas tree vendor, or a circus?
- **Permitted uses.** Do you want your Christian bookstore to operate next to a body-piercing salon? Is your assembly facility sensitive to vibrations or noise? These are the kinds of issues you need to consider if the space you're leasing is in a business park, shopping center, or other multi-use complex.

Here are the terms that should be included in a lease agreement:

- The names of the parties, and the address of the landlord
- The address of the property
- The duration of the lease, and any options to renew (or automatic renewals if notice of termination is not given)
- The place and time for payment
- Whether and when late charges apply

- Any utilities provided by the landlord
- Any duties the landlord or tenant have to perform repairs or maintenance
- Amount and terms of security and cleaning deposits
- Whether the tenant can withhold rent if the landlord breaches its obligations
- Any obligations of the landlord or tenant in the event of damage to the premises, or to the tenant's property in the premises; or of injuries to persons on the premises (this includes obligations of the landlord and/or tenant to have insurance that will cover these contingencies)
- The rights of the tenant to sublet the premises (for all or a portion of the remainder of the term) to another tenant, or to assign the lease (for the full remainder of the term) to another tenant
- The number of days prior to expiration of the term (or prior to the end of a month, if a month-to-month lease) that notice that must be given by either the landlord or tenant to terminate the lease
- The situations in which the landlord or tenant is able to terminate the lease

## NxLEVEL® GREEN TIP
ENVIRONMENTAL BUSINESS RESOURCES

### Green Leases

Generally speaking, a **green lease** is a lease of office or warehouse space in a building that meets (or will be upgraded to meet) formal standards for sustainability, water efficiency, energy use, and indoor environmental quality. The most common criteria are those mandated by the Leadership in Energy and Environmental Design (LEED) rating system, but other standards can be negotiated and pursued under a green lease.

The major issue in negotiating a green lease is allocating the costs and benefits of compliance and maintenance. The landlord and tenant must arrive at an equitable arrangement in which both parties maintain and share the benefits of green design and building practices. As in any other leasing agreement, the assistance of a qualified attorney with experience in commercial leasing law is absolutely essential.

Because this is a relatively new form of lease, with many potential pitfalls, the **California Sustainability Alliance** (www.sustainca.org) has prepared a **Green Leasing Toolkit** that can assist tenants and landlords in achieving a win-win outcome. Useful features include a Leasing Profile, an Options Matrix, a Due Diligence Scorecard, and a Green Lease Provision Database.

You can learn more by visiting **www.sustainca.org/content/leasing_toolkit**.

### Equipment Leases

Equipment leases are usually for such things as photocopiers, computers, and printing machinery. When a customer can't afford to pay the entire purchase price of the equipment at once, the seller offers either to finance the purchase price through the seller or a financing company, or to put the customer in touch with a leasing company who can arrange an equipment lease.

This can be a good deal, because the down payment under a lease is usually less than the down payment on a credit purchase. Also, leases usually allow you to trade old equipment for state-of-the-art equipment after a few years.

Equipment leases are similar to real estate leases, but with two important distinctions. The first is the purchase option. Often, a leasing company will provide that the lessee has an option to purchase the equipment at the end of the lease term. The option price may only be $1.00; or it may be defined as a set amount (e.g., 20 percent of the equipment's original cost to the leasing company); or it may be the equipment's fair market value at the time when the purchase option is exercised.

Never rely on a leasor's representation that you have a purchase option

Never rely on a leasor's representation that you have a purchase option. Make sure that you receive this commitment from the leasing company itself, and that the terms of the purchase offer are clearly set forth in the contract. The leasing company is a separate business from the seller, and will probably not be bound by any statements or promises made by the seller.

Since a leasing company doesn't choose, sell, or service the equipment it leases, it doesn't want to be liable for any failure of the equipment to function properly. For this reason, a second important provision of equipment leasing agreements is a warranty disclaimer. This disclaimer indicates that the leasing company makes no warranties or representations about the equipment, and that any defects in the equipment are not an excuse to stop making the lease payments. The lessee must look to the seller for any repairs or maintenance.

Courts routinely uphold such provisions, so long as the leasing company is independent from the seller. Remember, the leasing company is merely a financing tool, just as a bank might be on a sale of a car. Could you stop making car payments if the transmission failed? Probably not!

## Consignments

A **consignment** is neither a sale nor a lease. A consignment arrangement is one in which someone who desires to sell a product "consigns" it to a business engaged in sales of that type of product. No money exchanges hands until the product is bought by a third party (i.e., the store's customer). The consignee (the business that agreed to try to sell the product) takes a share of the purchase price and pays the rest to the consignor (the party who put the product on consignment).

The following provisions should be included in consignment contracts:

- Names and addresses of the parties to the contract
- Any provisions giving the consignee exclusive marketing rights (this should include a clause that allows termination of the contract if the consignee doesn't meet a specified level of sales)
- The dollar value of the consigned product
- The price of the consigned product
- The percentage of the selling price to be paid, and the date on which payment is due
- Any requirement that the consignee must have or buy insurance that will cover the consigned product
- The duration of the consignment
- Provisions governing return of unsold goods, including at whose expense the goods must be returned
- Any obligations of the consignor or consignee to market or promote the work, and who pays the expenses of marketing
- A right to inspect the books and records of the consignee as concerns the consigned product
- Choice of law/choice of forum provisions

It's also very important to include a statement that the consignee holds the product and any proceeds from its sale in a trust relationship, and that the proceeds must be kept in an account separate from the general business funds of the consignee.

## Conclusion

Contracts are crucial not merely in the world of business, but in human society itself. A contract is essentially an agreement, and an agreement can be binding whether it's verbal or written. As an entrepreneur, you're going to be making agreements with people. And since written agreements are much easier to understand and enforce, common sense dictates that all your business agreements must be in writing.

But it's not enough to put them in writing. They must also be legally enforceable, which means you need to understand the elements of an enforceable contract. Anything less is a recipe for disaster!

You can't do all this without legal help. Whether you have the money to hire a lawyer, or must avail yourself of free legal services, you'll need the help of an experienced small-business attorney—one who knows how to draft contracts that will protect your interests.

# Chapter 20
# BUSINESS SUCCESSION AND ESTATE PLANNING

*About This Chapter:*
- *Estate planning*
- *Succession planning*
- *Retirement plans*

## Introduction

Shrewd estate planning should provide for the support of your family; minimize estate taxes; and arrange for the payment of any taxes due. In conjunction with succession planning, it should also facilitate transfer of the business to the next generation, or to a third party.

Although they are often overlooked by entrepreneurs, estate and succession plans are a vital part of business planning. They can help your business to continue and prosper. But more important, they will protect your loved ones, and make a difficult time much less stressful for your survivors and beneficiaries.

## Estate Planning

If you don't have a will when you die, the state writes one for you under the **probate** statutes. The state's will (also known as **intestate succession**) usually provides that your surviving spouse receives half of your estate, and the remainder goes to any surviving children. Also, in most states, the estate—your business—is sold and the cash is distributed.

It's never to soon to talk to your lawyer about preparing an estate plan

Obviously, this is unlikely to result in the best possible outcome for your family or your business. Thus, our first and most important recommendation is that you see your lawyer and discuss the preparation of an estate plan.

### Estate Taxes

As of 2009, if your **net estate** (i.e., gross estate minus liabilities) is $3.5 million or less, your estate is exempt from federal estate tax. In 2010, no estate of any size will be subject to estate tax. The estate tax exemption will be reset to $1 million in 2011, pending further action by Congress. In recent decades, only about two percent of estates have been subject to estate tax.

Estate tax is not assessed on any property that is donated to a tax-exempt charity. Also, under federal law, you may leave any amount of assets to your surviving spouse without paying estate tax. However, if your estate were to exceed the projected federal exemption of $1 million in 2011, this may lead to a bunching of assets in the survivor's estate, which could result in higher taxes when your spouse dies.

The time to plan is while both spouses are alive and able to utilize their estate tax exemption. Simply splitting the estate into two entities can save several hundred thousand dollars.

Some small-business owners anticipate taxes owed with an insurance policy, which will prevent liquidation of business assets. You must not own the policy yourself, though, or it will be included in your estate. Either the business, or a third party (e.g., your children) should own the policy.

Some states also collect estate taxes, though rates are generally much lower than that imposed by the federal government. As with federal taxes, property left to a surviving spouse is exempt.

Estate taxation is a politically volatile topic, and it's unclear at the time of this writing what sort of tax structure will prevail in coming years. Be sure to consult your lawyer and accountant for current information.

### The Use of Trusts

Trusts are an effective way of planning for someone to assist you in the event that you become physically or mentally disabled

By utilizing a **trust**, your heirs can generally avoid the time and expense of probate. Trusts are also a very effective way of planning for someone to assist you in the event that you become physically or mentally disabled. You can provide for care and maintenance of minor children or a surviving spouse, and avoid the costs of court-administered probate.

These advantages are the best reason to continue to use trusts in estate planning. However, if your estate is taxable, then trusts are also an effective way of lowering taxes, by having each spouse utilize his or her federal exemption to its maximum. The various types of trusts are too complex to detail here. Consult your accountant and a good estate planning lawyer.

### Probate of Estates

If you die without a will, or your will doesn't include a trust, your estate may be subject to the procedures of the state probate court. A personal representative will be appointed to administer its assets under the supervision of the court. Legal documents disclosing your assets will be filed at the courthouse as public records. Filing fees, administration expenses, attorney fees, and accountant's fees are included in this procedure. The probate is ultimately resolved by the distribution of assets to the heirs pursuant to the court's order. This can take anywhere from six months to several years, and is a process you will definitely want to avoid in your estate planning.

*When Margaret Gaynor retired from her nursing career at the age of 62, she wanted to go into business for herself, and to provide employment for her numerous grandchildren.*

*As Margaret puts it, "I wanted my grandkids to understand the value of work and the value of family."*

*She purchased an ice-cream shop franchise to fulfill both needs. Margaret enjoys running the business, and is training her oldest granddaughter to take over. The shop provides decent wages for her grandchildren, who are saving for cars and college, and gives them the experience of running a thriving community-based business.*

*The transferability clause of her franchising agreement gives her the option of leaving the business to her grandchildren, so they'll be able to keep it going if they wish.*

### Gifts and Gift Tax

Gifts are an effective estate planning tool

Gift taxes are imposed primarily to prevent people from escaping estate taxes by giving away their assets to family members. Thus, they are usually paid by the donor rather than the recipient.

As of 2009, you can make a gift of up to $13,000 a year in cash or other assets to anyone. Your spouse can do the same, even if he or she doesn't actually own the asset. A lifetime gifting limit of $1 million above the annual exclusions is allowable before a gift tax is applied.

This means that you and your spouse can legally make gifts of up to $26,000 interest per year in your business to each family member who will carry on the business. If you start early enough, and live long enough, you can reduce your estate to the nontaxable level simply through the use of gifts. By making gifts of portions of a business that is appreciating, you can also reduce the growth of your estate. If your business is worth more than $1 million, this tax strategy may still be viable. Remember that your estate is also entitled to take the federal state tax exclusion at your death. In the future, "gifts" of part ownership in your business may be used more for succession planning than for estate tax planning.

One disadvantage of such gifts is that the income tax basis of property you give is your cost of the asset, minus the depreciation you took on tax returns. Often, the tax basis in a small business is quite low, because it grew on sweat equity over time, and the owners took as much depreciation as possible.

The second disadvantage of using gifts is that every gift of an interest in your business reduces your control. (However, this can result in a positive tax effect known as a **minority discount**, which we'll discuss later.) If you operate as a sole proprietorship, you can't give away portions of your business unless you restructure.

You must relinquish control of the business interest in order for it to qualify as a gift

You must relinquish control of the business interest in order for it to qualify as a gift. If you retain the right to vote, shares of stock, or interests, the IRS will take the position that the gift was never made. Unlike an S corporation, a C corporation may have more than one class of stock. In some cases, a trust or other corporation can be made a shareholder under a different class of stock, and you may be able to retain control even after giving away large amounts of stock.

A new technique in estate and succession planning is the **family limited partnership**, which is a standard limited partnership composed only of family members. After setting up this partnership, you can start a planned giving program of limited partner shares. You retain general partner interest, so you can still control the business.

You may not want an underaged child to control a substantial portion of your business if you die unexpectedly. Therefore, gifts to minors are usually made by way of a trust or family limited partnership. Again, gifts in trust require special planning to qualify for the gift exclusion.

## Succession Planning

The first step in passing your business to one or more of your children is to allow them to assume gradually increasing responsibilities. Before taking this step, ask yourself these questions: Are your family members capable of running the business properly? Can they work together? Do they want to? It's surprising how few parents ask themselves and their children these questions!

A family meeting, along with your lawyer and accountant, is a very good idea before you develop a final succession plan. See Chapter 8 *Family-Owned Business* for more on this subject.

### Sale During Your Lifetime

Selling your business is mentioned here because it's another way of reducing estate taxes, transferring the business to your children, and providing lifetime income for you and your spouse.

You must feel confident that your family members can profitably run the business and make payments, or you risk losing control over your major income-producing asset. By using the installment sale method, you should be able to defer a portion of the tax on the gain through the term of the sale contract. You can often structure the transaction so that you retain a lien on the business assets, but provide family members with the flexibility to make payments from business profits. The main disadvantage here is that family members won't receive a step-up in tax basis equal to the value of the business at the owner's death.

We previously discussed the use of buy/sell agreements in closely held businesses. They can ensure that the business remains in the family's control, and establish the value of the business for estate tax purposes. There are also a number of hybrid agreements, which you should discuss with your lawyer. One is a stock redemption agreement that requires or allows the corporation to buy the interests of the deceased shareholder, thus permitting the use of corporate money to fund the purchase agreement. Another is a cross-purchase agreement requiring or allowing the other shareholders to buy the right of the deceased shareholder. The use of insurance to fund these agreements is often recommended.

### Stock Options

**Stock options** are another method of freezing the value of the business in order to remove future appreciation from your estate. You may grant an option to your family to buy shares of the business at a set price, but be aware that unless it meets certain requirements of the Internal Revenue Code, this agreement will be disregarded in valuing the property for estate tax.

### Minority Discounts

It's hard to assess the value of closely held businesses, because unlike shares of a corporation sold on a public exchange, their shares have no established market value. It's also hard to assess the going concern and goodwill value of a closely held business when that goodwill rests primarily with the former owner.

The minority discount is one of the most effective estate and succession planning techniques

Therefore, one of the most effective estate and succession planning techniques is the minority discount. If you reduce your interest in your company to a minority position, you may be able to reduce your true value below the book value of that interest.

For example, if your estate owned only 30 percent of a closely held corporation, and the book value of the shares was $10 a piece, your 10,000 shares would in fact be worth less than $100,000, because a buyer would not pay that price to buy into a minority position.

There's no set percentage for minority discounts, so you must work closely with your accountant and estate planning lawyer.

### Exit Strategies—Children

Let's assume your parents established a business, and even though you took it to its present level of success, they're unwilling to hand over the reins. If possible, you need to convince them that they'll be ensured income under a buy-out or salary continuation plan, that you're capable of handling the business, and that their other children will be provided for.

Talk to your business lawyer and accountant about these ideas. Purchase agreements, coupled with parental consulting contracts, can often solve these problems.

Of course, any successful strategy requires your parents' active involvement.

*Mom feels that all her children should have equal ownership of the family business whether they have worked actively in the business or not, but Dad feels very differently.*

*A way must be found to reconcile the two contrasting views of fairness. Perhaps the children who are active in the business can be given more ownership, while the other children receive help with education, or the capital needed to launch businesses of their own. Or the active children might receive voting stock, while the inactive children get non-voting stock.*

*There are many ways to solve such problems, if communication between family members is frank.*

If you prepare for emergencies, your business will be far more likely to survive

#### Death/Disability Among Shareholders

The sudden death or disability of an owner of a closely held business can have devastating consequences. As discussed earlier, you should always have a means of acquiring that person's interest.

The use of life and disability insurance is very wise. Certain disability policies cover business overhead when an owner is temporarily disabled, and convert to permanent disability policies in the event that the owner can't return to work. If you prepare for these emergencies, your business will be far more likely to survive.

## Retirement Plans

Many of us are saving for retirement under Individual Retirement Accounts (IRAs) and similar plans. Taxpayers over 50 years of age may also be able to make "catch-up" contributions to IRAs, 401(k), and SEP plans. However, many small businesses are capable of funding retirement plans with even greater benefits than the plans mentioned above.

Your bang for the buck increases if the contribution is made by the business through a qualified plan. The business can deduct this payment, and pay it with pre-tax dollars. The income the plan earns isn't taxed until you withdraw the funds.

There are several qualified retirement plans available, depending upon the size and nature of your business. These are regulated under the Employee Retirement Income Security Act (ERISA). Generally, ERISA requires plans to have formulas for allocating contribution and distribution to the parties. They may not discriminate in favor of highly compensated persons (e.g., those earning over $500,000 per year). There are also disclosure requirements, and reporting forms to the IRS.

You may be able to roll over the amounts from a qualified plan or your IRA. The 2001 Tax Act makes rollover easier. It also gives a tax credit to lower income persons for pension plan contributions and qualifying IRAs of up to $2000 per year. This means they can make a retirement investment with money that would otherwise go to taxes.

Even if you don't wish to rely on Social Security for your retirement, you shouldn't ignore it. You may lose benefits if you have excess earnings after starting Social Security, so arrange your pension plan benefits and any income from your business accordingly. For example, stock dividends are not defined as earnings, and salary can be shifted to family members who provide services to the business. Many pension plans also allow you to defer benefits.

### Simplified Employee Pension Plan (SEP)

SEPs can work well for small businesses with just a few employees. The employer opens a SEP IRA for each eligible employee and makes tax-deductible contributions to the account. As of 2009, employer contributions are based on 25 percent of employee compensation, or $49,000, whichever is less.

Employee contributions are not allowed, but you can contribute to your own plan if you're self-employed.

The major benefit of a SEP is its simplicity. IRS filings are not required, and no documents need to be prepared and maintained (other than a one-page 5305-SEP form).

### Savings Incentive Match Plan for Employees (SIMPLE)

Unlike SEPs, SIMPLE IRAs allow employee contributions, and mandate an employer match. Annual contributions may be up to three percent of compensation, but as of 2009, may total no more than $11,500 for employees under 50, and $14,000 for employees who are 50 and older.

### 401(k)

In this plan, employees make additional contributions—which may be matched by the employer—to a retirement plan trust. There are limitations on the amount of contributions that can be made by the owners or highly paid employees. However, 401(k) plans do have the distinct advantage of being paid with income before it is taxed.

401(k) plans are paid with pre-tax income

### Pension and Profit-Sharing Plans

A number of qualified pension and profit-sharing plans are available to closely held corporations. These include profit-sharing plans to which discretionary contributions are made from profits; defined benefit plans with a benefit formula based on each employee's years of service and final pay; and money purchase pension plans that fix a percentage of the employee's compensation as the employer contribution.

These plans offer much greater benefits than an SEP or 401(k), but picking the right plan can be difficult. Discuss your alternatives with your accountant and a pension plan lawyer.

## NxLEVEL® TECH TIP

BUSINESS RESOURCES AND THE WEB

There are many documents related to business succession and estate planning. One good source for these documents is **Legaldocs** (www.legaldocs.com), which allows you to prepare customized legal documents online. Choose any of the documents offered, complete the questions, click the "Submit" button, and the finished document is ready for you to download or print. Many documents are free; others are available for a fee ranging from $5.50 to $89.75.

As with the legal software discussed earlier, remember that online documents are supposed to save time and avoid the preparation fees your lawyer would charge, not to replace your lawyer! All legal documents prepared through online or downloaded services must be reviewed by your lawyer.

### Transfer of Stock

Transfers of stock to family or other employees helps the recipients' retirement planning, and the owner's succession planning. Transfers can be given as additional compensation and/or as a percentage of company ownership. Stock bonuses often create an incentive for long-term employment.

Stock sale restrictions can keep outsiders from buying a piece of your business

Before taking this route, you should have a stock sale restriction in your buy/sell agreement that either requires the corporation to repurchase the stock, or gives other shareholders a first right of refusal. Otherwise, outsiders may own a piece of your business.

Although stock bonuses are a low-cost method of providing additional interest in the business to family employees, they have a negative consequence for your children, who'll have taxable income equal to the fair market value of the bonus share, without generating any current cash with which to pay the tax.

*Employee Stock Ownership Plans (ESOPs)*

ESOPs may provide you with an opportunity to sell stock to the plan—thereby raising cash to provide for your support—and to transfer a portion of your business to employees. One advantage of an ESOP is that it allows you to transfer stock to the plan without any income tax, as long as you reinvest the funds in qualified replacement property (which includes publicly traded stocks and bonds). Another advantage is that the purchase of the stock by the company is tax-deductible.

## Conclusion

A successful business is a major portion of your estate. Due to recent and ongoing changes to federal tax laws, you should meet with your accountant and lawyer to formulate plans for estate taxes, income for you during retirement, and transfer of your business to your children or third parties. It is essential to involve your family in this process!

# Part V
# Managing Your Business

## Chapter 21
## MANAGEMENT OVERVIEW

*About This Chapter:*
- *What managers do*
- *Finding the right management style*
- *Organizing business structures and processes*

### Introduction
Whether your business is small or large, management fundamentals remain the same. Your goal as a manager is to create the structures and processes that will keep your employees productive and happy, and your business profitable.

"Structures" describes the ways in which you assign responsibility for various tasks to your employees. "Processes" describes how your employees cooperate to get those jobs done.

This chapter is a realistic guide to the tasks that lie ahead. Remember, part of your challenge is to limit yourself to tasks that only you can do—such as assigning responsibilities, setting goals, and assessing performance—and to delegate other tasks. The best managers have the ability to identify and attract great employees, provide proper guidance and motivation, and let them contribute their unique skills to the business.

### What Managers Do
A manager is very different from a boss. A boss is an authoritarian figure who motivates people by imposing penalties or bestowing favors. When the boss is absent, workers lose motivation and focus, and their performance suffers.

Managers create the structures and policies that support business objectives, and inspire teams to meet those objectives. They give team members the responsibility and authority to contribute to the business, and they measure and reward those contributions as needed. They strike a healthy balance between encouraging the worker's individuality, and integrating the individual's skills and loyalties into a shared undertaking.

Managers create the structures and policies that support business objectives

Good managers work to get the maximum competitive advantage out of their business's strengths. Today, corporate managers call these strengths **core competencies**. This is a trendy way of describing the things your business does better than any competitor—the things your customers value the most.

Good managers also help businesses meet challenges. As your business grows, neither high energy nor innovative products are enough to sustain your success. That's why you must make a deliberate effort to create structures and processes that will maintain consistent performance through changing business conditions.

These structures and processes allow your business to be responsive to its customers. Often, your product will find uses in markets neither you nor your competitors had anticipated. Good management allows you to take advantage of these unexpected opportunities.

The ability to guide a business wisely through changing conditions is an essential quality of a great manager

Many well-known businesses started in one market and migrated to another. IBM originally marketed computers strictly to scientific institutions. Blue jeans were created as durable work clothing for ranchers and miners. These products succeeded because their manufacturers changed their business processes and upgraded their management structures as circumstances demanded. This ability to guide a business wisely through changing conditions is an essential quality of a great manager.

*Angela Kracauer loved baking, and she really loved bagels...big, chewy bagels like her grandmother used to make every Saturday morning. She always knew that someday she would open her own bakery. In 2008, she made that dream a reality when she opened Sunrise Bagels in her hometown of Jersey City, New Jersey.*

*Today, Sunrise Bagels offers 18 flavors of bagels, and a wide variety of toppings. But its real specialty is "Bagel Melts"—bagels topped with ham, eggs, and cheese, put into a press grill, and toasted until brown.*

*Angela opened her bakery with the help of Eloise Bloch, the previous tenant of the space Sunrise Bagels now leases. Their partnership was completely unexpected. Eloise was just leaving the empty space, and Angela was just arriving to take a tour of the premises. They started talking, and hit it off instantly.*

*Eloise's small pastry shop had closed mainly because her business was wrong for the location. She had operated her shop for two years, selling gourmet baked goods for special events. Hundreds of local commuters waited for the bus in front of her shop each morning, or passed it on their way to the nearby PATH station, but very few of them were in the market for a 12-inch ginger-lime cheesecake torte at 7am!*

*Still, Eloise loved baking, and didn't want to give it up. Fortunately, when she and Angela hit it off, she found a way to stay in the business.*

## Finding the Right Management Style

Think about the feeling you want your business to have. What type of environment do you thrive in? What kind of people do you most enjoy working with? What sort of behavior do you want to encourage and reward?

Next, review your business goals as set forth in your mission statement. Discuss these with your friends, family, and advisors.

Last, make sure that your management style matches your industry and your markets. Consider your customers, industry trends, and the strengths and weakness of competing products. These elements determine the design of such business processes as marketing, finance, accounting, and sales.

*Make sure that your management style matches your industry and your markets*

### Seeking Outside Help

Many small businesses benefit from having a formal or informal advisory board comprising three or four people who regularly provide advice, perspective, and new ideas. This board could comprise a mixture of fellow business owners, retired executives, investors, vendors, or even customers whose judgment you trust. Generally speaking, it's good to have a diverse board that represents a variety of viewpoints, and is knowledgeable about your type of business. Where possible, it's best to find people whose skills and strengths will complement or improve your own. For instance, if you know you're weak on managing employees, you might seek a board member with expertise in team-building.

Unlike a corporate board of directors, your advisory board has no legal power to determine the direction of your business. It's up to you to take their advice, or reject it. Obviously, though, someone who has lived through the situation in which you currently find yourself is well worth heeding. You can avoid some very costly problems by learning from other people's mistakes.

Your advisory board should meet twice a year, and be recompensed for their efforts with an honorarium, a meal, or some other form of modest reward. (Ideally, your advisors will understand that they are benefiting from the meetings, too. All board members will have a chance to learn from each other, and this should be an important part of their motivation for participating.)

Before the meeting, inform the members of the agenda items for discussion, so that they'll have a chance to think about the topics ahead of time. To maintain interest and focus, meetings should not last for more than two hours.

If you decide to set up an advisory board, bear in mind that you must be honest and open about your concerns, problems, and situation. Advice based on inaccurate information is not likely to benefit your business. How much information you choose to provide depends on a number of variables. In most cases, it's appropriate to ask board members to sign a nondisclosure agreement. Fellow business owners may want you to sign one as well, so that they can be honest about their own experiences.

### Step One: Identifying Activities

The first step in designing good management structures is to identify your business's main activities. Which tasks must be done every day to ensure your survival and success? Which are less critical on a daily basis, but important for ongoing performance? Some of these activities may be specific to your business, and may not fit neatly into traditional functional categories. Listed below are the functions that most businesses must perform every day. You may use this list as a starting point for your own brainstorming.

- Accounting
- Inventory
- Human resources
- Marketing and sales
- Logistics management
- Quality control
- Financial planning and budgeting
- Research and development
- Manufacturing and engineering
- IT
- Customer service
- Purchasing

The different types of activities that businesses perform fall into three basic categories:

- **Operational processes** create value for customers, employees, and owners.
- **Strategic planning and controlling processes** provide the context and resources for operational processes. They include developing performance measures, setting policies for rewards and recognition, and allocating resources.
- **Navigational processes** comprise the purpose and character of a business. They guide decisions, personnel interaction, and organizational objectives.

Identify what you do best, and delegate the rest!

### Step Two: Allocating Tasks

Whether you have two people or 200 in your business, you must shift your focus from your individual capabilities to those of your entire staff. Ask yourself which tasks you do particularly well, and which you're less comfortable with. Based on your conclusions, identify the activities you will perform and those you will delegate.

If you have a team assembled, which individuals are most suited to which tasks? One way to answer this question is to rank the necessary tasks in order of importance, and then list the skills that are needed to perform them. Having done this, you can compare the list to each employee's skill set, and assign tasks accordingly.

In some cases, you may find that you don't have the skill set you need for a certain task. When this happens, you have two options: You can train an existing employee, or you can hire a new person, either as an employee, or an independent contractor.

Both approaches have good and bad points. If you train an existing employee, you add new expertise to your company and increase its versatility. Furthermore, you avoid the uncertainty and disruption that comes with bringing new team members on board, since you already have a good sense of the existing employee's strengths and weaknesses. On the other hand, training can take time, and mistakes are more likely while the employee is getting up to speed. In some situations, you simply won't have the luxury of letting your employee learn on the job.

By contrast, hiring a new person will give you the expertise you need right away. However, the hiring process can be time-consuming and disruptive, and it can also affect the morale and camaraderie of existing employees. And there may still be a learning curve, because the new employee will have to adjust to your organizational culture. A similar argument applies to outsourcing: You have to balance the convenience of getting exactly the skills you need against the headache of finding and interviewing prospective workers, checking their references, and so forth. Working with an agency is one way to reduce the risks of outsourcing. A reputable agency should already have winnowed out substandard workers, and may be willing to guarantee the new employee's performance.

Give your team time to learn how to work together

Please note that when we use the word "team," we are not necessarily referring to a group of full-time employees hired by your business. It can be a **virtual team** composed of you and a collection of part-time or outside service providers. Virtual teams work together via phone, Internet, and teleconferencing. They allow you to benefit from the skills of many different people without having them inside your business.

*In the spring of 2009, Eloise and Angela started their new business. Their biggest challenge was earning the loyalty of the hundreds of commuters who passed within 100 yards of the shop twice a day, on the way into and out of Manhattan. Sunrise Bagels had stiff competition from the Starbucks down the street, and from a large bagel chain eight blocks away. To succeed, it would have to be managed impeccably.*

*Before hiring anyone, they decided to list the activities that needed to be performed at Sunrise Bagels, and to describe how critical each one was to the business's success. This would help them decide where to put the most time, energy, and resources.*

| ***Most Critical Activities*** | ***Critical Activities*** | ***Least Critical Activities*** |
|---|---|---|
| *1. Baking bagels* | *1. Managing supplies* | *1. General maintenance* |
| *2. Serving customers* | *2. Organizing the store* | *2. New product decisions* |
| *3. Training* | *3. Pricing and promotion* | *3. New locations* |
| *4. Managing cash* | *4. Coffee making* | *4. Community activities* |
| *5. Cleaning the store* | *5. Financial planning* | *5. New technology review* |
| *6. Employee management* | *6. Budgeting* | |
| *7. Payroll and accounting* | *7. Long-range planning* | |
| *8. Ordering supplies* | *8. Brand building* | |

*With this list in hand, Eloise and Angela began to form a picture of their successful business.*

*Angela was responsible for all baking. She would bake from 4:00am until 8:00am, then help to serve the morning rush of customers. She would bake all the bagels for the first three to six months. Then, if all went well, she would hire an experienced baker or two to help.*

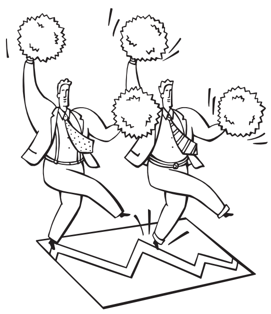
*Eloise took responsibility for managing the store. She would ring up sales, price the bagels, prepare toasted bagels and melts, train all non-baking employees, and maintain the store's impeccable organization and cleanliness. In short, she would create a welcoming and smooth-running environment in which customers would come first.*

### Step Three: Setting Expectations

As a manager, you need to communicate your expectations as clearly as possible. What does your business expect of each person? Who will be held accountable for specific tasks? What is the deadline for task completion and assessment?

Employees who know what is expected of them are able to measure their performance against the standard you've set, and adjust where necessary. By contrast, employees who don't have a clear vision of what is expected of them—either because expectations weren't clearly defined at the outset, or keep changing as new issues arise—quickly lose focus and morale.

Good managers usually base their expectations on a desired outcome. In other words, rather than micromanaging employees' time and activities, they set a standard and timeframe for performance, and allow employees to choose (within reason) the pace and working methods they prefer.



A successful business isn't about the achievements of individuals—it's about what individuals contribute to the team

Of course, this method only works when employees see the big picture, share the company's goals, and understand how their efforts fit together. That's another task that falls to you as a manager.

Give your team plenty of time to learn how to work together and share ideas. Don't expect them to meet impossible expectations right off the bat. Instead, try to identify what each person needs to do in order to help others perform well.

Here's another tip, which was suggested by management guru Peter Drucker: Don't think of your employees as people who are there to achieve. Instead, think of them as people who are there to *contribute*. A successful business isn't about the achievements of individuals; it's about what individuals contribute to the team.

### Step Four: Encouraging Communication

One of the biggest obstacles for businesses is poor communication. Imagine an army in which privates set their own marching orders without ever hearing from the general. Obviously, things would not run well!

For businesses, failure to communicate effectively can lead to marketers selling at the wrong price, financial planners creating inaccurate budgets, and operations producing the wrong products. One of the major responsibilities of any business owner is to ensure that communications are clear, concise, and complete.

Failure to communicate can also cause:

- Lack of cooperation
- Poor coordination between different functions
- Inefficient use of time and resources
- Missed opportunities for creative problem-solving
- Diminished morale
- Resistance to change
- Lack of discipline
- Failure to meet long-term goals

How can you ensure effective communication? Begin by establishing formal practices, such as daily or weekly staff meetings, in which employees get updates on goals and performance, raise questions, and get feedback. Here are a few additional suggestions:

- Regularly distribute a one-page report on problems and proposed solutions
- Schedule crisis meetings when necessary for all team members
- Schedule regular company sessions to address problems and opportunities
- Pursue suggestions for process, product, and structural improvements
- Don't stay in your office. Manage by walking around!
- Confront and resolve difficult problems in person. Don't rely on e-mail or phone calls unless absolutely necessary.
- Listen to criticism with an open mind. Act on constructive feedback, and learn not to overreact to negative feedback.
- Don't be afraid to open your books to employees

Act on constructive feedback, and learn not to overreact to negative feedback

*Once Eloise and Angela had sorted out the most critical duties, they took a look at less urgent issues. Who would manage payroll? Clean up? Design the menu? The partners decided that they simply didn't have enough time or energy to do all of the duties themselves. They would have to allocate some tasks to full or part-time employees, or even to outside contractors.*

*Neither of them knew very much about accounting, so they decided to use Art Donner, the accountant who'd helped Eloise manage her business. Angela and Eloise met with him, and worked out a contract whereby he would keep their books, manage their payroll, and pay bills. He would meet with them every two weeks to review the business's financial health. If they needed additional financing, he could help them with that, too.*

*The remaining duties—cleaning and organizing the store, making coffee, and ringing up sales during peak business hours—would be handled by three or four part-time counter employees whom Eloise would hire and train.*

## Organizing Business Structures And Processes

Businesses often create an **organizational chart** to represent how different business processes fit together. Think of it as a strategic map of employee relationships.

The most common structure for businesses is **functional organization**, which groups people who share responsibilities and skills. In its simplest form, the functional organization chart begins with the president or CEO and moves down to include sales and marketing, finance, and operations.

An example of a business structured along functional lines would be a metal foundry that supplies small parts to tractor manufacturers. It has a finance department to manage financial resources; an accounting department to allocate costs; a marketing and sales department responsible for pricing, promotional, and distribution strategies; and a manufacturing department that produces the goods. All functional areas work together to achieve the organizational goal of manufacturing and marketing tractor parts.

Functional organization is best for hiring, training, and managing people within the context of their individual functions. The downside of functional structure includes diminished attention to customer service, less employee flexibility, and a tendency to focus on narrow tasks rather than business goals.

*Together, Angela and Eloise wrote up a document that described what their employees would do, how they would be evaluated, and how each job would fit within the business. They focused on the counter employees, who would represent the store while waiting on customers:*

*"Counter employees should think of working at Sunrise Bagels as an opportunity to become friends with the people who come in. Our customers are our neighbors, and you will be responsible for treating them as you would a special guest in your home. When they come in, smile and greet them. While they're here, make them comfortable and provide them with whatever they want. When they leave, thank them, and invite them to come back soon.*

*"Most customers are in a rush, particularly in the morning, so speed is essential. Counter employees must know how to operate and troubleshoot all equipment, including the cash register. The customer must be able to walk in, order, and leave with a bagel in less than five minutes."*

*Angela saved the less enjoyable duties for last:*

*"At the end of each shift, employees will sweep the store (mopping only for closing shifts); thoroughly clean counters; wipe down the grill presses, cash register, all table tops, display counter, and coffee area; clean the bathroom; restock supplies; list any inventory that needs to be reordered, and detail any problems that occurred during the shift, along with any suggestions for improvement."*

## NxLEVEL® TECH TIP
BUSINESS RESOURCES AND THE WEB

Ever wonder how other managers deal with the stress and responsibility of running their businesses? A good place to find answers to this question—and countless others—is the Website of the **Institute of Management and Administration** (www.ioma.com). This enormous site (nearly 1,000 pages) publishes a broad range of information for business professionals.

Another great place to find help and advice online is **Startup Nation's Small Business and Entrepreneur Forum** (www.startupnation.com), which is a moderated forum for discussion, debate, and inquiries about entrepreneurship. Here you can post questions about starting a business, finding capital, controlling costs, personnel management, and so forth. Entrepreneurs of all ages, nationalities, and levels of experience can establish contacts and exchange information. This is one of the best online resources you'll find!

### Model Good Behavior
As a manager, you'll probably find that your employees, customers, and business partners tend to treat you the way you treat them. If you don't tell them the truth, they won't be honest with you. If you don't take responsibility for your actions, they won't either. If you're not open to new ideas, they won't make suggestions. You can lecture employees all you want, and surround them with motivational posters, but in the end, it's your everyday behavior that will have the biggest influence on their productivity, loyalty, and morale.

Your everyday behavior is the biggest influence on your employee's productivity, loyalty, and morale

### Testing Structural Integrity
Develop the habit of looking back on structures you've created and decisions you've made. Using the following criteria, test each of your business practices:

- Does it provide a means for getting into business more quickly?
- Does it lower the risk of market entry?
- Does it enhance flexibility?
- Does it build on your personal strengths?
- Does it maximize your business's resources?
- Does it allow you to evolve, and to redirect resources easily?
- Does it help to build your brand?
- Is it appropriate for your kind of industry?
- Does it maximize revenue generation and profits?
- Is it consistent with the kind of life you want to lead?
- Will it result in the kind of company you'd be proud to call your own?

**N x L E V E L ® G R E E N T I P**

ENVIRONMENTAL BUSINESS RESOURCES

### A Green Workplace is a Healthier Workplace

Creating a healthier office environment can boost employee morale and productivity and reduce employee sick days, all of which can greatly improve your bottom line. Here are some simple tips for improving conditions at your facility.

- **Don't leave fleet vehicles or gas-powered equipment running outside your business.** Not only will this save gas, but it may improve your indoor air quality. You might also consider placing your building's air-intake ducts on the roof, where air quality is better.
- **Install appropriate lighting.** Too little light, and your employees will find it hard to work. Too much light can also result in eyestrain, and will use extra electricity. Consider natural lighting from skylights or solar tubes. In addition to saving energy, natural lighting has been shown to improve employee morale.
- **Choose nontoxic carpeting, paints, and furniture.** Options include low or no VOC paints, coatings, and adhesives; virgin wool or natural fiber carpets (or no carpeting at all); and wood that's free of formaldehyde. Visit **Greenguard** (www.greenguard.org) for recommendations.
- **Use nontoxic cleaning supplies.** Visit **Green Seal** (www.greenseal.org) to find a list of environmentally preferable industrial cleaning products.
- **Reduce dust and mold.** Use vacuums and air purifiers with HEPA filters. You can find energy-efficient models by visiting **www.energystar.gov**.

Don't underestimate the importance of the physical layout of your work space!

### How Will Your Business Look?

Don't underestimate the importance of the physical layout of your work space. Your work area should be inspiring, comfortable, and ideal for teamwork. Many successful businesses allow employees to stamp their own personalities on their work spaces.

Possibilities include bringing pets to work (one software company even has dogfood stations), creating larger kitchens for lunch time cook-ins, selecting music to work by, rearranging the work space to fit employee preferences, and designating an area for employees to relax and blow off steam (e.g., a ping-pong table or volleyball area).

### Don’t Forget to Have Fun!

One of the most valuable things you can do is ensure that you and your employees have fun and work creatively. The more people enjoy their work, the more they’ll contribute. The more creative businesses are, the more likely they are to solve problems and outperform competitors.

Is the business you’ve created one for which you’d want to work? If there’s any doubt, you need to question how you’ve structured it.

The more people enjoy their work, the more they’ll contribute

*Angela and Eloise decided that Sunrise Bagels would have a relaxed hierarchy and management structure. People would fulfill their specific job responsibilities and if they wanted to help out in other areas, they could. They wanted happy, satisfied team members, who would be guided by the shared purpose of making their customers equally happy and satisfied.*

*All employees would be trained for three days (seven days for bakers), and evaluated by the owners after their first two weeks. After that, they would be evaluated every six months.*

*To keep the tight, family feel of the business, they decided that every month all employees would meet for an afternoon tea at the store. This would be an opportunity to voice concerns, ask questions, suggest improvements, and chat. At these meetings, employees would also get a health report for the business. Angela wanted them to know all about daily sales, major costs, and profitability. She believed that employees with a big picture of the business, and a stake in its success, would contribute more and take more pride in their work. This “open book” policy has worked well for them.*

*Today, Angela and Eloise’s planning has paid off: the business is thriving. Not only is it a favorite of locals, but it has begun drawing weekend customers from Manhattan, Newark, and beyond. Angela and Eloise are even contemplating a change from their original plans: opening a second store!*

## Conclusion

In designing the processes and structures that will guide your company, you are doing nothing less than creating a model work environment: a business that performs its tasks reliably while nurturing a spirit of independence and creativity.

Your management style must fit your personality and your environment, while leaving plenty of room for employees to be themselves, and to use their skills in ways that feel right to them. If you manage your staff properly, they won’t simply be a group of drones who follow orders with one eye on the clock—they’ll become infinitely valuable collaborators and contributors.

# Chapter 22
# TEAM BUILDING AND LEADERSHIP

*About This Chapter:*
- *Why do you need a team?*
- *Teams and leadership*
- *Building your team*
- *Virtual teams*
- *Overcoming obstacles*

## Introduction
A team is a group of people who contribute their individual strengths to reach a shared goal. As such, teams are the building blocks of successful organizations.

There's a difference between groups and teams. Individuals naturally form groups with different allegiances. Teams, however, do not form naturally; they must be initiated and maintained by a leader.

A leader creates an environment in which teams can thrive, and influences team members to contribute willingly and fully. This is the cornerstone of a successful company. This chapter introduces the basics of creating, leading, and benefiting from teams.

## Why Do You Need a Team?
Businesses of all types have realized that creating teams rejuvenates employees, making them more engaged, innovative, and responsive to customers. Large corporations are forming teams in order to infuse their organizations with the excitement and sense of empowerment that entrepreneurial ventures enjoy.

Teams inspire people to make their best efforts

Teamwork encourages people to make their best efforts, and increases the range of problems your organization can solve. Because they integrate a variety of skills and personalities, and encourage intellectual conflict and engagement, teams generate ideas and solutions that are greater than the sum of their parts.

### Types of Teams
The types of teams presented below are in hierarchical order, from the most complex to the most basic:

- **Strategic Planning Teams** determine strategy, mission, and policy
- **Issue Managing Teams** are responsible for specific technology or work issues
- **Directing Teams** are ongoing, part-time teams that coordinate complex organizational tasks

- **Project-Specific Teams** are temporary teams comprising individuals with mixed skills and backgrounds. They are formed to address a specific issue
- **Brain Trust Teams** are catalysts and supporters of decision-making and change
- **Task Teams** are responsible for the basic tasks of the business

Depending on your needs, you may choose to create several teams to perform specific functions, or simply organize your personnel into a single team with a broad range of responsibilities. Either way, your goal is the same: to create a cooperative, interdependent unit, committed to open communication, creative thinking, and a single vision.

*Bright Blue, Inc. is a Southern California business founded in 2007 by Nate Miguel and his cousin Jaime. Bright Blue rents custom-built dive boats and scuba gear to people who want to explore the undersea world on their own terms.*

*Aside from Nate and Jaime, Bright Blue has nine employees: two salespeople, six mechanics, and the office manager. Once reservations are processed, most of the business's time is spent maintaining and upgrading equipment. Bright Blue is dedicated to staying ahead of the latest adventure sports trends, and making its rental equipment the safest and most reliable around.*

*In 2008, Bright Blue had earnings of over $7 million, and one of the largest fleets of rental boats in the country. Its rentals have an impressive 90% utilization rate; they are out of commission for repairs only one out of ten days. Bright Blue doesn't do much advertising, since it generates as much business as it can accommodate from referrals and repeat customers. In the busiest months, Bright Blue has a waiting list for every type of equipment it rents. Bright Blue's customers are loyal, its equipment is reliable, and the business profitable and growing.*

*How do they do it?*

## Teams and Leadership

Teams are only as good as the people who lead them

Teams are only as good as the people who lead them. A true leader generates an emotional connection with team members, attracting and inspiring them towards a common cause. Such leaders succeed because they're trustworthy, personable, inspiring, energetic, and direct. They've learned the art of managing through influence; they know that when employees are given the opportunity to identify their own goals, and the freedom to select the best way to achieve them, their performance improves dramatically.

That said, it's important to understand that there is no single leadership style that works in all situations. The ideal way to lead your marketing team may be very different from the ideal way to lead your production team. Part of being a leader is the ability to adapt seamlessly to different environments and different types of teams. In most cases, this means finding the correct balance between directive leading and supportive leading.

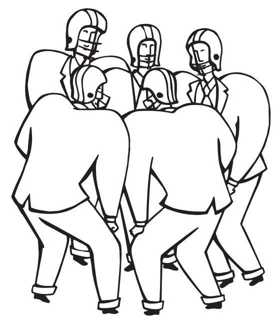
- **Directive leading** is similar to what traditional bosses do. It involves one-way communication, in which team members are told what to do and how to do it.
- **Supportive leading** requires two-way communication, as team members are encouraged to contribute ideas and participate in decision-making. The extent of this participation, again, depends on what's appropriate and necessary. What works for one team may not work for another!

## Managing Versus Leading

In the last chapter, we discussed the traits of good managers. What's the difference between being a manager and being a leader?

Good managers coordinate and organize their team members, and keep things running smoothly. Good leaders inspire and influence team members to make a personal investment in the business, and to contribute the very best that they have to offer.

Thus, a good manager is not necessarily a leader. And a good leader is not necessarily a manager. A great leader, however, is both a manager and a leader. A great leader inspires team members to peak performance, while removing organizational and bureaucratic obstacles from their path. As a leader, this should be your goal.



Do you have the skills necessary to lead?

## Are You a Leader?

Do you have the skills necessary to lead? Perhaps you're good at one-on-one communication, but how are you at one-to-group communication? Some people are born with the skills needed to be outstanding leaders. The rest of us must learn these skills.

Ask yourself these questions:

- When you were last in a leadership role, how did you perform?
- Who are the leaders you've most admired or responded to, and why?
- Which leadership traits and skills do you think you have? Which do you lack?

Having reflected on your ability to lead, consider the skills necessary to empower teams. A team leader should be:

- Coherent, forward-thinking, and consistent
- Able to adapt to a wide variety of circumstances and personalities
- Able to understand team roles, functions, and expectations
- Skilled at leading efficient, focused meetings
- Able to sustain a positive climate
- Able to resolve conflicts
- Able to diagnose weakness in the team and correct it

*Nate and Jaime Miguel built Bright Blue's success on leadership and teamwork. Though each member of the team has specific responsibilities and criteria for performance review, all have the same goal in mind: maximizing customer satisfaction and safety. This means staying on top of ordering parts, upgrading equipment, and anticipating problems.*

*Nate spent most of the nineties in the Navy, as part of a jet fighter maintenance crew aboard the USS Enterprise. There he learned that the keys to having a team that "thinks with one mind and works with one body" are division of duties, continuous and clear communication, common goals, and shared rewards.*

*Nate and Jaime hire and train their employees carefully. Bright Blue focuses the bulk of its energy on the employees who are most critical to the business's success: the mechanics. All Bright Blue mechanics have at least three years of experience working on boats and diving gear. Nate tries to hire former Navy or Army mechanics, because they understand better than others the kind of operation he strives to run. Mechanics are trained by spending two weeks repairing each type of equipment Bright Blue rents out. New mechanics work as buddies with experienced employees; by the end of their eight-week training period, they develop considerable expertise and a solid working relationship with their new team-mates.*

### Developing Leadership Skills

As a leader, you must persuade your team to share a goal, and to contribute generously towards reaching that goal. Then, you can facilitate the process by which the team allocates its own tasks, arrives at a plan, and sets a reasonable deadline for completion.

Start by focusing on who you are. Pay attention to the way you interact with people, and work to improve your "self-leadership" listening skills.

Something you've probably noticed in your own life is that the best leaders—those who inspire loyalty, trust, and a desire to work hard—are usually friendly and likable. After all, who *wouldn't* want to work for a charming and engaging person with a great sense of humor? By demonstrating that you don't take yourself too seriously and are able to keep a healthy perspective, you will inspire others to do the same.

Good leaders take pride in their teams

Another important part of leadership is knowing when to let someone else take the spotlight. You should ask for help, and accept it graciously when it's given. When you use other people's ideas, give them the credit publicly. Good leaders take pride in their teams, and are happy to show off their capabilities.

One of the best things you can do, as a leader, is to create *new* leaders. Your goal as a leader should be to turn big people into giants. When you make people feel small, your business shrinks with them.

## NxLEVEL® TECH TIP
BUSINESS RESOURCES AND THE WEB

As team leader, your biggest challenges are coordinating your team's efforts and making sure that all team members have access to the information they need. Here are a number of tools that can make your job easier:

- **Google Wave** is an exciting new Web-based networking application that will allow users to communicate and collaborate by means of richly formatted text, photos, videos, maps, and more. It has not been formally launched as of this writing, but you can learn more about it, and view a demo, by visiting **wave.google.com**.
- **Central Desktop** is an on-demand social technology platform that allows team members to collaborate in real time in an online workspace. It can also be used as a training and management tool. For a free trial, visit **www.centraldesktop.com.**
- **Teamsoft's TeamAgenda**. This cross-platform application can help you to coordinate projects, track hours, manage employees, and optimize time management. For a free trial, go to **www.teamsoft.com**.

## Building Your Team

The best way to build a team is to break the process into these easy steps:

- **Identify needs.** Let your knowledge of your business and your creativity determine which area of your business would benefit most from the strength of a team.
- **Identify key people.** By mixing people with different backgrounds (e.g., a sales person and a financial planner), your team will be able to explore a wider range of solutions.
- **Inform and listen.** Having assembled your team, explain why you have chosen to create the team, and what you hope to accomplish. Encourage and listen to your people's feedback. At this early stage, your active participation is crucial.
- **Set objectives.** Clearly set forth specific, measurable, and time-bound team objectives. Without these parameters, teams tend to lose focus.

Set forth specific, measurable, time-bound team objectives

Open communication and constructive confrontation are the essential attributes of an effective team

Always remember that open communication and constructive confrontation are the essential attributes of an effective team.  Your team members must:

- Identify common ground and points of disagreement
- Encourage full expression of all viewpoints
- Regularly share both positive and negative feedback
- Monitor the resolution of issues and conflicts
- Support and trust one another

The team should decide how it will make decisions on a day-to-day basis.  This is dictated by the size of the team and the challenges it faces.  Will its decision-making be formal or informal?  If you are a member of the team, will you remain the leader?  Will leadership become a collective function, or migrate to another member?  What are the time constraints?

Keeping your team focused yet open to new ideas requires dedicated attention to group dynamics.  Your team must learn to identify issues, explore problems, gather information, seek new perspectives and alternatives, and select the best possible course of action.

### Setting Goals

All great leaders know the importance of setting goals. In order to be effective, business goals should be generated collaboratively, in writing, by managers and employees. They must also be consistent with the company's ethics and mission.

Above all, your team's goals must be SMART:

**S**pecific
**M**easurable
**A**ttainable
**R**ealistic
**T**ime-bound

Goal-setting is often discussed in conjunction with management by objective; this is a managerial strategy in which workers' goals are mutually agreed upon, and guided by performance standards that are specific, measurable, and time-bound.

The following steps will make this process easier to accomplish.

1. Determine why you are taking the time and making the effort to accomplish a particular goal (e.g., to improve productivity, gain market share, or introduce a new product).
2. Write the goal down.
3. Identify obstacles, and methods for overcoming them.
4. Identify deadlines and milestones.
5. Identify the steps and resources that will be required to meet these deadlines.

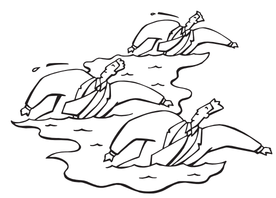
6. Form a mental picture of accomplished goals, and use it to motivate your team.
7. Prepare a final list of all goals, in descending order of importance.
8. Regularly review and reassess individual employee and business goals.

This may seem like a headache, but it's very much worth your while. The process of collaborative goal-setting enhances individual and team performance by focusing participants' attention on priorities, motivating them, and providing a standard for measuring their progress.

Studies show that goals that are ambitious but attainable often lead to better performance from team members. By getting your team to commit to attainable, worthwhile goals—and to each other—you will improve the attitude of your employees, and your bottom line.

**The Basics of Goal-Setting**
When setting business goals, always consider the following questions:

- **Who** is responsible for meeting the goal?
- **What** benchmarks will you use to measure progress?
- **Where** will efforts take place?
- **When** can the goal realistically be accomplished?
- **Which** requirements and constraints must be addressed?
- **Why** is the goal necessary?
- **How much** will it cost to plan, to implement, and to measure?



An empowered team sets its own goals

### Empowering Your Team

Empowerment means giving employees the authority to manage themselves. In many cases, this requires stripping away layers of management so that functions traditionally performed by managers—such as setting goals, assessing performance, and restructuring work processes—can be performed by line employees. Some organizations empower teams to hire and fire members, and to evaluate and contract with outside suppliers.

Regardless of your industry or the size of your business, an empowered team must collaborate in setting its own goals, and be given the responsibility of selecting the best way to achieve them. Leadership of an empowered team comes from within, and decision-making is by consensus.

How can you implement this process in your business? The starting point for creating an empowered team is establishing a shared vision. A vision is more than a business goal. It provides a context for all decision-making, and is a yardstick to measure progress. It gives your employees a focus for collaboration, and a motivation for excellence.

Your second task is to create a climate of shared responsibility within your team. This means that in order to reap the rewards, every member of the team must perform. If any member does not, it is the responsibility of the entire group to assess the difficulty and remedy it.

*It is the responsibility of every mechanic at Bright Blue to help the company meet its goal of 90% equipment utilization. This means that on average, breakdowns must be repaired within 24 hours. Routine maintenance checks between rentals must average no more than 30 minutes.*

*How does Bright Blue ensure quality with such a short turnaround time? By clearly allocating responsibility, giving team members authority to make decisions, and encouraging initiative. All the mechanics at Bright Blue have the authority to order new parts, and to allocate their time as they see fit. They work in pairs, with every member of the team qualified to repair any type of equipment.*

*Rentals are generally returned in the late afternoon, and rented out again in the morning. Therefore, the busiest time of day is between three and seven pm. During this time, new parts must be easily accessible, the floor organized and uncluttered, and the team working at its best. Afterwards, each pair of mechanics must organize and clean their workspace.*

*They also quickly complete an equipment status report and update the supplies list. This takes only a few minutes on any one of three computer terminals in the repair area.*

### Evolving and Adapting

Teams can improve only by assessing how successful their actions have been

Teams can improve only by assessing how successful their actions have been. Use the following questions as a guide for post-project team review:

- Did you use the procedures set up by the team? What were the biggest challenges and successes? Solicit feedback from all members.
- Are members pleased with the team's performance? What would they most like to change for the next time?
- Which team members communicate freely? How can you encourage those who don't?
- What is the quality of the team's output compared to others?

## Networking Tools and Tips

The rise of social networking technology offers new ways of forming teams, and keeping team members informed and efficient.  Sites like Facebook and LinkedIn allow you to search for team members with the skills and experience you need, while blogs and Twitter can be used to keep team members in close contact, share information with all of them at once, and get their input and feedback.

Twitter is a service that allows subscribers to read short messages that can be sent from cellphones, PDAs, or computers. This allows your team members to post questions, get answers, and report on progress, even when they're away from their desk. You can easily set up a Twitter account that is restricted to people within your business, so that they can use it to stay up to date on deadlines, meetings, leaves of absence, and so forth.

A team blog is a good way to keep your team informed and engaged.

A team blog is a particularly good way to keep your team informed and engaged. For instance, if you have an article you think that team members should read, you can post it to the blog, and alert team members via Twitter. The team can then comment on the article, trade ideas, and so forth. It's a good way of keeping your team engaged and alert, while tracking progress. And when the process is over, you have an online record that you can refer back to as necessary. Best of all, they're easy to set up, and hosting is usually free. (Note that blogs needn't be public. You can set them up with password protection, so that only team members will be able to read and post.)

Setting up a Facebook group is another, similar way to support your team. As with blogs, you can set up a members-only forum that will not be visible to the public, and use it to share information, provide motivation and guidance, and promote creative thinking.

Handled correctly, such sites can help your team to form lasting bonds and work together more effectively. However, they can also become a distraction, or lead to miscommunication.

Don't make the mistake of thinking that technology will solve all your problems;  these media will benefit your team only if there are clear ground rules that specify proper use, responsibilities, and etiquette. Social media should enhance real-life values and communication, not substitute for them.

We'll discuss these technologies further in our chapter on the Internet.

## Virtual Teams

A **virtual team** is a team that collaborates via the Internet or other communication technology. Virtual team members may be in different cities, or even in different countries. In some cases, they may work in the same office, but do most or all of their collaborative work online.

There are several advantages to forming virtual teams:

- Finding better employees or value than are available locally
- More time, greater flexibility, and fewer traveling and dining costs for workers
- No need to provide office space for workers
- Environmental and social benefits from reducing the number of commuters
- Ability to track progress
- Disciplined collaboration may make the business more competitive
- Allows handicapped or injured workers to contribute equally

Of course, there are disadvantages, too:

- Collaboration is only as good as the technology, which in turn is only as good as the users' understanding of the technology
- Workers may develop tunnel vision, and fail to see how their efforts fit into a larger whole
- Communication problems can arise when working across cultural or national borders
- Having workers in different time zones may delay projects
- Virtual communication may not be as fulfilling as face-to-face meetings
- Text-based communication often leads to misunderstandings, because it can be hard to judge the "tone" of an e-mail
- Local employees may resent working with an offshore team, especially if the foreign team is working for less money

Generally speaking, the biggest obstacle that virtual teams face is a lack of adequate communication and cooperation. Here are some tips on alleviating communication problems:

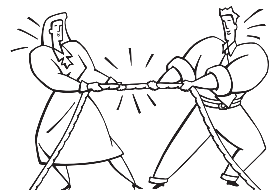
Make sure team members understand how they fit into the big picture

- **Make sure team members understand how they fit into the big picture.** As the team leader, you have to share your overarching vision of the team's project. Be sure to report on milestones, deadlines, and progress throughout the process. A team blog is a good way to do this, but if possible, a regular face-to-face meeting or virtual conference is even better.
- **Set a mandatory response time for e-mails and phone calls.** Virtual collaboration depends on timely responses to questions and concerns. Team members should be instructed to answer all queries within a day or two, even if it's just a matter of acknowledging receipt of the message. E-mail and cellphones can be unreliable, of course, which is why having an alternative means of communication—like a team blog or Facebook group—is a very good idea.

- **Make team members' schedules available to each other.** Team members should be aware of days off, business trips, illnesses, and so forth. An online calendar is one way of keeping team members up to date; blog posts, e-mails, and Twitter are others.
- **Avoid text-only communication.** Where possible, encourage voice-based communication, videoconferencing, and so forth. This will give your team members a better sense of each others' personalities, sense of humor, and so forth, and help to build trust.

## Overcoming Obstacles

The biggest challenge in creating and maintaining a team is managing group dynamics. Personality conflicts, peer pressures, conflicting loyalties, and old habits can cause a team to work at cross purposes. Your daily task as team leader is to create an atmosphere in which people can freely express positive and negative views. In this way, they can vent frustrations and overcome negative feelings, which will allow them to focus their energy on the mission rather than on team dynamics.



Constructive conflict is a tremendous source of team energy

In some cases, you may wish to assign seating location at random. This can help to prevent the appearance of coalitions within the group, and encourage minority voices to speak freely.

Constructive conflict can be a tremendous source of energy and spirited debate—use it to improve team performance. In the following contexts, constructive conflict can bring creativity and realism to a team:

- When there is flexible thinking among group members
- When dissenting thoughts are clearly and fully expressed
- When team members feel free to give their honest opinions
- When conflict resolution techniques are understood and used

Keeping clear lines of responsibility and accountability within the team is a major challenge. However, you can overcome this difficulty by helping your team to return to the basics: talk, listen, encourage one another, and focus on the mission.

### Groupthink

One of the most common problems encountered by teams is the tendency towards **groupthink**. A team afflicted by groupthink develops a distinct identity that limits its ability to investigate alternative courses of action. In the rush to make decisions, the minority view is often rejected in favor of a reactionary majority mindset.

Groupthink stems from the natural desire of cohesive groups to minimize or avoid disagreements between members. An additional problem is the perception that there's safety in numbers; insecure team members sometimes try to shirk responsibility by voting with the majority, either because they don't feel confident in their dissenting viewpoint, or because they fear the group's disapproval.

The natural tendency towards groupthink is one of the main reasons that you should encourage and listen to dissenting voices. It's not easy to go against the majority viewpoint; a person who has the character or conviction to do so may not always be correct, but should always be heard. The worst thing you can do as a leader is encourage self-censorship of team members, whether directly or by tacit consent to groupthink.

*The most important factor in Bright Blue's smooth operation is team coordination. This is Nate's responsibility. Every evening, Nate reviews computer reports to determine which supplies they need. Before the mechanics head home, Nate quickly debriefs them to uncover any problems they encountered or challenges they anticipate.*

*Nate restocks the repair area, estimates turnaround time for repairs, and allocates team responsibility for specific jobs based on rental demands. Several of the mechanics specialize in engine repairs, so Nate makes sure that if boats get returned in the morning, those mechanics are ready to jump on the maintenance job.*

*During peak business months, Nate and Jaime meet with Bright Blue's team at the end of every week. During these 60-minute gatherings, the team reviews its performance for the past week. What was the average utilization rate for equipment? What special repair challenges came up? What team coordination or cooperation issues came up? This is the time for members to speak up, ask questions, and resolve conflict.*

*Nate has found that it is during these informal meetings over coffee and pie that some of the shop's most successful improvements have come about. The best to date? The idea of installing an easy-to-use software system for managing inventory and tracking projects; that upgrade alone helped the business jump from 70 to 90 percent utilization!*

### Conflict Resolution

Conflict is inevitable in any team situation. Unless it's addressed and resolved, it can bring your team's efforts to a standstill. In some situations, the hostility and negativity may spill beyond the team and affect other employees.

Good leaders must understand how to resolve conflict quickly and effectively

That's why good leaders must understand how to resolve conflict quickly and effectively. Far from being destructive, conflict that's handled correctly can support the team's goals, and reaffirm individual members' faith in the process and its outcome. It will also establish a standard for resolving future conflicts.

Organizational theorists have identified two primary forms of conflict.

- **Cognitive conflict** is essentially conflict over ideas. As such, it's precisely the type of conflict your team should be having! The beauty of teams is that they bring together people with different skills, knowledge, and opinions. The conflict and tension between these various points of view is what eventually leads to an idea that transcends individual capabilities, which is the whole point of teamwork.
- **Affective conflict** is conflict over personalities and power. It deals not with ideas, but with the people who express them. This makes open communication and achieving consensus virtually impossible. Any affective conflict can sidetrack the entire team, by making them irritated, apathetic, or hesitant about participating.

Your job is to encourage cognitive conflict, while nipping affective conflict in the bud. There are as many possible causes of affective conflict as there are types of people, and learning to defuse it is often a process of trial and error. But as a general rule, the best way to resolve affective conflict is to depersonalize it, by turning it into a problem-solving situation for which both parties share responsibility. Encourage them to win by solving the problem, rather than by "defeating" the other person.

Remember, too, that many affective conflicts arise when people fail to distinguish between their positions and their interests. Positions are reflexive, stubborn views about reality, to which people tend to retreat when they feel threatened. Interests are what would actually benefit the person most. You can read more about the difference between interests and positions in Chapter 41 *Negotiations and Dealmaking*.

Affective conflicts arise when people fail to distinguish between their positions and their interests

While there are many different type of conflicts, the following resolution tactics are helpful in most situations.

- **Leave personalities out of it.** Instead, focus on the problem. For instance, if a team member is being negative, make a respectful effort to identify the person's underlying concerns, instead of focusing on his or her "bad attitude." You may find that the real problem has little or nothing to do with the employee's initial complaints.
- **Listen and learn.** Let team members have their say without interruption, and do your best to put yourself in their shoes. Summarize their points calmly before answering, to show that you've heard and understood them, and ask for clarification if necessary. If you need to take time to think before responding, do so. This can keep discussions from becoming overheated, and it will also show that you're seriously considering what the other person said.
- **Identify common ground.** Look for facts, goals, and ideals on which you agree, and use them to find a way out of the conflict.

- **Define the problem in practical terms**. If your team has a project due in two weeks, then it's clear that you need to find a path from where you currently are to where you need to be. Discuss the results of failing to resolve the conflict, and the likely consequences for your team and your business.
- **Ask for help.** Once you've found some sort of common ground, the value of coming up with a solution is obvious. Instead of telling employees what must be done, ask them to suggest a constructive course of action. In some cases, shifting the burden of responsibility—even if you're only doing it rhetorically—can defuse a tense situation. Negative and angry comments should be politely but firmly discouraged, on the grounds that they don't contribute to arriving at a practical solution.
- **Work jointly towards a solution.** The goal should be a win-win solution that will allow upset team members to feel that their concerns were addressed, while allowing the project to move forward. In extreme situations, differences may be impossible to resolve and it may be necessary to transfer or even fire a team member. But if the process that leads up to this decision is fair, calm, and rational, it's much less likely to affect the morale of the remaining team members.

### Reaping Rewards and Having Fun

Everyone who has ever played a team sport has experienced that brief moment of ecstasy when all team members do the right thing at the right time. This feeling that one has triumphed as part of a collective mission is one of the most rewarding aspects of being part of a team. When your team has one of those euphoric moments, take time out to savor it. Do something to celebrate, like taking a team photo or having a team dinner.

Reward your team for a job well done!

Rewards propel and motivate your team, so remember to take notice of the special people who surround you. How do you reward your team for a job well done? Here are some suggestions:

- Peg performance to financial rewards
- Offer non-monetary rewards such as time off or a better office
- Hand out props, trophies, or other small incentives
- Offer promotions and new responsibilities to outstanding team members

*The final ingredient of Bright Blue's recipe for success is a unique team compensation strategy. For every month that the company achieves its equipment performance targets and other customer service goals (number of complaints, refunds, and referrals, to name a few), each employee earns a percentage of the profits. When the business falls short of its goals, the percentage of profit sharing drops. If the business earns no profits in a slow month (this has happened only twice in three years), no bonuses are paid out.*

*Nate and Jaime review employee performance every three months, and employees anonymously review each other's performance every six months. Bright Blue pays for regular employee training seminars, enabling its mechanics to hone their skills and upgrade their expertise.*

*Other employee benefits—such as the spring and fall adventure weekends, Christmas parties, 75% discounts for friends and family—make Bright Blue a fun place to work. Bright Blue is living proof that a well-trained, well-managed, and well-rewarded team is the key to success!*

## Conclusion

By virtue of being a small business, your company already enjoys many of the qualities that corporate America covets: a collaborative atmosphere, swift communication, and the ability to respond rapidly to changing market conditions.

By honing your leadership skills, you can lay the foundation for an effective team, or group of teams, that will commit your company to a course of continual innovation and improvement, and open the door to steady growth.

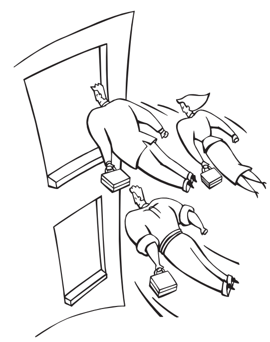
# Chapter 23
# MANAGING HUMAN RESOURCES

*About This Chapter:*
- *Interviewing and hiring people*
- *Compensating your people*
- *Motivating your people*
- *Corporate culture and employee relations*

## Introduction

Your business's most important asset is its people. That's why hiring, training, and motivating your employees is one of your most important jobs.

If you want your business to run smoothly and grow consistently—even in your absence—you must hire exceptional people, and empower them to contribute the best of what they have to offer. In practical terms, this means devising a system of rewards, policies, and guidelines for all your employees; writing job descriptions and performance evaluations; setting salary levels; and offering fair and competitive compensation.



But beyond that, it means hiring shrewd, talented people, and being secure enough to listen and learn when they come to you with suggestions, ideas, and criticism.

## Interviewing and Hiring People

Your first employees will perform the primary tasks of your business: marketing, accounting, selling, producing, financial management, and customer service. Your standards for these people should be high, but realistic. Beware of expecting too much and rewarding too little; this creates resentment, resulting in poor performance and high employee turnover.

*Bill Hodgson and Gus Meyrink started designing software together in 2002, when they were classmates at Vermont Technical College in Randolph Center, Vermont. They soon became close friends, and formed a comfortable working relationship.*

*After they graduated, Bill and Gus moved to Burlington. Taking advantage of the city's financing program for start-up firms in the Pine Street business district, they formed a small software development firm called Borderlands. After they completed a few freelance jobs, word* *got around about their quality and integrity. Soon, Borderlands had found a profitable niche as a provider of high-quality and cost-effective custom software to area businesses.*

*Today, Borderlands has a full-time staff of eight programmers and technical engineers, and a close relationship with ten additional independent contractors (many of whom are students at St. Michael's College, working on degrees in computer science). Borderlands produces almost 25 software projects each year. And yet, it's still located in the same small office where it started out as a two-man business.*

### Writing Job Descriptions

Before hiring even one employee, the first thing a good manager does is write a clear, concise job description, including:

- Employee responsibilities
- Performance criteria
- Necessary skills or qualifications
- Supervision
- Future projects
- Training
- Growth and advancement

Consider this job description for a marketing manager:

**Inkhorn Press**
**Job Title**: Marketing Manager
**Department**: Sales and Marketing
**Reports to**: President

**Responsible for**: Creating market development strategies and processes for our line of environmentally friendly postcards and stationery featuring 100% post-consumer paper stock and soy inks; focusing on new product introductions; working closely with sales force to ensure that they have the tools necessary to launch product and meet schedule commitments; managing communications between the president and the sales staff; acting as an advocate for different product and customer segments; tracking progress against plans; and communicating changes to plans.

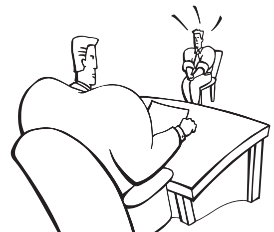
The ideal candidate will flourish in a fast-paced, entrepreneurial setting, and know how to have fun. Knowledge of the printing industry is essential.

**Minimum Qualifications**: BA/BS in Marketing/Communications or equivalent; three years of product management experience; creative ability; and independent judgment. Computer skills: word processing, spreadsheet, and design software.

### Hiring Smart People

If you want a strong, capable team, you need to hire talented people to whom you can immediately delegate responsibility.

Sad to say, managers who are inefficient or unsure of themselves often don't like to do this. They're afraid of being shown up or outperformed, so they try to surround themselves with people who won't threaten their position. The end result of this process—in which mediocre managers pass over, isolate, or fire exceptional personnel—might well be called a mediocracy. But whatever you call it, it's a leading cause of organizational failure and corruption. Your business can't afford it!



Don't be afraid to hire exceptional people!

Perhaps the best argument for hiring exceptional people was devised by David Ogilvy, of the renowned advertising firm Ogilvy and Mather. Mr. Ogilvy used to give a very pointed gift to those of his employees who had hiring responsibilities: a set of Russian nesting dolls.

As you probably know, each of these dolls opens to reveal a smaller doll nested inside the larger one. Mr. Ogilvy left a message in the smallest doll, which said "If each of us hires people who are smaller than we are, we shall become a company of dwarfs. But if each of us hires people who are bigger than we are, we shall become a company of giants."

The former president of Sony, the multinational electronics company, took Mr. Ogilvy's advice to heart. Sony instituted a policy whereby managers were required to seek out and hire employees who were smarter than they were. In the aggressive, fast-paced field of home electronics and entertainment, this policy was very important to Sony's continued survival and success.

*Borderlands initially specialized in application software and database development. Since then, in response to consumer demand, they've branched into site design, multimedia development, e-commerce, and intranet development. Borderlands has completed projects for clients in manufacturing, financial services, consulting, and retail operations, as well as in the airline industry.*

*For the most part, Borderlands's team works remotely. Twice a week, all full-time staff attend a meeting at Borderlands's office. During the rest of the week, they work wherever and whenever they feel like it. Each team member communicates via e-mail, or through the company's wide-area network. They log directly into Borderlands's main computer network to upload finished code, check out parts of projects to work on, and swap e-mails and IMs with co-workers. Despite the fact that there's little or no day-to-day supervision, jobs almost invariably get done properly and on time.*

*As you can see, Borderlands has a great management policy. But it didn't come easy. In fact, their trial-and-error process of developing these policies almost shut the company down!*

### The Hiring Process

Two criteria guide the hiring process: the first is functional or technical qualifications; the second has to do with style, attitude, and personality. Here are some hiring basics:

*Have face-to-face interviews*

Obviously, it's important that you like the people you work with, so you'll want to hire people you feel are personable and engaging.

Next, you need to assess the candidate's accomplishments. What exactly has this person achieved in the past five years? Get the person to talk about his or her contributions to other businesses, and move from there to a more general discussions of interests, goals, and values. Ask to hear about specific projects the candidate has started and finished.

An honest person with a clear grasp of his or her strengths and weaknesses is likely to be a valuable team member.

It may also be valuable to ask the candidate to describe his or her best and worst qualities as an employee; you can disarm the candidate by first offering the same critique of yourself. Remember, a business is a shared project, and nobody's perfect. It's fine for people to be good at some things, and not so good at others! Don't get caught up in a fruitless quest for "perfection." An honest person with a clear grasp of his or her strengths and weaknesses is likely to be a valuable team member.

Another good strategy is to present prospective employees with a selection of possible business and interpersonal scenarios. Ask the candidate how he or she would react to a specific crisis, an ambiguous or uncertain situation, or a given challenge. This will give you some insight into the candidate's personality, judgment, and work style.

At the end of the interview, you should feel that you understand the candidate's employment history, skills, and qualifications, and you should have a good sense of how you feel about him or her as a person.

*Check references*

Use reference checks to verify the candidate's qualifications and get information on work habits. How does the candidate work under pressure? Is he or she disciplined, detail-oriented, and able to complete tasks without constant supervision? Use your interview notes and the resume as a guide as you dig for more information.

*Bill and Gus didn't plan to have an office of telecommuters; it just happened. They both felt strongly that they wanted to have a relaxed environment where employees would feel inspired to contribute—the kind of environment in which they themselves were happy and comfortable, and in which they had always delivered their best work. But they never actually sat down and plotted out how to create this environment.*

*Instead, the relaxed structure of the office came naturally from their early practice of working with independent contractors who worked offsite. Eventually, three of these workers became invaluable team members, and were given full-time positions. It seemed natural for them to* *continue to telecommute. They were self-motivated, reliable people who'd proved themselves time and again.*

*But not everyone works well in the same setting, as Bill and Gus would soon find out.*

## Compensating Your People

The rewards that businesses offer can be divided into two categories: regular compensation and benefits, and additional rewards and incentives. Basic benefits are the things that all employees receive, regardless of their level of performance. Rewards and incentives are given in order to motivate employees to exceed performance targets, and increase innovation.

When you find special people, reward them well!

It's hard to find capable people who are truly motivated. Those special people who can invest their spirit in your business are treasures. Reward them well!

### Salary

This is the annual or monthly dollar amount you offer your employees for the job they do. You should know what your people are worth, and create competitive compensation packages to pay them accordingly. Many small businesses lack the cash flow to pay out big salaries, but you can compensate and reward your people in other ways, such as stock options, flexible work hours, and vacation time.

### Vacation Time

Vacation leave practices are often dictated by the geographic region and industry in which a business operates. Your main decision is whether to have staggered vacation times, or plan for a two-week shutdown once a year.

### Holidays

Although some holidays—such as Christmas, Thanksgiving, New Year's Day, and President's Day—are considered standard paid time off, it is entirely at your discretion which holidays you choose.

### Sick Leave

Sick leave practices are usually dictated by the region and industry in which a business operates. You can manage your policies any way you please. Decide how many sick days you will pay, and how many you will tolerate before taking disciplinary action.

## NxLEVEL® TECH TIP

BUSINESS RESOURCES AND THE WEB

An increasing number of companies have taken outsourcing to a new level by contracting with a **Professional Employer Organization (PEO)**, which enables the PEO to serve as the business's virtual human resources department. Unlike temp agencies, PEOs do not provide personnel. A PEO manages complicated and time-consuming human resources functions, including payroll and tax filings, unemployment and workers' compensation reports, 401(k) plan and health insurance administration, and compliance with regulations. Certain PEOs provide additional services, such as employee handbook and policy development, or employee counseling and training. Some will even act as your personal workplace issues consultant, providing up-to-date advice on new or pending labor regulations that can protect you from costly non-compliance penalties.

For some business owners, PEOs offer a chance to increase efficiency while reducing stress. For example, by delegating personnel responsibilities to a PEO, you can spend more time developing new products or satisfying customers. Much of this work is done on the Internet.

Before entering into a co-employer relationship, check to see whether the PEO is a member of the **National Association of Professional Employer Organizations (NAPEO)**, or better still, is accredited by the Institute for the **Accreditation of Professional Employer Organizations (IAPEO)**. You should also investigate how long the PEO has been in existence, and if it will furnish names of current and past clients for reference checks. For more information on how best to search for a PEO, contact NAPEO at (703) 836-0466, or visit the organization's home page (www.napeo.org).

### Health and Medical Coverage

This is one of the fundamental benefits that many employers offer their employees. However, providing this benefit simply may not be financially possible in the earliest stages of a business's life, especially given the ever-rising cost of healthcare.

As soon as possible, consider getting some form of group medical coverage for your company

As soon as possible, though, you should consider getting some form of group medical coverage for your company. It's better to have a modest plan with high deductibles and simple benefits than to have no insurance at all. You can begin by paying a small fraction of the cost of coverage, and increase the contribution as you grow.

Many medical coverage packages also include some form of life insurance and dental care coverage. Shop around and ask a lot of questions in order to find the best deal.

Different types of basic coverage are discussed in Chapter 17 *Managing Risk*.

*When Gus's girlfriend Tracy finished school and moved to Burlington, she became Borderlands's project manager. She loosely supervised Borderlands's three employees, who worked from home. The system worked well, usually. And when it didn't…well, it wasn't the end of the world.*

*Then, Borderlands got a big break. A local human-services firm wanted a content management system that would allow employees to post, edit, and monitor online content. At the same time, government agencies and other professionals needed to be able to access these data securely. It would be the biggest, most complex job Borderlands had ever tackled.*

*The client wanted the system on an Oracle 8 database, using an SQL server, with security that would meet or surpass the standards of the Sarbanes-Oxley bill. Gus and Tracy immediately created a time and materials estimate, as well as a process and workflow proposal.*

*One of the first things they realized was that they'd need a bigger team. Accordingly, they hired four freelancers, and assigned a staff member to mentor each of them on a one-to-one basis.*

## Motivating Your People

Some people assume that salary is the most important motivation for employees, but this isn't always the case. Often, new challenges and opportunities for learning are what employees consider most important. This type of motivation is critically important for a growing business.

You should develop year-long motivational training strategies for your business. These may include a schedule of programs that your salespeople can look forward to throughout the year. You may also want to create an agenda for internal sales, productivity, or quality contests. Each month, gains can be measured, winners selected, and fun prizes awarded.

This schedule provides markers throughout the year that will keep your people motivated and focused. You should also post your business's performance goals prominently around your work space.

For example, if your t-shirt printing business is shooting to hit an all-time sales record of 1,000 shirts per week, the number "1,000" might be posted at key spots on walls, or printed on shirts to be worn by your employees.

Good managers continually refresh their employees' awareness of the business's goals and rekindle their enthusiasm. One method is to build incentives for exceeding targeted levels of performance into your system. Most businesses do this by rewarding employees who exceed sales quotas, or complete projects ahead of schedule. How much employees are rewarded depends upon how much they have exceeded their targets.

Consider creating incentives for:

- Meeting or exceeding quality standards
- Environmental improvements, like saving energy or resources
- Reducing customer complaints
- Coming up with redesign ideas
- Solving problems with products, processes, or delivery of services
- Exceeding standard order turnaround time
- Acquiring new skills or expertise outside of one's functional area
- Reducing pollution
- Exceeding targeted inventory turnover or sales quotas
- Exceeding accounts receivable collection targets

Incentives allow the business to pay for performance once it has been delivered. The best example of this is an incentive-based compensation system for a salesperson. Here are two of the most common ways to reward employees:

- **Stock purchase plans.** The stock purchase plan (which is the opportunity to buy shares in the business) is one of the most common systems of rewards in entrepreneurial ventures. This is particularly true in high-growth, high-tech industries like those in California's Silicon Valley, where the issue of stock options invariably comes up during the first interview with prospective employees. The stock purchase plan gives employees an added incentive to help the business succeed, and allows the business to compensate its employees with earnings it has not yet produced. As your company grows, you should tailor the plan to fit your business. Always engage your attorney to help you review your choices, and the tax and business benefits of each.
- **Profit sharing.** In the early stages of your business, stay away from promises to share profits. It will be a while before your business generates profits, and it will be even longer before you've generated enough cash to pay out on a formal plan. If you choose to share profits, consult your attorney and bankers for guidance.

## Corporate Culture and Employee Relations

Your business must have a document—or series of documents—that explains your corporate culture and human resource policies.

### Corporate Culture

A business's culture is usually a function of its values

A business's culture is usually a function of its values. These values may range from how employees dress, to the language they use, to how they deal with each other and their customers. Values govern both the spoken and unspoken rules of behavior in a business. These vary from company to company, and can be very difficult to change once they are in place. (For example, the corporate culture of a skateboard shop would be very different from that of an accounting firm.) For this reason, you should pay particular attention to the values you endorse and reward at the outset of your new business. This is one of the reasons that it's so important to formalize employee relations in writing.

Pay attention to the values you endorse and reward at the outset of your new business

### Employee and Company Handbook

Early in your business's life, you should develop an employee and company handbook or Website comprising the following documents:

- A letter from you—the founder, team leader, and coach
- The company mission statement
- Your employee relations policy
- Your employee benefits package
- A "principles of doing business" statement, including its purpose and author; who should use it; an explanation of its terms, and the timeframe it covers
- Your employee performance appraisal and problem resolution procedures
- Vacation and holidays policy
- Organizational reporting structure and functions
- A statement of ethical and environmental policies

The handbook gives managers and employees information regarding all issues, practices, and procedures related to employee relations. Here are the key elements:

*Employee relations policy*
This is a clear statement of your business's commitment to its employees. What qualities and skills does your business value in its people? Consistency? Creativity? Speed? Accuracy? Loyalty? Write it down!

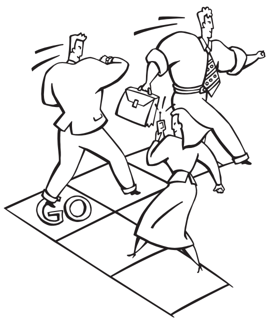
This statement also broadly outlines the structures and policies by which your business manages its people. This can include a brief summary of health, educational, and training benefits; and promotional policy.

*Problem resolution policy*
This is management's tool for resolving failures to perform, personal conflicts, and employee complaints. It provides employees with a clear indication of how and to whom they can present their issues and problems. Consider some of the situations you might want to address:

- Drug or alcohol abuse
- Poor performance
- Excessive absenteeism
- Theft
- Racial or religious discrimination
- Sexual harassment
- Interpersonal conflict

Corrective action should include:

- Verbal warnings
- Written warnings
- Counseling
- Termination




***Employee development and performance appraisal policy***
Outlining this policy is vital to the professional development of your employees. This statement should emphasize the ongoing responsibility of your business and its employees to develop and demand the highest standards of quality. Here again you will lay out in broad terms the core objectives of the business. This statement may offer an explanation of your business's policy regarding employee development and training. It can also outline how frequently and by which criteria you will judge employee contributions.

***Employee benefits policy***
This clearly describes the benefits that your business offers its employees. It identifies who is eligible for which benefits, and when.

***Employee compensation policy***
This explains how your business compensates its employees. It should address full-time, part-time, contractual, and temporary employees; and the various job classifications that exist within your business. It should also address:

- How and when salary is paid
- Payment options (e.g., direct deposit)
- Overtime compensation
- Work hours
- Holiday pay

As with all employee-related issues, you must make sure you are in compliance with federal, state, and local regulations. Be sure to have your legal advisor review your company handbook and any other human resource policies and practices.

*Once they'd clarified the schedule and the deliverables with their new client, Bill and Gus turned their developers loose. Under Gus's supervision, four workers began designing the user interface of the content management application. Meanwhile, Bill guided the other four employees in creating the back end: the APIs and function calls that would drive the database. Using the Subversion version-control system, the teams worked in parallel, checking out segments of code, uploading completed APIs, debugging, and addressing security vulnerabilities.*

*Tracy was concerned. The new workers had different temperaments and work styles, and had been given no time to adapt to their new working environment. However, Bill and Gus pointed out that their hands-off style had always worked in the past. And after all, what worker would fail to flourish under such relaxed, flexible conditions?*

*Bill and Gus were so confident in their team that they even accepted a couple of smaller jobs, and worked on them personally. These jobs distracted them, and there were a couple of weeks when they canceled one or both of the staff meetings, over Tracy's objections.*

*And then, suddenly, things started to fall apart. First, Tina quit and moved to Montreal. Then, Tracy complained that Colin kept sending her panicked e-mails asking about deliverables and bug fixes that Jane had already logged and uploaded. Meanwhile, Jane complained that she was having to do her job, and Evan's. And no one had heard from Eli in three or four days!*

*Within 48 hours, the project was at a standstill.*

### Outsourcing

The papers are full of stories about **outsourcing**, but few of them explain what it really is, why it happens, and how it can affect a small business.

Simply put, outsourcing transfers one of your services, processes, or functions to a external provider. In the era of globalization, this provider is increasingly likely to be located in a foreign country.

Outsourcing transfers one of your services, processes, or functions to a external provider

Suppose your business is functioning well, but there's a bottleneck in accounting. Invoices aren't being mailed promptly, and expenses are rising as your volume of work increases. It may be that your accounting department comprises people who drifted in as the need arose. Whatever the cause, the result is that your continued success requires efficiency and expertise that your department can't provide.

Bringing in an accounting firm with a proven track record—one that deals on a regular basis with small businesses—might provide the level of skill and efficiency you need, so you can concentrate on what you do best.

Here are some other things outsourcing can accomplish:

- Outsourcing can lower costs by eliminating redundant personnel, freeing up staff, and reducing unnecessary hardware and licenses for proprietary software.
- Improvements in efficiency may allow you to reassign tasks to staff members who earn less money, thus reducing overall costs.
- Relatively well-paid employees may become available to work at lower scales, through adjustment of contract labor terms and duration of contractual relationships.

#### *Problems with outsourcing*

Everyone knows that outsourcing to foreign firms has increased in recent years. The public image of outsourcing is linked to globalization, and the fact that many firms outsource to countries where underdevelopment has resulted in labor costs that are up to 90 percent lower than in America.

If you want to pursue outsourcing, you'll need to pay attention to employee and customer perceptions

If you want to pursue outsourcing, you'll need to pay attention to employee and customer perceptions. Consider the ill-will outsourcing may engender, and its long-term effects on your business. Remember that outsourcing done needlessly or foolishly, with no regard for the people involved, can tarnish your brand image and reduce employee loyalty.

Can you make a good case for what you're doing, and can you handle the internal frictions and unhappiness that may result? Internal discontent and resistance can sink any initiative, particularly one that involves redelegation of responsibility. The more time you take to explain what's happening, and to help those who may be displaced, the less trouble you'll have down the road.

Understand that you're not just changing your letterhead, or putting in a water cooler. You're changing a structure in which people live and work. Make them unhappy, and the structure may start to crumble.

You must also remember that your outsourcer must be experienced, and willing to guarantee savings in a contract. You're entering into a contractual arrangement that is likely to determine the future of your enterprise. Don't assume anything! Contracts must explicitly address all eventualities. Performance standards, expense caps, and time-certain milestones must be understood and put in writing.

*Call centers*

Many businesses have established offshore **call centers**, using such innovative technology as **interactive voice response (IVR)**, which can forward calls directly to an officer of the client company. India has seen an exponential growth in this business, and entrepreneurs have also made it a lucrative business in the Bahamas, South Africa, and the Philippines.

It's important to remember that cheap labor doesn't always translate into cost efficiency and added value. Dell Computers found this out in March of 2004, when they closed their call center in Bangalore, India because it wasn't meeting customer expectations.

The failure in Bangalore didn't prevent Dell from opening additional call centers in India. Part of the lesson they learned was to employ service representatives with better diction and no accents. Still, many companies have chosen to locate and operate call centers in the United States.

*Is outsourcing right for you?*

As with any business strategy, outsourcing will be successful or unsuccessful depending on how well you understand your business, your customers, and yourself.

Here are some things you'll need in order to make an informed decision about outsourcing:

- **A complete grasp of your company's core competencies**, the degree to which they extend into other areas, and the time and effort required to train your people to do a job others are prepared to do.

- **A clear understanding of the big picture.** You can't simply assume that decreasing labor costs will provide big savings. You must consider how outsourcing will affect your production output; your workplace culture and brand image; and changes in real estate costs, utility bills, taxes, and insurance. You must assess the value of outsourcing in terms of long-term viability, not short-term enthusiasm and imagined savings.
- **A detailed picture of costs.** If the total costs—including layoff expenses, remote telecommunications, and overtime costs for workers who will have to work longer during the transition—are going to exceed your projected savings, outsourcing may be a nonstarter. Is outsourcing going to be more profitable than streamlining or improving the operation you have? If not, forget it!
- **An understanding of what makes your business special.** If it's customer service, you need friendly, full-time, in-house employees. If it's discounting, then relying on an outsourcer—like an automated phone system or overseas call center—might make more sense.
- **An understanding of the importance of goodwill in the marketplace, and a concern for the well-being of your employees.** If you ignore these issues, you stand as much chance of damaging your business as you do of improving it.

Assess the value of outsourcing in terms of long-term viability, not short-term enthusiasm and imagined savings

It can't be overstated that some tasks are not suitable for outsourcing, and some jobs are not economical to outsource. Before you make a move, you must understand your core competencies, calculate how the initial expense of outsourcing will affect your cash flow, and assess how the move is going to be received inside your workforce. If you do all this, you might very well profit from a move into outsourcing.

*Borderlands was in a bad position. They had only three weeks left to finish the project, and their new team had fallen apart. Tempers were flaring, feelings were hurt, and morale was low.*

*Bill and Gus realized they'd been asleep at the switch. In trying to create a relaxed, no-pressure work environment, they'd created a system in which there was no oversight for disorganized employees, and too much work for conscientious ones. They agreed that it was time to start listening to Tracy.*

*The first thing they had to do was get two new workers. They placed ads at St. Michael's computer-science department, and quickly found replacements for Tina and Eli. These developers worked daily in the Borderlands office, under Tracy's close but friendly supervision, as did Evan and Colin. Bill and Gus had learned that great telecommuters are made, not born!*

*Tracy felt strongly that they needed to know how their team was spending its time, and how this affected profitability. Tracking hours, deliverables, and development time accounted for over three hours a week of their time, but it was worth it. Also, they made modifications to their* *project-management software, to account for the new developers. A Twitter account reminded team members about deadlines, and alerted them when pieces of code were "locked," or being modified by another member of the team. Bill in particular took great pains to ensure that no efforts were duplicated, and that all communications were recorded in detail.*

*In the end, the project was completed on time—just barely!—and their client was happy with it. It's no wonder that Bill and Gus look back on this project as a milestone for their company. They learned the value of managing human resources, and the systems they created in order to manage that project serve them well to this day.*

## NxLEVEL® GREEN TIP

ENVIRONMENTAL BUSINESS RESOURCES

If you've decided to make a commitment to green business practices, it makes sense to hire people who are at least interested in sustainable business, and preferably have some actual expertise with green products and processes.

A company called **Bright Green Talent** (www.brightgreentalent.com) helps companies find talented, experienced people who can drive or support sustainability and corporate responsibility initiatives. They offer entry- or executive-level search services, and fees are contingent upon a successful placement.

Since they research candidates and check their references in advance of recommending them, this can be a more cost-effective option than reading applications, conducting interviews, and checking references yourself. Furthermore, it gives you access to talented people outside your immediate area, who may be willing to relocate for the right job.

### Firing People

Deciding whether to fire an employee is one of the most important decisions you will have to make

One of a manager's least pleasant duties is to ask someone to leave. There are several reasons you might arrive at this difficult decision:

- The employee has stolen from the company
- The employee has not performed as expected
- The employee has a personality conflict with other members of the team
- You can no longer afford to pay the employee

When it's handled incorrectly, firing people can have huge consequences. The biggest fear, for most business owners, is being sued. But an unhappy ex-employee might also sabotage or steal from your business, or even become violent. Even if the employee leaves peaceably, a badly handled firing can lead to resentment or loss of morale among the remaining employees. On the other hand, failing to fire an underperforming or difficult employee can have exactly the same effect.

For these reasons, deciding whether or not to fire an employee is one of the most important decisions you will have to make as an entrepreneur. It's little wonder that many new business owners hesitate to terminate problem employees, even after giving them several warnings.

There is a standard process for terminating an employee, and you should always adhere to it. In some cases, there may be legal consequences for mishandling employee discipline or termination procedures. Your lawyer can help you understand these issues.

- Always begin by offering friendly, private suggestions to improve shortcomings in performance or attitude. In some cases, the employee may simply need a little more help, guidance, or information.
- If the problems persist, proceed to a firm verbal warning that describes the improvement you expect to see, and explains what the employee should do to achieve it. Offer help, if necessary.
- If the verbal warning has no effect, proceed to a written warning that states the problem, the performance you expect, and the date by which it must be delivered.
- Schedule a follow-up review.
- Meet again to share your assessment of the employee's performance.
- Make the decision to keep, terminate, or reassign the employee.

Each stage of this process must be documented in writing, in your employee's personnel file. You should thoroughly and professionally describe the problems your business has with the employee, and his or her improvement or failure to perform. Above all, stick to the facts, and don't get personal.

Each stage of the termination process must be documented in writing

If you do decide to terminate an employee, here are some more steps you should follow.

- **If you're feeling angry, do your best to calm down.** In most cases, it's better to keep an unsatisfactory employee for an extra day or two than to risk losing your temper during the firing process. You need to feel confident that you can maintain your self-control.
- **Call the employee into your office, or some other private place.** Do not humiliate him or her in front of other employees. In some cases, you may want to consider having another manager present as a witness, depending on the employee's temperament and behavior.
- **Prepare to be sympathetic, but firm.** It's normal to feel like the bad guy. But if you followed the procedures listed above, you should feel confident that you treated the employee fairly, and be able to act decisively, with a clear conscience.

- **Inform the employee of your decision, and explain the rationale for it.** Don't make small talk, or beat around the bush. Refer to previous warnings, and the opportunities you offered for improvement.
- **Don't get personal, even if the employee does.** Stick to performance issues. If you've handled the preliminary steps properly, the employee should not feel that termination comes as a surprise. Even so, understand that the employee may not really hear you the first time, and you may have to repeat yourself.
- **Allow the employee to retain as much pride and self-respect as possible.** You should avoid humiliating the employee any more than is unavoidable. However, don't try to make the employee feel better with praise or compliments. It's important not to send mixed messages.
- **Keep it short.** Don't get bogged down in debate or argument. You have made your decision, so there is very little to discuss. The important things to resolve are the next steps: severance pay, clearing out personal belongings, and so forth. Ten to fifteen minutes should be adequate for the entire process.

In the very unlikely event that the employee becomes violent or makes threats against you, your employees, or your business, you should take it seriously, and contact the police, your lawyer, and mental-health professionals in order to find out what to do next. While such threats are rare, and the majority of them are never acted on, how you handle them can be vital from a legal standpoint, as well as a safety standpoint.

## Conclusion

In the rush of day-to-day pressures to make products, fill orders, and collect payments, the important task of creating company policies is often pushed aside. Skilled managers create organizational structures that motivate employees to invest themselves in growing the business.

If you create a fulfilling and enjoyable place to work, hire smart people, motivate them, and compensate them fairly, you will have a better chance of success in your business. Employees are crucial to your success, so treat them well!

# Chapter 24
# MANAGING GREEN

*About This Chapter:*
- *Setting priorities*
- *Saving energy and resources*
- *Green and sustainable building materials*
- *Green procurement*
- *Pollution prevention*
- *Getting help*
- *Creating a green action plan*

## Introduction

As energy, fuel, and water prices continue to fluctuate, and global regulatory and competitive pressures continue to intensify, there is no business that can't benefit from adopting at least a few green business practices.

However, many small-business owners are overwhelmed or confused by this relatively new way of doing business, and lack a solid basis for measuring the value of specific green strategies.

In addition, they may believe that anything that makes a business more environmentally friendly will inevitably cause its costs to rise. In fact, this is not true. By improving efficiency, and looking at the real costs of doing business, businesses of all sizes are improving their quality *and* their bottom line.

Accordingly, this chapter will help you to take a realistic look at the costs and benefits of environmental policies, so that you can decide whether they're appropriate, affordable, and attainable.

By looking at the real costs of doing business, businesses of all sizes are improving their quality and their bottom line

## Setting Priorities

There are many options for making your business greener. Some are easy and cost little or nothing, like turning off lights and office equipment when they're not in use, or recycling paper. Others involve a bit more capital and effort up front, but will pay for themselves in a comparatively short time, like installing a solar water heater. Then there are projects that represent a serious commitment to green principles, like getting your business off the electrical grid, achieving zero emissions, or being certified by an eco-labeling organization. Steps like these require a considerable amount of capital, coordination, and planning.

It's important to prioritize green goals in terms of their expense, impact, difficulty, payout, and timeframe

It's important to prioritize green goals in terms of their expense, impact, difficulty, and payout, as well as the timeframe needed to complete them. Obviously, you should start with the things that anyone can do, like setting your air conditioner a little higher in hot weather, and build towards more ambitious goals (e.g., by using the money you save on lighting or heating to help finance next steps). This will help you to avoid squandering resources on goals you're not ready to achieve. It will also help you to shift your company's culture naturally towards a green outlook, instead of disrupting operations and employee morale with an overwhelming array of new demands and expectations.

Another option is to research and copy successful green initiatives launched by other companies in your industry, which may help you to avoid pitfalls and reduce roll-out time.

Here are some of the questions you should ask yourself (and, in some cases, your employees) when setting priorities:

- What regulations must I obey? How much time and money does it cost to obey them? Are there any ways of changing my business that would eliminate regulations (e.g., replacing a hazardous material with a nontoxic one)?
- What hazardous materials does my business use? Does using them increase my shipping, storage, training, and insurance costs? Are there nonhazardous substitutes that would solve these problems?
- What materials flow into and out of the business? What processes and products are causing waste, pollution, health risks, and inefficiency?
- What goes into our waste stream in an average month? Is poor inventory management adding to our disposal costs, and putting unnecessary materials into the landfill? Are we throwing away materials that could be reused, recycled, or upcycled or sold as a production input? If packaging from suppliers is going straight into the trash, could we ask suppliers to eliminate it or make it recyclable or biodegradeable?
- What are my energy costs? Where and how is energy being wasted?
- What are my competitors doing to be greener? How are they communicating those efforts? How are their customers and other stakeholders reacting?
- What are my suppliers doing—or willing to do—to be greener? If they refuse to offer greener products, do I have a reliable substitute?
- What happens to our products and their packaging after we sell them? What environmental problems are caused by poorly designed or nonrecyclable products and packaging?
- What do my customers want? How do they feel about local, national, and global environmental issues? (Note that many people who claim to dislike "environmentalism" may still have strong negative feelings about pollution and waste.)

Once you've prioritized your goals, you can consider taking actions that will help you achieve them. As noted above, some ideas are simple, and obviously worth pursuing. Others may require plenty of due diligence and professional assistance.

### Calculating Costs

Once you've identified a problem, the next step is to assess how much it's costing your business. This requires you to look at a wide range of factors, from employee training costs, to transport and disposal costs, to time spent dealing with regulatory agencies, to storage costs, to special equipment and protective gear, to resource use (e.g., water, heat, or electricity that would be saved if the problem were addressed). You should also consider any risks a given material or process presents, and the cost of insuring against that risk.

In addition to these direct costs, there are two other types of costs that are very important when considering green business decisions.

**External costs** are the costs of doing business that society inadvertently pays on your behalf. For instance, if your product comes in a Styrofoam container that consumers throw away, then whatever costs are associated with the clean-up and disposal of these containers are external to your business, because you've passed the responsibility for dealing with this waste onto your community.

External costs are the costs of doing business that society inadvertently pays on your behalf

Many people feel that problems like these need to be addressed by the manufacturer, rather than the community. This is the logic behind takeback programs for batteries and toner cartridges, as well as the **extended producer responsibility** laws that are an increasingly popular way for municipalities to deal with electronic and packaging waste. Consumer awareness of external costs is increasing, which is causing many businesses to take steps to reduce or eliminate them.

Of course, there are also **external benefits**. These are decisions you make that benefit society, like installing permeable paving in your parking area, or using recycled paper in your copy machines. Unlike external costs, external benefits can earn goodwill, customer loyalty, and positive PR.

The other type of cost is **opportunity cost**. This is the cost of the things you decide *not* to do. As a simplistic example, let's suppose that you save 10 cents per unit by keeping your traditional Styrofoam packaging, instead of switching to biodegradable packaging. If you sell 100,000 units per year, that means that keeping your packaging saves your business $10,000 per year.

But what if by getting rid of your packaging, you could compete in the European Union and sell an additional 25,000 units per year? If your profit margin on each unit is three dollars, then the opportunity cost of keeping your old packaging is $65,000 per year (i.e., $75,000 in profit that you forfeit, minus the $10,000 that you save by keeping your old packaging). As you can see, the savings here are much smaller than the opportunity cost.

In the real world, few business calculations are this simple. But external and opportunity costs are very real economic factors, and they can also affect how your business is perceived by your customers. For that reason, you should do your best to keep them in mind while assessing the feasibility of your options.

Once you have a good sense of your costs, you can begin to assess options for addressing problems, and prioritizing them based on cost and effectiveness. The end result of this process should be a **green action plan** that will help guide your business towards environmentally responsible policies that are **appropriate, affordable, and attainable**.

In the following pages, we'll introduce some of the most common methods of greening business operations, with an emphasis on reducing waste, improving efficiency and safety, increasing competitiveness, and reducing or eliminating regulatory and insurance costs.

*Joel Gandy runs Silver State Stonecutting, a small masonry firm based in Reno, Nevada, which designs, cuts, and installs countertops and tiles made of granite and marble.*

*During the housing boom, Joel's business was very profitable; remodeling and new construction jobs gave his business as much work as it could handle. But when the housing market crashed, Joel's revenue dropped considerably, and he started looking for ways to cut costs.*

*Unfortunately, it was hard to see where he could make cuts. He'd always prided himself on running an efficient operation. Outside of laying off employees, which was his very last resort, he couldn't see too many ways of saving money.*

*The answer came to him almost accidentally, when he accepted the offer of a free energy audit from his local utility.*

*"I figured, well, maybe they'll save me fifty cents here, or a dime there," Joel says. "I really didn't expect much. It turned out the savings were substantial, but what's more important is that it changed my thinking. I started to look at my business in a whole new way, and that made a huge difference."*

## Saving Energy and Resources

Saving energy and resources is fundamental to any well-run business

No matter where you stand on environmental issues, saving energy and resources is fundamental to any well-run business. Fortunately, there are plenty of comparatively easy ways to get started. You may be able to lower your costs by 30 percent, simply by making small improvements to your lighting, heating, air conditioning, weatherproofing, and office equipment.

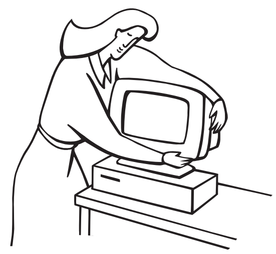
It's possible to gain a better understanding—and bigger savings—by looking at your energy usage as carefully as possible. One of the easiest ways to do this is to request a free **energy audit** from your local utility, which will usually include tailored advice on reducing your energy use. Your local Small Business Development Center (SBDC) may also offer energy audits for small business. Alternatively, you can hire a green business consultant, who will look at everything from your office equipment to your supply chain, and offer suggestions on saving energy and improving efficiency.

One important thing to keep in mind when taking steps to become more efficient is the **rebound effect**, which explains how more efficient or greener technology can actually *increase* overall consumption. In other words, if you use low-energy lightbulbs or install a solar water heater, your employees may leave lights burning longer, or waste hot water.

As you can see, this makes educating your employees on conservation crucial. It's not enough to install the latest energy-saving gadget; behavior has to change along with technology. And that requires leadership and commitment on your part.

### Saving Electricity

Before you consider any other green ideas, how about turning off lights and appliances when they're not in use? IBM estimates that this simple action saved them $17.8 million in a single year.



That said, it often takes more to turn off an appliance than hitting the power button. Many appliances continue to use significant amounts of energy even when they seem to be off. Fortunately, you can buy a "smart" power strip that senses when your appliances are turned off, and cuts their power. SmartStrip (www.bitsltd.net) is a popular brand.

Here are some more suggestions:

- Look for products with Energy Star certification.
- Use large equipment during off-peak hours (7pm - 7am), if possible.
- Choose laptop computers, which use up to 90 percent less energy than desktop models.
- Install and use power-management software.
- Consider allowing employees to telecommute one day a week, or have them work four 10-hour days.
- Use timers to ensure that lights and electronic equipment automatically turn off when the office is unoccupied.
- Unplug chargers when not in use.

If your goal is not just to save money, but also to support renewable energy, note that many utilities offer 100%-renewable power for a small monthly surcharge. Some businesses find that this is a relatively inexpensive way to earn positive PR and consumer goodwill. Contact your local utility for more information.

Last, make an effort to stay informed about the development of **smart grids**. A number of utilities are experimenting with systems that will allow businesses to budget their energy usage, program appliances to respond to energy availability, and even to specify the source of power. While such systems are currently in the testing phase, they're likely to revolutionize how energy is used and sold in the relatively near future. Visit **www.gridpoint.com** to see how one company is promoting this technology.

*Erin Walsh was an energy auditor for the local utility district. The first thing she saw when she pulled up to Ray's building was that his sign was lit with floodlights, in the middle of a warm spring day.*

*She felt a breeze as she walked through the open door. The air conditioner was running at full blast, even though it was only 70 degrees outside.*

*As she and Joel went through the building, she found a lot of other problems. There was a broken window in the warehouse. Some doors didn't have weatherstripping. There were at least twice as many overhead lights as Joel's workers needed, and they were using older, more inefficient fluorescent bulbs. Worse, lights had been left on in empty storerooms and offices.*

*Joel was surprised, to say the least…especially when Erin explained that these problems could be costing him as much as $750 per year. He'd always thought of himself as a detail-oriented manager, but clearly, he hadn't been paying as much attention to costs as he thought.*

*Most of the changes Erin suggested were easy to accomplish. In the first week, the broken window was fixed, the weatherstripping was installed, and the old rows of fluorescent lights were replaced with a smaller amount of more efficient, brighter bulbs.*

*It was a good start, but Joel was wondering what other unnecessary hidden costs he was missing. So when Erin suggested that he contact the local Small Business Development Center and ask them for help, he was quick to make an appointment.*

*"A big part of it was that I didn't know what to do about the decrease in revenue," he explains. "I'm the type of guy who has to keep busy when things are tough, so I focused on the lack of efficiency. That was a good move, as it happens, because it turned out that going green helped me with costs and revenue."*

### *Lighting*

According to the US Department of Energy, lighting accounts for roughly 29 percent of the average office's energy use. Fortunately, it's easy to reduce this expense.

Lighting accounts for roughly 29 percent of the average office's energy use

- **Natural lighting.** Well-placed skylights can provide some or all of the light the average office needs, and studies suggest that natural light may have the added benefit of improving your employees' mood. **Solar tubes** are another possibility: they diffuse natural light through your office by means of lenses and reflective tubing. They can also deliver light to areas with no windows, like basements and storerooms. You can learn more at **www.sunpipe.com**. A more expensive option is **fiberoptic solar lighting**, which uses a rooftop collector to gather sunlight, and fiberoptic cables to direct the light into the building. For more information, visit **www.sunlight-direct.com**.
- **Compact fluorescent bulbs (CFLs)** use much less electricity than incandescent bulbs, and last much longer. Because CFLs contain a very small amount of mercury, some people worry that breaking a CFL involves hazardous materials response teams and high fees, but that's an urban myth. Sweeping up the glass and wiping the area with a damp cloth is sufficient. Large retailers like Wal-Mart and Costco offer collection bins for broken and dead CFLs.
- **Light emitting diodes (LEDs).** These are small semiconductor devices that convert electricity into light. They don't get hot, unlike incandescents, and they don't flicker, unlike CFLs. And although they're currently more expensive than either, they last much longer. The US Department of Energy predicts that LEDs will replace incandescent bulbs and CFLs within the next decade. Although current LEDs can't provide enough light for an office or warehouse, they can be a very good choice for signage, display cases, and similar applications.

### *Solar photovoltaics*

Solar photovoltaic panels convert sunlight directly into electricity. Choices range from small, portable devices that can recharge your laptop or cellphone to fixed photovoltaic (PV) arrays that generate enough power for most small businesses.

When weighing the costs and benefits of solar photovoltaics, it's essential to have your electric utility conduct an energy audit, so that you'll know how much electricity your business is actually using. Since PV panels aren't cheap, cutting your power usage as much as possible *before* installing them is a very good idea. A good contractor will be able to help you with this, and if necessary, can switch some appliances to other energy sources in order to reduce the load on the PV system.

PV regulations vary greatly from town to town and state to state, as do the fees associated with permitting. As solar power increases in popularity, the trend is towards simplifying permits and lowering fees, but some locations are far ahead of others in that regard.

One of the more exciting developments in solar photovoltaics is being pioneered by the state of California. A law enacted in July of 2008 allows cities and counties to make low-interest loans to homeowners and businesses who wish to install solar panels. The loans are paid back over 20 years, through a property tax assessment that's lower than typical monthly electric charges. If the property changes hands before the 20 years is up, the tax assessment is simply transferred to the new owner along with the PV panels. Other states are devising similar programs.

### Air Conditioning and Heating

Heating or air conditioning may be one of your business's largest—and most controllable—energy costs

Depending on where you live, heating or air conditioning may be one of your business's largest energy costs. It's also one of the most controllable. This is one area where simple behavior changes can have an immediate effect on the bottom line.

*Staying cool*

One of the simplest ways of reducing your cooling costs is to apply energy-efficient film to your windows. This is an inexpensive product that's easy to install, and it can block up to 70 percent of the sun's heat. (It can also greatly reduce cold air infiltration in winter.)

If you're going to use a traditional AC system, you should buy an energy-efficient model, and make sure it's the right size for the space you need to cool. If it's too big, it'll waste energy and money, and it may also fail to dehumidify your space.

Check the unit's **energy efficiency ratio (EER)**. A window unit should have an EER rating of at least 11. A central unit should have a rating of 13 or higher.

Here are some tips on getting the most from your air conditioner:

- Install your unit in a shady area. This can reduce air conditioning costs by as much as two percent.
- Set your thermostat to 78 degrees, or as high as comfort permits. You can save up to five percent on electric costs for every degree you raise the thermostat.
- Close blinds and curtains during the hottest part of the day.
- Close cooling vents in unused rooms, and keep doors to unused rooms closed.
- Clean filters twice a month, and clean the outside condenser coil once a year.

*Keeping warm*

Sealing and weatherstripping your facility is the cheapest and easiest step you can take to save heat. Most utilities will either tell you how to do it, or do it for you.

You should also consider various types of insulation. In larger, draftier buildings like warehouses, you can easily install a **radiant barrier** (also known as foil insulation) across the rafters in order to reduce heat loss.

Double-paned windows are a great way to keep heat in, but there are also cheaper options. Simply covering your existing windows with comparatively inexpensive storm windows can reduce heat loss by 25 to 50 percent.

Here are a few more tips:

- **Set the temperature as low as possible.** Lowering the thermostat by just a couple of degrees can save 10 percent on your heating bill. If you have a programmable thermostat, you can set it at a lower temperature at night. Also, clean your furnace air filters frequently.
- **Seal off vents in unused rooms.** Inexpensive magnetic vent covers are available at most larger hardware stores.
- **Install a low-speed fan overhead.** This can reduce heating costs by making warm air circulate throughout the room.
- **Consider underfloor heating**, which uses either circulating hot water or electricity to warm the floor. A hot-water system will be more expensive to install than a traditional radiator, but it can save 15 to 40 percent on energy costs, which may make it a better deal in the long run. Electric systems have much lower installation costs, but are usually less efficient (unless they're powered by renewable sources).

*It was Joel's SBDC counselor, Danny Liang, who pointed out that running Silver State as a green business could both save money and attract new customers. He helped Joel understand his options, and assess the advantages of re-engineering and re-branding as a green business.*

*"I had a lot of homework when I came out of there," Joel says. "Not only did I have to overhaul everything, but I also had to come up with a marketing plan that would address the changes in my target market and the new options for profitability. Like Danny said, there's not much point in going green if you're going to be out of business in a few months anyway. I felt like I had to go green in order to prosper, but I also had to prosper in order to go green. Either way, it meant a lot of research and a huge change in the way we did things."*

*Joel decided that his operational strategy would focus on tactics that would offer a rapid payback, either by saving money or attracting new business. With that in mind, he worked to save energy and water wherever he saw the business wasting it. At the same time, he concentrated on efforts that would have some PR value, like switching to drought-resistant landscaping around his office. His overriding goal was to emphasize Silver State's credentials as a green business, particularly among local contractors and real-estate agents.*

*GeoExchange systems*

**GeoExchange systems** are very efficient and environmentally friendly, and can save you up to 50 percent on your cooling and heating bills. Most systems can also be designed to provide free hot water.

These systems use the subsurface temperature of the earth to provide heat in the winter and cooling in the summer. When the air in the building is colder than the ground ten or fifteen feet below the surface, the subsurface heat is transferred to the inside of the building through pipes. In summer, the subsurface temperature is cooler than the air, and can be used to cool your facility. In a typical cooling system, water at subsurface temperature is pumped into a radiator. A fan blows hot air over the pipes, which cools and dehumidifies it.

If you decide to investigate this option, try to find a dealer who is familiar with local ground conditions, as well as permitting, codes, and fees. A good dealer should also be able to tell you about local, state, and federal incentives for GeoExchange systems, and provide you with the names of nearby businesses who have installed them.

For more information, visit **www.eere.energy.gov/geothermal/heatpumps.html**.

### Heating Water

It takes a lot of energy to run a traditional water heater, which keeps water hot even when it's not being used. This has led to the development of "on-demand" heaters, which heat water as needed with a single, large burst of energy. Unlike traditional water heaters, they never run cold. And they take up much less space than traditional heaters.

Weigh costs and benefits with a skeptical eye!

These heaters aren't cheap, and their energy efficiency can vary by manufacturer, model, location, and time of year. Furthermore, having unlimited hot water may cause some people to use more water and energy than they would otherwise. In short, on-demand water heaters are a perfect example of a "green" innovation that requires you to weigh costs and benefits with a skeptical eye.

Solar water heating systems may be a better option for some businesses. They're extremely simple, and comparatively inexpensive. Water heating panels are cheaper to manufacture than PV panels, and they capture more of the sun's energy.

There are two primary types of solar hot water systems:

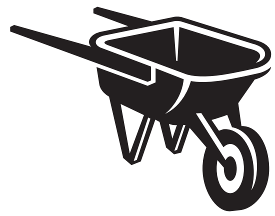
- **Passive systems** are usually mounted on the roof. They comprise a solar collector to heat the water, a tank to store it, and pipes to distribute it. They're called "passive" because they have no moving parts; heat and gravity force water through the system.
- **Active systems** have a pump that forces water through the collector or—in the case of "closed loop" systems designed for colder weather—a non-freezing fluid that transfers heat to stored water. This makes them more versatile than passive systems, and possibly cheaper, as they don't have to be mounted on the roof.

Whichever system you choose, you can expect to pay around $5,000 for materials and labor for a system that will serve a small business, or a family of four. Is the cost worth the benefits? It depends on your situation. Variables include the amount of hot water you use in an average month, your local climate, and the availability of grants, tax breaks, and rebates for solar hot water systems.

Another option for saving hot water is **heat recovery**. These systems capture the heat from water as it goes down the drain, and use it to heat water in a storage tank. A properly installed system can save a substantial amount of money, whether you heat your water with natural gas or electricity. In addition, installing one of these systems may make you eligible for a rebate from your utility.

### Saving Water

Municipal water shortages have been common in recent years, and this trend is expected to continue. Many areas impose fines and surcharges for wasting water, or offer rewards for conserving it. Here are some easy ways to reduce your water use.



- **Fix leaky faucets and dripping pipes.** Every leak you stop will save about 20 gallons of water per day.
- **Choose native plants and grasses** that are adapted to your climate and require little or no water. Your local nursery should be able to help you with this.
- **Don't leave the hose running while washing your vehicles.** Instead, use a bucket of water, and give the vehicle a quick spray when you're done.
- **Use a broom instead of a hose** to clean driveways and sidewalks.
- **Install low-flow, dual-flush toilets, if possible.** Also, watch out for toilet tanks that don't shut off when full. They can waste up to 1,200 gallons per month.
- **Harvest tap water.** While waiting for tap water to get hot, catch the cold water in a pot and use it to water plants or make coffee.
- **Install faucet aerators.** These are simple screw-on attachments that reduce the flow of water from your faucets. They cost as little as two dollars, and each one you install could save you from $40 to $150 per year, depending on where you live.
- **Install a recirculating pump.** These devices recirculate water until it reaches a desired temperature, so that you no longer have to run the tap while waiting for the water to get hot. Different pumps have different efficiencies, operating costs, and drawbacks, and some may require permits, so be sure to do your homework before installing one of these systems. Depending on the design of your facility you may also be better off with a gravity-driven **hot water recirculating loop**. You can talk to your contractor or plumber about the feasibility of this option.
- **Reward employees** for meeting water conservation goals.
- **Harvest rainwater**, and use it for irrigation, cleaning, and so forth. If your building has a traditional downspout, you can either collect water in rain barrels, or redirect it to an underground storage tank. This replenishes groundwater, and puts less strain on the municipal sewer system (which is why some cities offer water-bill discounts for installing these systems).

If you want to make a more dramatic statement, consider replacing waterproof asphalt or concrete areas with **permeable paving**, which prevents stormwater runoff and thus reduces pollution of the watershed by gas, oil, antifreeze, and heavy metals.

Permeable paving can be more expensive than conventional paving, but this cost may be offset by eliminating the need for conventional drainage solutions. A contractor can help you assess whether permeable paving would be appropriate and affordable at your site.

### Saving Gasoline

High fuel prices can be especially devastating for auto-related businesses like tow companies and taxicabs, but since we all rely on trucks and planes for food and other essentials, no business or consumer escapes unscathed from rising fuel costs.

Hybrid vehicles, which make gasoline go further by deriving some power from electricity, have been a popular solution to higher fuel costs. It may be tempting to run out and convert your fleet to hybrids, but there are many other gas-saving ideas you may want to try first. The first and simplest is to drive less. Encourage employees to take public transportation, bicycles, or carpools when they can, and to do as many errands as possible during a single trip when they drive company vehicles. This could require you to be more organized, of course...but that can benefit your business in many other ways, particularly in increased productivity.

The second is to drive differently. Nowadays, many cars come with a useful meter that shows how gasoline consumption changes depending on how you drive. If you have one of these meters, keep an eye on it while you drive, and try to avoid actions that reduce your mileage. You'll probably find that fuel-efficient driving becomes second nature. If your company vehicles aren't equipped with these meters, it's easy to buy and install them. ScanGauge (www.scangauge.com) is a popular model.

Here are some other tips for maximizing your mileage:

- **Keep your vehicles tuned up, and the tires properly inflated.** These are two of the most important things you can do to save at the pumps. Under-inflated tires can lower fuel efficiency by 1.4 percent for every 1 psi drop in tire pressure.
- **Don't carry things you don't need.** The heavier your vehicle is, the more energy it takes to move it.
- **Keep acceleration and braking to a minimum.** Pay close attention to what's happening ahead, so you can avoid stop-and-go driving and maximize coasting time.
- **Don't let your engine idle while sitting.** Idling for ten seconds uses more fuel than turning the engine off and on.
- **Utilize fleet management tools.** Many companies have fleet management software that helps them scrutinize fleet costs and maintenance, and configure delivery routes for maximum fuel efficiency.

Idling for ten seconds uses more fuel than turning your engine off and on

**NxLEVEL® GREEN TIP**
ENVIRONMENTAL BUSINESS RESOURCES

**Looking for a Greener Fleet?**

The American Council for an Energy-Efficient Economy maintains a green consumer guide to current car and truck models at **www.greenercars.org**. They calculate a Green Score for each car, minivan, pickup, and SUV on the market, based on official emissions, fuel-economy tests, and other specifications reported by auto manufacturers.

Here, you'll find lists of the greenest models in each vehicle class, as well as the cars and trucks that scored lowest on ACEEE's environmental tests.

The site also features analysis of market trends, and offers plenty of fuel-saving tips for drivers.

*Videoconferencing*
The high price of airline tickets, along with concern over greenhouse gas emissions, has led to an increase in **videoconferencing** and other alternatives to face-to-face meetings. In addition to saving energy and reducing carbon emissions, these tactics allow you to slash common business expenses like hotel accommodations, meals, and rental cars.

Paper accounts for roughly 40 percent of all municipal solid waste in the United States!

## Saving Paper

According to the US EPA, the typical office worker generates 1.5 pounds of waste paper per day. It's no wonder that paper accounts for roughly 40 percent of all municipal solid waste in the United States!

There are several ways to cut down on how much paper you use, including:

- Switch to electronic communications, and use paper only when clients request it, or the IRS demands it. Send your faxes via computer, with programs like Microsoft Fax.
- Make sure all printers and copiers are set up to print on both sides of the paper.
- Opt for online banking, accounting, tax processing, purchasing, bill payment, and statements. (Be sure to back up your files frequently!)
- Buy recycled paper with a high percentage of post-consumer recycled content. Recycled paper uses 90 percent less water and 50 percent less energy than paper made directly from trees.
- Use a rubber address stamp in place of return address labels. Also, try printing directly onto envelopes instead of using labels.

- Keep your mailing lists up to date, and remove people and businesses who don't need to be on them.
- Send ads and brochures electronically, in PDF format. If you must mail advertisements, try to use postcards or tri-fold brochures instead of envelopes.
- Shorten and simplify your documents. If a promotional mailing runs to a page and a half, try to cut it down to one page. This will save paper, printing costs and the reader's time.

*Danny and Joel also took a long, hard look at his company's waste stream, which included several tons of stone chips and fragments. Joel was paying a lot of money every year to have this material cleaned up and hauled to a landfill.*

*Danny pointed out that there were companies that would gladly pay for his waste rock, and mentioned a California firm called CounterBalance, which made luxury countertops out of recycled rock. Joel was intrigued, and decided to give them a call.*

*It seemed farfetched that someone would pay Joel to haul away a full-sized dumpster full of marble and granite chips, but he figured he might as well give the idea a chance. If nothing happened, he wouldn't be any worse off.*

*He called CounterBalance and talked to a sales agent named Devorah Kantor, who said that they were indeed in the market for waste stone fragments. Joel was naturally curious about the countertops, and over the course of the conversation, he learned a lot about their business.*

*He found out that they were extremely busy...so much so that there was currently a three-month waiting list for countertops (and in a downturned economy, no less!). He also learned that they were looking to license their patented process in order to help meet demand in certain markets.*

*Joel was intrigued. Could this be the new market he'd been looking for? He decided that next week, he would drive down to Sacramento and pay a visit to CounterBalance's facility.*

## Green and Sustainable Building Materials

Recent years have seen an explosion in green and sustainable building supplies. They tend to be somewhat more expensive than their conventional counterparts. But in many cases, they provide greater value: they may be more effective, durable, or attractive; or less likely to trigger allergies and other respiratory complaints.

Here's a brief list of environmentally preferable building supplies:

- **Low VOC/No VOC coatings.** You can find a wide variety of paints, stains and finishes that contain few or no volatile organic compounds (VOCs). These durable, odor-free coatings are more pleasant to use than traditional paints, and much better for the environment. Manufacturers include AFM (www.afmsafecoat.com), BioShield (www.bioshieldpaint.com), and Yolo (www.yolocolorhouse.com). Larger manufacturers like Kelley-Moore and Sherwin-Williams also make eco-friendly paints.
- **Non-fiberglass insulation.** Options include cellulose, spray polyurethane foam (soy-based brands are available), and recycled denim. Prices are likely to be a bit higher than fiberglass, but they're generally safer to work with, and easier to dispose of if you need to remove them later.
- **Alternative countertops.** A number of companies make stylish and durable countertops from recycled glass, concrete, fly ash, old newspaper, and other materials. If you were thinking of installing granite, you may find these eye-catching counters to be an attractive alternative, as well as a great conversation piece for employees and customers. Popular brands include EnviroGLAS (www.enviroglasproducts.com), IceStone (www.icestone.biz), and Paperstone (www.paperstoneproducts.com). Some of these companies also make flooring and tiling.
- **Wood flooring.** If you want wood floors, a simple green solution is to look for wood that's been certified by the Forest Stewardship Council (www.fscus.org), which requires producers to meet 57 environmental criteria. Generally, these woods are comparable in price to standard brands, so there's really no reason not to choose them. Another possibility is to use reclaimed wood, which can be a very attractive choice for certain types of business.
- **Other flooring options.** Cork flooring comes from tree bark that's harvested harmlessly every nine years. It's attractive, durable, and warm, but it's also soft and may be vulnerable to moisture. The price is comparable to mid-range hardwoods. If you prefer carpeting, a wide range of low-VOC and recycled brands are available from traditional and specialty manufacturers. Last but not least, natural, hypoallergenic, odor-free linoleums like Marmoleum are available in a wide variety of colors, at a competitive price.
- **Formaldehyde-free plywood** is increasingly popular, and most larger building supply stores will either have it in stock, or be able to order it.
- **Outdoor wood substitutes.** Companies like Trex (www.trex.com) make decking, railing, and fencing from a mixture of reclaimed wood and recycled plastic. It's slightly more expensive than wood, but it's more durable and weather-resistant, doesn't need protective coatings, and is not subject to insect damage. It's also splinter-free.

Most good contractors will be familiar with these products. Those who aren't can learn more by talking to manufacturers, sellers, and other contractors.

If you're in a larger city, you may be able to find green building supply stores that carry products like these exclusively. Although the salespeople at such stores will usually be knowledgeable about manufacturers' specs for a given product, it's best to talk to people who have actually installed it for other customers. You can also contact the manufacturer directly for more details.

***Green demolition and salvage***
If you find yourself remodeling or demolishing a building, bear in mind that there may be local businesses that will salvage cabinets, doors, windows, wood, bricks, and other construction materials. In some cases, these firms will remove and transport the items for free. Better yet, the value of the materials may be tax-deductible. In other cases, you may prefer to recycle the materials by using them in the new building, which is even easier on your budget and the environment. Either way, the local landfill should always be your last resort. The more you can recycle or reuse upfront, the better!

## Green Procurement

Many companies are opting for products that are designed for easy recycling or disassembly, or are less problematic when disposed of in landfills. These buyers are leaning on their suppliers to help them find solutions, and taking a harder look at prospective suppliers' environmental, health, and safety performance (along with normal considerations like price, quality, availability, and performance).

Some green products may be more expensive than conventional brands. However, they may last longer, or reduce expenses and risks associated with waste disposal. They will also reinforce your brand image as a green company.

You have two basic options. You can look for new suppliers who specialize in green products, or ask current suppliers to start offering them. What you choose to do will depend on the quality of your relationship with your existing suppliers, and your level of commitment to green business.

If you can find other small businesses that want green products or services, you may be able to join forces and gain leverage with your suppliers.

Even so, finding reliable suppliers and products may be difficult. And even when you *do* find them, the popularity of green products means that some companies may not be able to meet the level of demand. Manufacturers of newer green products, in particular, may not have been in business long enough to determine long-term usage patterns.

Avoid making any drastic, sudden changes to your existing supply chain

For this reason, and many others, it's best to avoid making any drastic, sudden changes to your existing supply chain. Instead, place small initial orders, or get samples, and evaluate them carefully over a period of weeks or months.

If it turns out that they meet your needs, make sure that your supplier will be able to supply a sufficient amount (if applicable, include some room for growth in your calculations). In some cases, you'll also want to overlap the old product with the new, so that if there's a problem with the new one, you'll have something to fall back on.

Most important, tell your customers and partners about the changes you're planning well in advance. Be prepared to address their questions and concerns, and to explain how the change will benefit both of you.

Tell your customers and partners about the changes you're planning well in advance

### Green Procurement Resources

The EPA has several publications that can help you with green procurement. You can find them online by title.

- ***Green Purchasing Guides*** are full of free, detailed advice on evaluating and buying a wide variety of green products.
- ***Environmentally Preferable Purchasing Guides*** provide an in-depth look at the costs and benefits of copiers, carpets, and cleaning products. It also includes a guide for greener meetings.
- ***Lean and Green Supply Chain*** provides innovative suggestions for green purchasing, materials handling, and storage.

Here are two more useful resources:

- **Responsible Purchasing Network** (www.responsiblepurchasing.org) is "a diverse network of stakeholders that promotes and practices responsible purchasing by identifying best practices, developing effective purchasing tools, educating the market and utilizing its collective purchasing power to maximize environmental stewardship, protect human health and support local and global sustainability." They offer a number of purchasing guides "for everything from paint to lights."
- **Buy Green** (www.buygreen.com) offers a wide variety of green products for small business and industry.

*When Joel saw CounterBalance's countertops in person, he was impressed. They were elegant and sturdy, and the technical specs on water, heat, and acid resistance were impressive. They used other waste materials for some of their countertops, too, like broken bottles and shattered windshield glass, which made for an almost limitless spectrum of colors and patterns. They were marketed as an eco-friendly alternative to granite and marble, at a slightly lower price.*

*"I pretty much decided right then and there that I was going to offer alternative countertops," Joel recalls. "It wasn't about the environmental angle so much, although I could definitely see that being a selling point for customers. The main thing was that these were really unusual*

*countertops with a lot of personality. They were the sort of product where as soon as you see it, you want it. Although the prices were a little less than the marble, it was really the environmental benefits and the unusual aesthetic that pushed people to buy.*

*"Now that I know all about the green aspects, I'm sold on that feature as well. But my first reaction was that I knew I could sell these countertops, and I had a limited time to get out in front of the competition with a new product line. So I got busy right away with a market survey and a feasibility study."*

## Pollution Prevention

The best strategy for dealing with waste is **pollution prevention (P2)**, which the EPA defines as "elimination of or reduction in waste quantities or toxicities at the point of generation." In plain English, this means not making pollution in the first place.

By cutting wastes, you cut disposal costs, energy fees, and water fees, and increase the efficiency of your business

Even the smallest businesses can benefit from a P2 program. By cutting wastes, you cut disposal costs, energy fees, and water fees, and increase the efficiency of your business.

If you wish to begin a P2 program, here are some hints:

- **Write a policy statement on pollution prevention for employees and customers.** Explain what you're doing, why you're doing it, and how it benefits your business, your customers, and the environment.
- **Educate and involve all employees.** A safer working environment increases employee morale and productivity. Once employees understand the P2 goal, they'll generate valuable new ideas.
- **Set appropriate, affordable, and attainable goals.** You might choose to decrease your solid waste output by 25 percent in one year, or reduce your hazardous waste by 10 percent every year for five years.
- **Collect data.** Determining the types and amount of waste your company generates helps you evaluate your options, and establishes a baseline for measuring progress.
- **Publicize your efforts.** Tell your community that you're implementing a P2 program. This will result in good publicity, and enhance your green brand image.

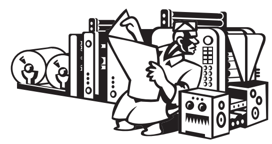
Most states have P2 programs, and some offer attractive incentives for instituting pollution control policies. The EPA maintains a list of regional offices that oversee state-level P2 resources at **www.epa.gov/oppt/p2home/pubs/local.htm**.

In the next section, we'll look at some useful P2 strategies, from simple steps like improving your recycling capabilities, to more ambitious projects like changing how you make and deliver your products.

### Purchasing and Inventory Control

Overhauling purchasing and inventory policies with P2 in mind can reduce material and energy consumption, minimize waste generation, and lower disposal costs.

- Factor in waste-management costs when buying raw materials and other products. Remember: materials that generate hazardous waste cost more than their purchase price!
- A large inventory ties up money that might be better utilized elsewhere, and increases the potential for spills and spoilage. Order materials in smaller amounts, and ask your suppliers if they have a takeback policy for unused products.
- Avoid overproduction. Are there areas in your business where things are being produced faster than they can be used? Do you have inventory sitting around, taking up space and costing money? Overproduction can cause serious problems with resource allocation and cash flow.
- Broken packaging or expired materials may increase your waste load. Don't accept deliveries of materials that are damaged, have an odor, or show signs of leakage. Also, make sure all materials have legible labels.
- Follow proper storage methods for perishable materials. Using stock on a FIFO (first in/first out) basis reduces the chance that materials will deteriorate in storage. If possible, arrange to return expired materials to your suppliers.



Good housekeeping and employee training reduces the risk of spills

### Good Housekeeping

- Install spigots and nozzles to dispense fluids from bulk containers, and use drip pans and splash guards to avoid spills.
- Check for leaks at least once a week. Even the smallest leaks can lead to waste problems and exposures if not remedied. Also, check closures to prevent spills and evaporation of liquids.
- Keeping track of where spills have occurred may help you prevent future spills.

### Materials and Waste Storage

- Make sure that spills or leaks won't contaminate sewer or storm drains.
- Keep different wastes separated. Mixing wastes can be dangerous, and may make reusing or recycling impossible. Also, mixing hazardous and nonhazardous waste effectively increases the volume of hazardous waste, thus increasing disposal costs.
- Store hazardous waste indoors or in a covered area to prevent moisture from seeping in. Moisture may increase the volume of your hazardous waste, increasing disposal costs.
- Store hazardous waste in a safe location out of major traffic areas, and have emergency equipment ready for immediate use in case of spills and leaks. Make sure employees are trained to use emergency equipment.

*Joel's research showed that there was definitely a market for alternative countertops in the Reno area. Although new housing starts were down, there was still plenty of remodeling activity. Some homeowners were trying to make their houses more saleable in a buyers' market. Others were worried about looming inflation, and were accordingly remodeling their existing homes rather than buying a new one.*

*Unfortunately, the demand didn't look like it would be sufficient to cover Joel's costs. In addition to the licensing fees, he had new equipment to buy, a steep learning curve, and employees to re-train. Even if he added the population in the area between Truckee and South Lake Tahoe, the numbers simply weren't big enough to justify the expense.*

*But what if he could get a larger area? There was Las Vegas to the south, and Salt Lake City to the east. If he could get exclusive rights to Nevada, Utah, and Idaho, the plan would seem a lot more feasible.*

*With this in mind, he conducted a new, wider market survey, and a new feasibility study. This time, the numbers looked good. He decided to call Devorah back, and make his pitch.*

### Materials and Waste Exchanges

Materials and waste exchanges are Websites that connect businesses that have unwanted materials with businesses that can use them as a production input. Generally, such sites allow users to post a description of the materials they have or are looking for, and work out a private deal on price and transportation. Waste exchanges usually offer hazardous materials and industrial waste, while materials exchanges offer nonhazardous items like paper, bottle caps, rubber mats, or gravel. These exchanges have been very useful for green businesses that are pursuing cradle-to-cradle production techniques.

You can find links to a directory of international, national, and state-based materials and waste exchanges at **www.epa.gov/epawaste/conserve/tools/exchange.htm**.

### Product Redesign

Redesign usually involves finding nontoxic or renewable inputs, reducing the amount of waste material (e.g., unnecessary packaging), extending product life, and reducing energy and material usage through the product's life cycle. Aside from the environmental benefits, getting rid of unnecessary inputs and production stages can significantly improve your bottom line through cost-reduction strategies.

The redesign process can also encourage innovation by challenging assumptions, and offer opportunities to create attractive designs and novel branding strategies. A patent for an innovative, eco-friendly form of packaging might end up being worth more than your original product!

***Materials substitution***

Materials substitution decreases or eliminates the amount of toxic, hazardous, or polluting materials used in your business. It can also save money and time by exempting you from hazmat regulations, shipping surcharges, and insurance costs.

Look into substitutes carefully. Some will solve one problem but cause another (e.g., replacing Styrofoam pellets with biodegradable starch-based pellets can turn your shipping area into an all-you-can-eat buffet for rats). Try to contact other users to learn how the substitute materials worked for them. Also, when considering a substitute chemical, remember to look at the Material Safety Data Sheets (MSDS). Less toxic substitutes may still have a low flash point, or be regulated for their VOC content.

Materials substitution can exempt you from hazmat regulations, shipping surcharges, and insurance costs

*After several weeks of negotiations—during which Joel had to develop a marketing and sales plan, and demonstrate that he had adequate workspace, plenty of experience in the industry, and was eligible for a loan that would cover the new equipment he'd need—Joel signed a deal with CounterBalance. It stated that Silver State Stonecutting would be the exclusive manufacturer and dealer of CounterBalance's products in Nevada, Utah, Idaho, and Montana.*

*This raised a new question, though. Where would Joel get the stone fragments he needed, once his current supply ran out?*

*Danny Liang suggested he look online for materials exchange sites. Joel soon found that there was a very active exchange program in Reno, which attracted businesses from most of the surrounding states. After monitoring the site for a couple of weeks, he was able to get several loads of granite chips, as well as a couple of truckloads of broken auto glass, and red, yellow, and green glass from discarded traffic lights.*

*As he prepared to offer this new product line, Joel maintained his focus on increasing his efficiency. Danny had insisted on the importance of being consistently green when you offer an environmentally preferable product, so Joel did his best to put as many sustainable practices and policies into effect as he could, in order to reinforce his brand image as the green alternative to the area's traditional masonry firms.*

## Getting Help

Many utilities and states offer rebates for energy-saving equipment and facility improvements. Some also offer low-interest loans for upgrades. Also, the Energy Independence and Security Act of 2007 stipulates that SBDCs must do more to help small businesses save energy. Ask your local utility, state energy office, and state utility regulator for more information on financing, rebates, and tax breaks.

Federal, state, and local grants and subsidies can greatly reduce your up-front investment and your break-even time

Federal, state, and local grants and subsidies can greatly reduce your up-front investment and your break-even time, and are well worth looking into.

The following programs are subject to change. Consult the appropriate agencies for the most current information.

### Loans

Under the SBA's 504 loan program, small businesses that generate renewable energy—including solar, biomass, hydropower, wind power, geothermal, and ocean thermal—are eligible to finance a real estate purchase or construction project with up to $4 million. It's not necessary to be in the renewable energy industry to get this loan. For instance, a bakery that purchases solar panels would qualify.

The 504 program also offers up to $2 million in financing for businesses that use sustainable design practices when building their facilities.

Most states have their own low-interest loan programs for renewable energy and green business practices. As an example, consider the Texas-based LOANStar program, which offers below market rate loans to businesses that wish to improve their energy efficiency. As of this writing, interest rates are three percent, and loans are repaid through energy cost savings.

### Tax Credits

- **Business Energy Tax Credit.** For solar energy property, solar hybrid lighting, and geothermal systems installed on or after January 1, 2009, the tax credit is 10 percent. The credit for fuel cells is capped at $500 per 0.5 kilowatt (kW) of capacity. The maximum microturbine credit is $200 per kW of capacity.
- **Modified Accelerated Cost-Recovery System (MACRS).** Under MACRS, businesses may take depreciation deductions on solar, wind, biomass and geothermal property, as well as on fuel cells, microturbines and solar hybrid lighting technologies. For more information, see ***IRS Publication 946, IRS Form 4562: Depreciation and Amortization***, and ***Instructions for Form 4562***.
- **Renewable Electricity Production Tax Credit (PTC).** The PTC provides a corporate tax credit of 1.5¢ per kilowatt hour (kWh) for wind, closed-loop biomass and geothermal. Currently, the PTC for these technologies is 2.0¢/kWh. Electricity from open-loop biomass, small irrigation hydroelectric, landfill gas, municipal solid waste resources, and hydropower currently receive 1.0¢/kWh.
- **Rural Energy for America Program (REAP).** This USDA program promotes energy efficiency and renewable energy for agricultural producers and rural small businesses by offering grants and loan guarantees for up to 25 percent of project costs. Eligible projects include solar water heating, solar thermal electric, photovoltaics, wind, biomass, hydroelectric, renewable transportation fuels, geothermal heat pumps, hydroelectric, and microturbines.

- **The Economic Stimulus Act of 2008** included a 50% bonus depreciation provision for eligible renewable-energy systems acquired and placed in service in 2008. This provision was extended (retroactively to the entire 2009 tax year) under the same terms by The American Recovery and Reinvestment Act of 2009.
- **State, local, and utility incentives.** Many states, towns, and utilities offer subsidies, tax breaks, and other incentives for renewable energy and energy efficiency. You can see what's available in your area by visiting the **Database of State Incentives for Renewables and Efficiency** (www.dsireusa.org). We also suggest checking your state's official Website.

Many states, towns, and utilities offer subsidies, tax breaks, and other incentives for renewable energy and energy efficiency

## NxLEVEL® TECH TIP

BUSINESS RESOURCES AND THE WEB

**The Tax Incentives Assistance Project (TIAP)** provides consumers and businesses with the information they need to make use of federal income tax incentives for energy efficient products and technologies.

You can find a list of business incentives at **energytaxincentives.org/business**. The site also features valuable pages that compile "current information on pending legislation relating to the federal tax incentives," and "information on IRS rules, notices, and guidelines as they are released." This is a very easy way to keep track of these important issues!

### Government Programs

- **Environmental Loans, Grants and Incentives** (www.business.gov/expand/green-business/grants-and-loans) compiles links that will help you "find money to pay for energy efficient upgrades to your facilities, environment-related projects and improvements, and financial incentives that can save you money such as tax credits, tax deductions, sales tax exemptions, property tax exemptions and rebates."
- **Environmentally Preferable Purchasing** (www.epa.gov/epp) can help you find and evaluate information on green products and services; identify federal green buying requirements; and calculate the costs and benefits of purchasing choices.
- **Green Power Partnership** (www.epa.gov/greenpower) provides "technical support in identifying green power products that meet your organization's needs and goals."

### Green Business Advocacy Groups

- **Apollo Alliance** (www.apolloalliance.org) is a coalition of business, labor, environmental, and community leaders working to reduce America's dependence on foreign oil, cut carbon emissions, and expand opportunities for American businesses and workers.
- **Business Alliance for Local Living Economies** (www.livingeconomies.org) is a network of green businesses committed to building local economies and transforming the community economic development field. BALLE comprises nearly 60 local networks of independent businesses in a variety of locales across the US and Canada, and represents more than 15,000 entrepreneurs.
- **Green America's Green Business Network** (www.coopamerica.org/greenbusiness/network.cfm) works on a national level bringing together businesses that are already green. The Network has added more than 2,500 companies to its ranks through its evaluation program. It lists them in its *National Green Pages*, and links them with any of the Co-Op's 60,000 companies looking for green supplies and services.
- **Green Chamber of Commerce** (greenchamberofcommerce.net) is aiming to create a coalition that will lobby states and Congress to promote the interests of businesses that are committed to the triple bottom line, and provide networking opportunities for green businesses.
- **ClimateBiz** (www.climatebiz.com) is a resource center focusing on strategies for companies seeking to reduce their carbon footprint while saving money and increasing productivity. Its free e-newsletter, ***ClimateBiz News***, offers the latest developments, research, and strategies related to business and the environment.
- **Sustainable Business** (www.sustainablebusiness.com) provides global news and networking services to help green businesses grow.

*A year later, Silver State is doing well. Alternative countertops proved to be a very popular choice among builders and sellers who were looking to differentiate their properties in a sluggish market. Although there are now rival brands, utilizing everything from scrap metal to bamboo, relationships count for a lot with contractors, and Joel has benefited from being ahead of the competition. In fact, he's been successful enough that Devorah Kantor eventually relocated to Reno to handle his sales and marketing.*

*With the aid of a low-interest SBA loan for businesses that wish to install renewable energy systems, he installed a GeoExchange system for heating and cooling, and put solar panels on the roof of his warehouse. And he's currently contemplating the daring step of discontinuing marble and granite countertops altogether.*

*"The eco-friendly stuff is such an important part of our brand that I feel like the traditional products are diluting that image," he explains. "I feel like if I want to make the case that this is a better way to go, I have to stand behind that belief. There was a time when it made sense to offer all the options. We didn't want anyone else getting the sale. But now the training wheels are off, and I believe we have to stand or fall as a truly sustainable business. It's not what I set out to do, but now that I'm doing it, I want to be the best there is."*

## Creating a Green Action Plan

As you've learned, some green ideas are simple, and obviously worth pursuing. Others require plenty of detailed, careful research. Once you've prioritized your goals, you can consider taking actions that will help you achieve them. All actions that are appropriate, affordable, and attainable should be added to your business's green action plan. This plan outlines how, by whom, and when each of your green goals will be accomplished.

Remember that seemingly simple goals can become difficult if they involve changing behavior. Even if the goal is simply to get employees to turn lights and appliances off when they're not in use, having an action plan can help. After all, someone needs to be in charge of spreading the message, establishing benchmarks, and monitoring compliance.

Remember that seemingly simple goals can become difficult if they involve changing behavior!

When it's finished, your Green Action Plan should be posted where all team members can see it. You can update it every week or two as necessary to reflect changing circumstances. Be sure to share your progress with employees, in order to keep them focused and inspired.

Utilizing this system conscientiously will help you to choose the right green projects, and finish them on schedule and on budget. It will also help your employees know exactly what is expected of them. These kinds of projects are perfect for teamwork-building exercises, and provide an excellent opportunity for you to improve your leadership skills. For more information, see Chapter 47 *Project Management*.

Some businesses make the mistake of thinking that once they've improved efficiency, greened their products and processes, and offset their carbon emissions, their work is finished.

This is wishful thinking. Doing the hard work of assessing every aspect of your operations, uncovering the hidden costs of business as usual, and weighing the costs and benefits of taking action, should have given you a keen eye for waste and false economy. These are skills that every business owner should have, and use daily. Not only does it make good business sense, but today's competitive pressures—and the advantages of emerging technology—make it essential to your firm's survival.

If you lack the skills needed to create a Green Action Plan, we recommend seeking out NxLeveL®'s *Going Green* course and textbook.

## Conclusion

Greening your business isn't a simple matter of following the latest trend. It's a way of looking at the real costs of your business, and its real effects on your customers, your community, and your world. It takes discipline, creativity, and dedication, but the rewards are worthwhile and measurable.

When your business is more efficient, everybody wins. You save money, speed up production times, reduce waste, and avoid burdensome regulations. Your customers get a better, safer product or service—one they'll feel better about buying than a competitor's brand. And your fellow citizens benefit from cleaner air and water, and smaller demands on natural resources. No matter what kind of business you run, it makes good sense to run it as efficiently as possible. Choosing appropriate, affordable, and attainable green business practices is one of the best ways to achieve this.

# PART VI
# MARKETING YOUR BUSINESS

## Chapter 25
## THE MARKETING PLAN

*About This Chapter:*
- *Marketing means communication*
- *Objectives, strategies, and tactics*
- *Contents of the marketing plan*
- *Getting results from your plan*
- *Evaluating your plan*

### Introduction

Would you consider taking a long car trip without knowing where you wanted to go, which route you would take, how much money you had in the bank, or what stops you would make along the way? Of course not—you'd plan your trip and develop an itinerary!

A plan is just as important for your business's marketing efforts. Your marketing plan describes what you want to accomplish, how you plan to go about doing it, and which tools you'll use in the process. It's your chance to demonstrate your expertise, and your knowledge of your customers and market. It's an opportunity to spotlight the actions you will take to be competitive and successful. The time you spend researching and designing your marketing plan will definitely pay off in the end.

Every team member must understand the importance of marketing

### Marketing Means Communication

In a well-run company, every team member understands the importance of marketing, and treats every interaction with customers as an opportunity to communicate the company's message.

Your Web designer ensures that your site is attractive and easy to use. This communicates your sense of style, your wisdom, and your commitment to making life easier for your customers. The receptionist who answers your phone communicates your friendliness, your knowledge, your efficiency, and your eagerness to solve problems. The shipping clerks who package your merchandise communicate the value you place on it, and on customer satisfaction.

Let's look at that last example a little more closely, because it says a lot about how important little details are to your company's identity. Think what a difference it makes to receive an item that's nicely packaged in clean protective material, versus an item that's been tossed into a stained, flimsy box full of old newspaper. As you can see, the image of your company can depend as much on a part-time shipping clerk as it does on your more elaborate marketing efforts.

And it doesn't stop there. Are your customers concerned about the environment? Should you package your merchandise in Styrofoam or lots of excess plastic, or would it be better to spend a little extra money on biodegradable or renewable packaging?

Should you use free weekly newspapers as packaging material, even if they contain large sections devoted to ads for adult businesses? Your customers may not care, of course…but what if they do?

Anything that affects your customer affects your company!

From a marketing perspective, no detail is insignificant. Anything that affects your customers' perception of your company affects your bottom line. That's why it's necessary to create a marketing plan that explains how all the different parts of your business work together to communicate your company's message consistently.

### Why Every Small Business Needs a Marketing Plan

As an entrepreneur, you have limited time and resources with which to achieve your marketing goals. Your margin for error is smaller than that of larger businesses. You may have loan payments due, another job to hold down, or a family to support. This is no time to spin your wheels! A good marketing plan organizes your thoughts, prevents you from duplicating your efforts, and keeps you from spending your business's precious capital on the wrong things.

Prospective investors and lenders will pay careful attention to your marketing plan. They look to it as an indicator of your business's potential. Who will the business sell to? How will it position itself in the market? How well does it know its customers and its market? How realistic are its goals? What makes it special? The marketing plan must answer all these questions, and many others.

*Marjorie Bowen and her brother Sam grew up on a ranch outside of Denver, wearing sturdy leather cowboy boots while they rode horses and worked the cattle. Over the years, Marjorie became an expert at resoling, relining, and re-stitching her favorite boots to extend their life and improve their appearance. She taught Sam how to do it, and soon they were both repairing old cowboy boots as a hobby. They fixed up their own boots, their parents', and eventually their friends' and neighbors'. They even created their own unique mixture of dye and adhesive for repair work.*

*After working in a local bank for several years after college, Marjorie became interested in starting her own business. What could she do? What did she know well, and what were her hobbies?*

*Boot repair, of course!*

*She thought about how important well-maintained boots were to her, and how great it felt to revive a favorite pair. Inspired, she decided to look more closely at the market for boot repair.*

## Objectives, Strategies, and Tactics

Businesses work to achieve their marketing objectives by designing complementary strategies, and mixing and matching different tactics for each.

**Objectives** are your business's goals within chosen markets. This could mean controlling 20 percent of the market, increasing sales by 50 percent in the next six months, or having 100 new customers by the end of the year.

**Strategies** are your plans for achieving objectives. These may include going after customers who are between 24 and 40 years old, or targeting a niche market for environmentally safe cleaning products. Your marketing strategies show how you've segmented your customers into target groups, and how you'll position your business to show off your competitive advantages to those groups.

Strategies guide each element of the **marketing mix**, which comprises the Four Ps: **product**, **price**, **promotion**, and **placement**. Your goal is to find the ideal balance of these elements, which are discussed in greater detail elsewhere in this book.

Your goal is to find the ideal marketing mix

**Tactics** are the actions dictated by your strategies. Marketing tactics might include repackaging heavy products in smaller, easier-to-lift containers; offering a two-for-one promotion; creating a classified ad that emphasizes your customized service; or distributing your products through specialty boutiques.

## Contents of the Marketing Plan

The marketing plan summarizes your market research and analysis by breaking it down into the following three sections:

- Product Description
- Market Analysis
- Marketing Objectives, Strategies, and Tactics

### Product Description

What is your product, and what does it do? What needs does it meet, and what problems does it solve? Don't limit your thinking to the product itself. Think about the materials that go into it, too. Are the materials American-made? Are they green, sustainable, renewable, or organic? Are they of higher quality than competing brands? How is your product made, and how does that make it special? Does it offer the guilt-free convenience of eco-friendly disposability, or the reliability of long-term sturdiness? Does it offer the excitement of brand-new technology, or the nostalgic pleasure of old-world craftsmanship?

Consider the psychological appeal of your product's design and appearance, too. Remember: Marketing is communication, and every single aspect of your product—from how it's made, to how it's delivered, to how it's used, to how it's discarded—communicates something essential about your company's values.

What makes your product special?

Here are the basic questions your product description should answer:

- What are the features and benefits of your product?
- How is it different? What makes it exciting?
- How will your design choices help sell your product?
- What is the psychological appeal of your product to your target customers?

*Before Marjorie could prepare her marketing plan, she needed information. She began her market research by going online and downloading the census data from her local Chamber of Commerce. She checked demographic patterns for her community and estimated how many cowboy boot wearers there were, based on the number of farms and ranches in her area. Next, she counted the number and types of cowboy boot sellers within 100 miles. She estimated how often people needed their boots repaired by interviewing friends, neighbors, and family.*

*Next, she created a simple one-page customer survey, which she distributed in the downtown shopping district, at several ranches, and the local mall. Using open-ended questions, she asked people where and how often their repair needs were met, what were their most common boot problems, and what people wanted most from a boot repairer. She also asked how much people were willing to pay.*

*When she was finished, Marjorie had confirmed her hunch that there was a market for a custom boot-repair business in her area. And she had identified her market: loyal cowboy boot wearers of all ages—both ranchers and city professionals—located within 100 miles of her town, who spent $100–300 on their boots, and were willing to spend about $60 on boot repairs. These people would typically have at least one pair of boots repaired in the fall and the spring, depending on how often and where they wore their boots.*

## Market Analysis

This is a description of how many customers you have, who they are, where they live, why they need or want your product, how much of it they'll buy, and what they're willing to pay. The goal here is to demonstrate that you've found the correct market for your product, and that it's large enough to support your business.

Market analysis also means assessing your competitors' strengths and weaknesses. Remember that this is the age of e-commerce; depending on your business, your competitors may be headquartered almost anywhere on earth.

Last, market analysis must include **PEST analysis**: this is a discussion of the political, economic, social, and technological landscape in which you and your customers interact.

Depending on your business, this analysis might describe:

- Local, state, and federal regulations, and other legal considerations
- The state of the economy and the impact of globalization
- Public opinion about such issues as immigration, outsourcing, or the environment
- Trends in shopping, distribution, and customer desires
- Population demographics
- The impact of current and emerging technologies on your product, its promotion, and how it's sold and delivered
- Governmental and private investment in green products and technology

Here are the questions this section of the marketing plan should answer:

- How big is your target market?
- What are the major segments of your market?
- Who are your customers?
- What are their needs (a table)?
- What are their desires (a wood table)?
- What are their preferences (a wood table made from bamboo)?
- Why do they buy?
- Where do they buy?
- When do they buy?
- How do they pay?
- How do they feel about your product?
- Is your market expanding, shrinking, or stable?
- Is your market seasonal, or do consumers buy year-round?
- Who are your competitors?
- Where are they?
- What are their strengths and weaknesses?
- How do your target customers feel about them?
- What competitive advantage does your business have?
- How will political trends affect your business?
- How will economic trends affect your business?
- How will social trends affect your business?
- How will technological trends affect your business?

Is your market expanding, shrinking, or stable?

### Marketing Objectives, Strategies, and Tactics

This section of the marketing plan describes where you want to go, how you intend to get there, and the things you'll do to make sure you arrive on schedule.

Here, you will describe your marketing objectives for each of your target markets. Each of these objectives should be measurable and quantifiable, and should have a specified date for completion. You will choose these objectives based on your knowledge of your customers and their buying habits, and all the other data that you'll glean from conducting market research.

Once you've described your objectives, you must explain the strategies you've chosen to reach your objectives (i.e., your marketing mix), and the tactics you've chosen to support your strategies.

Here are the questions you should answer in this section:

- What does your business want to accomplish, expressed as specific objectives?
- How will you position your business in the market?
- What is your marketing niche?
- What is your business's marketing mix (product, price, promotion, placement)?
- In which geographic areas will you sell?
- What product or service enhancements will you offer?
- What financial, technological, and human resources will you require?
- What social and environmental benefits does your business offer?
- What is your timeframe for achieving specific goals?
- What is your schedule and budget for specific marketing tactics?
- What level of sales do you forecast for the next 1, 6, and 12 months?

*Creating sales forecasts*

Sales forecasts should be ambitious, but realistic!

**Sales forecasts** predict how much of your product you'll sell over a specific period of time; they help to pinpoint exactly how and when your business will become profitable. You can create forecasts for target markets, geographic regions, and specific products. They're also useful for planning production schedules, and allocating responsibility, time, and resources.

Sales forecasts should be ambitious, but realistic. It's fine to set a challenge for yourself, but that challenge must be achievable given your time and resources. Also, make sure that your forecasts specify a timeframe for results, and that you clearly set forth the amount of product units you'll sell, and the amount of revenue you'll earn, within that timeframe.

For entrepreneurs—who might be selling an innovative product for which there is little precedent or market information—forecasting can be difficult. That's why they often rely on industry publications, trade associations, or other business periodicals for information on typical costs and profit levels for similar businesses. There are also many professional forecasting companies that offer both general and highly specific forecasting information.

Here are some common approaches to sales forecasting:

- **Breakdown forecasting** means looking at your largest population of prospective customers, then breaking that group down to define the level of sales you can expect from target customers. Begin by gathering data on the population of your state, city, or town, then quantify the number of target customers using such criteria as age, income, needs, preferences, access to technology, or buying patterns. Last, predict the average number of times each customer will buy your product per year. Useful data sources include census reports, surveys, articles in national marketing periodicals, state Department of Commerce data, and information gathered through your own surveys or focus groups.

- **Buildup forecasting** estimates the size of each market segment, and adds them together to arrive at a forecast. A business that sells children's bathing suits could first calculate how many children aged ten and under there are in the four surrounding counties, then add these numbers to estimate total market size.
- **Indirect forecasting** is a method businesses use when they can't get specific market data. Instead, they gather related data to indicate the size of the market. For example, lacking specific information on bathing suit buying patterns for its markets, a business might gather information on total spending on summer play clothing for children. It could also gather data on the number of swimming pools in the surrounding counties, and the number of children enrolled in swimming lessons. You often have to be creative to find relevant, reliable data.


*Marjorie was rarin' to go. She knew her product, she knew her market (she'd been living there for 29 years, after all), and she knew there was a need for her service. Initially, she would work out of a small room in her house. As the business grew, she would rent a more central location in town.*

*Because of the isolated, local nature of her target market, she felt she could rely on three simple, low-cost ways to promote her business: word of mouth; classified ads in her local newspapers; and a colorful display with fliers, which she'd place in the major western supply stores and hardware stores in her area.*

*Once she met her initial sales goals, she'd consider running ads during the farm report on the local AM radio station. But for the time being, she wanted to keep her expenses as low as possible.*

*What was Marjorie's positioning strategy for her service? She would return worn-out boots to top form with the best tools, materials, and expertise around. Her competitive advantage? In-depth knowledge of cowboy boots and unique tricks for extending their life. Also, she was a true professional—and a likable, neighborly one too!*

*Marjorie had successfully begun her marketing efforts long before she invested a penny in her business: she had preliminary knowledge of her customers, her service, her price range, and where and how she would deliver her service.*

## NxLEVEL® TECH TIP
BUSINESS RESOURCES AND THE WEB

The Internet is a marketer's dream. Not only can you find plenty of essential raw data online, you can also find countless services and products that will help you make the most of those data. Here are some sites to visit for a look at the possibilities:

**American Marketing Association** (www.ama.org). This useful site provides all sorts of information about the American Marketing Association and its services.

**D & B MarketPlace** (www.dnb.com). Registration with this site gives you access to reports on any US industry. D&B's Marketing Connection provides marketing tools to help you research your market, identify your best prospects, and locate marketing service providers. It also offers desktop access to D&B's information base of more than 10 million US businesses.

**United States Census Bureau** (www.census.gov). Need demographic information? There's no shortage of it at this site, which provides access to complete US census information.

## Getting Results From Your Plan

Once you've got all the information you need, it's time to think about how best to present your marketing plan. Where possible, you should explain financial and statistical data with simple, easy-to-understand charts and graphs. You don't need fancy charts with 3D graphics and every color of the rainbow; you just need something that will make the pertinent data perfectly clear.

Your finished marketing plan might be several pages long, but first try to state its conclusions in a single paragraph. Give it careful thought—make it brief, to the point, and focused. This will help you to keep track of what's really important when presenting the plan.

Customers and markets are dynamic, so your marketing plan will require fine-tuning

Eventually, you will need to create a more detailed marketing plan that includes long-, medium-, and short-term projections. You may also want to include several "what if" scenarios and contingency plans. Customers and markets are dynamic, so your marketing plan will inevitably require fine-tuning.

### Implementing Your Plan

Your marketing plan sets forth a strict timetable for strategies and tactics, and it's your responsibility to make sure that your team adheres to that timetable.

The most important thing you can do is to plan ahead. Make sure your team members know what's expected of them—and why—well in advance. Remember that newspapers and other media have deadlines for submitting promotional material, and that many other marketing opportunities may require you to think weeks or months ahead. You can use an online calendar system, or put a dry-erase board in the office, or send out regular e-mails. Use any system you want, as long as it keeps your team informed, energized, and on schedule.

## Evaluating Your Plan

The most important part of any marketing plan is committing yourself to it and using it. This should be a living document—one you consult and reexamine at least every three months. This helps you to see what works and what doesn't, and to learn from your successes and failures.

Reexamine your marketing plan at least every three months

Therefore, you must put systems in place that will allow you to judge the effectiveness of your strategies and tactics. One of the most important purposes of marketing is to gather more and better marketing data. Positive and negative results are equally important. Treat every response to your marketing efforts as an opportunity to narrow your focus and improve your targeting.

The best way to keep track of this information is with a computer database. You'll want to set one up before you launch your marketing plan. Use it to keep track of how many customers are new, how many are old, and whether they were influenced by a specific marketing tactic (e.g., a sale). This is vitally important information, so make sure it's backed up often, and that the person in charge of the system understands it perfectly. Try to reduce the potential for input error by using drop-down menus, buttons, checkboxes, and the like. Otherwise, spelling mistakes and incorrect terminology may make data hard to retrieve.

Most important of all, look regularly at how your marketing tactics affect sales. If some aspect of your marketing mix is obviously not producing results after you gave it a fair chance, don't hesitate to change it or drop it.

*With her market research completed and her positioning strategy in place, Marjorie created her marketing plan. She would average 60 pairs of boots a month during her first year. After introductory discounts, she would settle on her preliminary price of $60.00 per pair. After six months, she would investigate extending her services to include custom decoration, heel repair, welting, rebuilding, and repairs by mail. Marjorie was excited to take on bigger challenges, but she knew she had to meet her preliminary goals first.*

*And that's just what she did. Things were slow at first: she had to perfect her technique; find reliable, affordable suppliers; and develop a good working routine. Her biggest worry had been sticking to her budget. She overcame that challenge by hiring a local bookkeeper to keep her books for a small monthly fee.*

*Where necessary, she adjusted her marketing plan to reflect opportunities like a western wear trade show, and several local rodeos. Finally, after eighteen months and a few wise revisions to her marketing plan, Marjorie had met her goals, and was ready to start producing radio ads and expanding her services!*

## NxLEVEL® GREEN TIP

ENVIRONMENTAL BUSINESS RESOURCES

Green marketing is a hot topic these days, and there are many sites and blogs that offer a variety of perspectives on what works and what doesn't. Here are a few sites to get you started on your own research.

**Ecopreneurist** (ecopreneurist.com) provides information on new green products and services for the Lifestyles of Health and Sustainability (LOHAS) demographic, and provides marketing and branding assistance for green entrepreneurs.

**Environmental E-Market Express** (www.buyusa.gov/eme/enviro.html) is a free service of the US Department of Commerce. It compiles environmental market research, trade leads, and events from around the world. You can also electronically submit requests for environmental market research created by the US Commercial Service's overseas staff.

**Natural Marketing Institute** (www.nmisolutions.com) is "a strategic consulting, market research, and business development company specializing in the health and wellness marketplace." Its Website offers data, white papers, and podcasts relating to market trends in health, wellness, and sustainability. You can join their e-mail list for free trend information.

## Conclusion

Your marketing plan identifies your customers, your product, and how you'll achieve your business objectives. It presents the specifics of your business's marketing mix and the sales that you expect to generate.

It also aids management efforts. It synchronizes the different parts of your business, so that all team members understand how their interactions with customers affect the perception and profitability of your business. A clear marketing plan helps you to communicate a consistent message about who you are and what matters to you.

Research and write your marketing plan carefully, and revise it often. A good marketing plan can be your most compelling argument for the viability of your business!

# Chapter 26
# MARKET RESEARCH AND ANALYSIS

*About This Chapter:*
- *What is market research?*
- *The market research process*
- *Market analysis*

## Introduction

**Market research** is the process of gathering the information you need to make informed, intelligent, strategic decisions. What product should you produce, and in what quantity? Which stores should you target? Where should you locate your retail shop? What should you charge for services? Which green business practices should you pursue? How should you use the Internet to attract and retain customers?

**Market analysis** tells you how attractive the environment is for your chosen industry. Who are your competitors? How strong are they? On what basis do they compete? What technology do they use? How and where do they advertise?

Your marketing plan is the road map for your business, so make sure it's based on accurate information. Your market research and analysis must be valid, reliable, and representative of your target customers.

Your marketing plan is the road map for your business

## What is Market Research?

Market research allows you to identify opportunities, test alternative strategies, evaluate marketing performance, and predict changes in your market. It also gives you feedback so you can challenge your assumptions and fine-tune your marketing mix.

Effective market research requires planning, collecting, and analyzing data about your customers, industry, and competitors. It's an ongoing process of understanding the changing environment in which your businesses operates.

### Demographic and Psychographic Data

**Demographic data** describe specific characteristics of an individual such as age, level of education, occupation, income, marital status, and address. Businesses gather demographic data to discover who and where their customers are.

Psychographic data give marketers insight into how prospective customers live, make buying decisions, and plan for the future.

**Psychographic data** describe an individual's activities, interests, opinions, and beliefs, and give marketers insight into how prospective customers live, make buying decisions, and plan for the future.

These data are particularly useful for small businesses, who usually offer more personal customer service than larger competitors.

In the following pages, we'll look at some recent demographic and psychographic trends.

### Three Major Demographic Trends

*The changing age make-up of the American public*

In the United States, 77 million baby boomers (people born between 1946 and 1964) make up one-third of the population, and represent more than one-fourth of the economy's purchasing power. The size of the youth market (people aged 12-19) is expected to continue decreasing, but their spending is increasing. The mature market (50 years old and up) commands half of the discretionary income in the United States and holds 77 percent of its assets. Within 30 years, one-third of all Americans will fit into this group.

*Rural rebound*

Studies show that America's rural and suburban areas continue to gain population, a phenomenon that was dubbed "rural rebound" in the late nineties. Skyrocketing consumer debt, a tough job market, the volatile price of gasoline, ever-lengthening commutes, and new communications technology have caused many American suburbanites to stop commuting to jobs in metropolitan areas.

Many small towns are trying to rejuvenate their struggling commercial areas, having found that an increasing number of residents prefer to look for the things they need closer to home. In some areas, "suburban villages" that previously had few or no services outside of a mall or shopping complex have seen an influx of entrepreneurial retail shops, and have become more self-sustaining, diverse, and pedestrian-oriented.

At the same time, many of these communities are facing urban problems as they increase in popularity, including poor air quality, traffic congestion, and crime. This has led to a greater interest in land use and environmental issues, and an emphasis on "smart" and "sustainable" growth.

*Changes in the ethnic makeup of cities and towns*

By 2042, minority groups are expected to make up more than half of the US population. As minority populations rise, many businesses are altering their products and marketing strategies to attract minority customers.

The influx of minority groups into rural America has also led to new business opportunities, as well as new competitive threats to existing businesses from entrepreneurial immigrants.

### Three Major Psychographic Trends

*Increased interest in "healthy" lifestyles*

As healthcare costs and insurance premiums rise, Americans are giving up smoking, drinking less alcohol, and eating less meat. Fat-free, low-fat, low-salt, sugar-free, and "natural" products are increasingly popular. Americans are more interested in fitness and the environment, too; they're exercising, jogging, climbing, hiking, biking, and swimming more avidly than ever before.

*Ethical consumption*

Although the explosion in green and sustainable business is the most visible example of socially engaged buying, it is part of a larger trend towards ethical consumption. Consumers increasingly believe that their buying decisions can help their families, their communities, their country, endangered species, or the planet. This attitude isn't restricted to a particular political viewpoint, although specific *types* of ethical consumption often do reflect the buyer's political values.

As this trend grows in popularity, it has inevitably attracted businesses that attempt to cash in without delivering the ethical results consumers demand (in green business circles, this is known as **greenwashing**). As a result, customers are educating themselves and becoming more skeptical, which is a trend that will strongly favor transparent and authentic businesses that deliver on their promises.

An allied trend is **deconsumption**, in which consumers may forego purchasing unnecessary items instead of buying "green" versions. This has driven some entrepreneurs to make products from materials that would otherwise end up in landfills, in order to reduce the use of raw materials to the bare minimum.

*Personalization*

Although successful businesses have always strived to meet changing consumer needs, online business has drastically shortened the timeframes involved, and intensified the competitive pressure on the average business. Even if you don't make a customizable product, consumers may expect you to offer highly individualized service, promotional messages, price breaks, or delivery options.

However, the fact that consumers expect personalization doesn't necessarily mean they're willing to supply the personal data that high-level personalization requires. The growth of personalization depends to a huge extent on trust, which in turn depends on the security of stored data and payment systems, but also on the public perception of a business as trustworthy and transparent.

### Trends Mean Opportunity

Trends like these (and the countertrends that form as reactions to them) present a tremendous opportunity for entrepreneurs, and not just for businesses in large cities. Even the smallest rural communities are affected by such trends.

Trends present a tremendous opportunity for entrepreneurs

For example, you may think that a trend towards longer commutes has no importance for you. But when you look more closely you might find that in the past two years, traffic on your local highway has increased by 20 percent, and that 30 percent of that traffic consists of women commuting to work. Seeing an opportunity, you might investigate opening an express dry cleaner/coffee shop somewhere along the highway, that will cater to professional women.

*Twila Robinson participated in seven weddings in one year, and ended up with seven bridesmaid's dresses that she felt were ugly, ill-fitting, and of poor quality. She was fed up!*

*While she was helping yet another girlfriend plan a wedding, her friend suggested that they work together to design and sew her wedding dress and bridesmaid's dresses. Twila was enthusiastic about the idea; she loved to sew and make clothing for her friends (she'd even helped design and sew wedding dresses for two very tough customers, her sisters-in-law).*

*The project went so well that Twila became intrigued by the idea of starting a new business—one that would generate a little extra income and allow her to use her creativity.*

## The Market Research Process

While large corporations have the budgets to create entire market research departments or hire research consultants to test their ideas, smaller businesses have to be more creative. Limited budgets mean most entrepreneurs depend on salespeople, distributors, and their own ingenuity to conduct and gather market research. Quality market research can indeed be gathered for little or no money, but it does take effort.

Your research should be guided by an initial set of objectives; this helps to keep the project within budgetary constraints. It's also a good idea to break the research process into small parts. This organizes your efforts, and makes the task a lot less intimidating.

### Understanding Your Customers' Buying Behavior

What, when, why, where, and how do customers buy?

To create a profitable business, you must identify and satisfy your customers' needs. One of their most important needs is the ability to buy in the manner, time, and place they choose. Market research helps identify customers' needs, and uncovers buyer behavior—the attitudes that influence what, when, why, where, and how they buy.

***How do individual consumers make purchase decisions?***

Consumers who buy products through retail outlets make their decisions in different ways depending on the products they buy. (Just think how differently you'd go about buying a car, a candy bar, or aspirin.) In general, buying behavior involves identifying a need, gathering information, evaluating alternatives, making the purchase, and evaluating satisfaction.

Consumer purchases vary according to the following:

- **Level of involvement.** How important is the product to customers? What percentage of their income does its price represent? How often do they buy? How complex or unique is the product?
- **Degree of brand loyalty.** How important is a particular brand to customers? Do they associate the brand with particular events, memories, related products, or people? Or do they fail to distinguish between different brands altogether?
- **Habits and learning.** How complex is the decision process? How much must customers know to make an informed purchase? Do they purchase the product habitually? Or must they learn something new—or change old behavior—before buying?
- **Consumer motivation.** Why is the customer making the purchase? Is it satisfying physiological (food, shelter), safety (protection, security), social (acceptance, friendship), ego (prestige, success), altruistic (good for people, animals, or the environment), or self-actualization needs? Note that many purchases are motivated by more than one of these factors.
- **Consumer perceptions.** How do consumers perceive different brands and product offerings? By what criteria do they evaluate different products? Do consumers have a positive or negative image of a product?

*How do organizations make purchase decisions?*

For the most part, organizations buy very differently than consumers do. Their purchases are riskier, because if the components they buy fail, so will their finished product. There's usually more negotiation and ongoing business relationships between buyers and sellers, so personal selling tends to be more important in business-to-business markets than in consumer markets.

Personal selling tends to be more important in business-to-business markets than in consumer markets

For important or expensive purchases, businesses often rely on teams to dictate product performance and type. Within the buying team, individuals tend to fall into the following roles:

- The **gatekeeper** regulates the flow of information to the team, and finds alternative products and vendors.
- The **influencer** has some ability (based on experience, position, or technical expertise) to influence the other members of the team.
- The **buyer** decides what to purchase, and may help to evaluate different choices (although he or she often defers to colleagues who have more technical expertise).
- The **user** helps set product specifications, and evaluates the product after using it.

Knowing who fills these roles, and how they make decisions, can help you focus your sales efforts. For more information, see Chapter 32 *The Art of Selling*.

## Define Your Research Objectives

If you're targeting an industry that's new to you, there will probably be a lot of information you don't have. Your research objectives might be to identify events, trends, or cause-and-effect relationships in your marketplace; or to define specific problems.

Start by writing down the information you need to fill the gaps in your knowledge. Are customers spending less on your type of product? Is there a viable distribution channel for your product? Are production costs prohibitively high?

As you define your research objectives, try the following:

- Rephrase questions about your market to get a new perspective.
- Test your objectives by creating sample data about your market. Do they help to answer questions and inspire strategy?
- Identify the most and least important issues, and prioritize your research.

Try not to let social, political, or philosophical prejudices and assumptions influence your thinking. Start out with an open mind, and expose yourself to plenty of viewpoints that differ from your own. Remember that no one is always wrong or always right, and that things aren't necessarily true just because you want them to be.

Listen to what you need to know, not what you want to hear!

At every step of this process, you should approach your data—and your opinions—with a healthy dose of skepticism. Instead of trying to confirm your beliefs, try to disprove them. That way, you'll learn what you *need* to know, instead of what you *want* to know. If you don't learn things that surprise you and challenge your assumptions, there's a good chance that your research wasn't thorough enough.

When defining your objectives, be sure to create a realistic budget and a timetable for each of them. If you don't place firm financial and time boundaries on this process, it can easily spiral out of control.

*Twila decided to investigate opportunities for designers and seamstresses of wedding and bridesmaids' dresses in her community. She wanted the following information:*

- *The geographic area of her market*
- *The market for wedding gowns and bridesmaids' dresses in her region, as determined by tracking marriage rates, population size with age breakdowns, and income levels*
- *Potential sales volume for the first year*
- *How much brides were willing to pay for dresses*

*Twila's major marketing problem: Could she count on the current wave of weddings to continue and support her in a full-time business? Or would she have to operate part-time and continue her sales job? How could she compete with the bridal sections in local department stores?*

## Conduct a Situation Analysis

A **situation analysis** is a preliminary look at the available market information. It tells you whether you must spend time and money gathering your own, original market research. A good situation analysis takes little time and delivers a lot of information.

- **Primary data** are collected for the purpose of answering questions about your customers or markets. This may involve observing customer behavior, or designing questionnaires and surveys to learn more about a representative customer population.
- **Secondary data** comprise information that has already been gathered and published. This information might come from academic research studies; articles in magazines, trade journals, or newsletters; census reports; or contact with distributors, middlemen, customers, competitors, or other knowledgeable people in the industry. You can answer many research questions through readily available (and free) secondary data.

## Identify and Plan Primary Research

If you complete a situation analysis and find there are insufficient secondary data, you'll need to gather your own primary data.

When businesses gather primary data, they generally go after **qualitative data**, which are data that can't be quantified or counted. A person's political beliefs, interest in backpacking, or preference for chocolate over vanilla are examples of qualitative data.

**Quantitative data** describe statistical quantities that can be measured and analyzed. What do your customers earn each month? How old are they? How much do they spend each month on groceries? Rent? Gas? How many kids do they have?

Businesses use two major methods to gather this data: surveys and observation.

*Surveys*

Surveys are the most widely used means of collecting primary qualitative and quantitative information, including facts, opinions, and attitudes.

Surveys are the most widely used means of collecting primary data

The first step in creating a survey is to decide to whom you'll give it. This group, chosen from the target population (i.e., the people whose opinions, behavior, preferences, and attitudes influence your marketing strategy), is known as a **sample**. Sample selection can be random or non-random.

- **Random sampling** ensures that each member of the target population has an equal chance of being included. These samples have greater validity, but can be time-consuming, expensive, and complex to design and execute.
- **Non-random sampling** is usually done to save time, money, or simply because it is more convenient. However, it's hard for a researcher to calculate the degree to which the non-random sample represents the larger population.

Businesses that use non-random samples try to choose respondents who represent their target customer base, in that they live in a specific geographic region, or fall into an age, income, or lifestyle bracket.

Which sampling method you choose depends on the type of research you're conducting, and the amount of time and money you budget. Because your business is small, you'll probably opt for the convenience of non-random sampling. This may include a list of current customers, people who fit your customer profile, members of your church, or people who shop at your local grocery store.

Make sure your respondents represent a cross-section of your customer base

As you create your list of respondents, make sure they represent a cross-section of your customer base; too many of any type of respondent will skew your findings.

Here's a brief summary of random and non-random sampling techniques:

| Random Sampling Techniques | Non-Random Sampling Techniques |
|---|---|
| Computer programs can select random samples from electronic lists of names (telephone books or customer lists) | Select targets on the basis of convenience, or referrals from other respondents |
| Using a list of people (e.g., telephone list), assign a number to each name, select numbers from a table of random numbers, and choose the numbered entries on the list that correspond to those random numbers | Use your judgment to determine who is best to include in the sample on the basis of how well the person represents your targeted population |
| Decide on a "skip interval" (e.g., select every third or fourth name) | Use a quota system that designates how many respondents of each gender, income bracket, geographic location, education level or other criteria you will sample |

The most common types of survey research include:

- **Personal interviews.** These can either be **focus groups** or individual interviews. Focus group interviews are the most widely used questioning technique for gathering market research because they can yield very in-depth information. Interviews gather qualitative data about a target group. They can be conducted door-to-door, by intercepting people as they shop in a mall, or at a booth or trailer set up by the business conducting the research.
- **Internet surveys.** Online surveys are usually free or low-cost, and can generate valuable data in a very short time. Although the response rate is often low, the cost of conducting the survey is low enough that it doesn't really matter. Remember, though, that Internet surveys inherently target people who have a certain level of technological capability and expertise. If you're targeting older people in a rural area, your online respondents may be very different from your target customer. If you do use online surveys, be sure to include a space for the subject to add additional comments; this can bring in information you don't expect. You can use sites like SurveyMonkey.com to create free surveys.

- **Telephone interviews.** These are best for shorter interviews (five minutes or less). They can be more economical and time-effective than personal interviews, but it's getting hard to find people who are willing to interrupt their at-home time to participate. Keep your questionnaire short and concise!

Remember, your goal is to gather reliable, relevant, and accurate information. Be careful not to taint your respondents' answers by asking leading questions or offering feedback. Always ask open-ended questions with an open mind. The most valuable answers are usually spontaneous, unprompted, and free-form.

**Creating a Survey? Try These Tips!**

- Keep questions short, simple, and to the point.
- Use a rating scale of 1 to 5 (1 = strongly disagree; 5 = strongly agree).
- Surveys should take no longer than 5-10 minutes to complete.
- Be careful not to bias the answers with leading questions or feedback.
- Offer respondents some reward for completing the survey.
- Always be professional and polite.
- Say thank you!

Tracking past customer behavior often helps to predict their future behavior

***Observation***

Through observation, marketers try to determine how consumers behave as they buy and use a product, or how they're influenced by marketing strategies. The pitfall of observation is that the observer can influence the subject's behavior.

Museums, department stores, and even professional sports venues use observation to understand their visitors' movements and needs. Most retail stores use checkout scanners or other simple computer software to keep track of buying behavior. Tracking past customer behavior often helps to predict their future behavior.

*Twila decided to give herself one month to gather her data. She began by buying all the major bridal magazines, and visiting every Website she could find on brides and wedding planning. What sort of dresses were women buying, and where did they shop? Who were the major manufacturers, fabric suppliers, boutiques, and designers?*

*Next, she went to the library and gathered the census data for her city and county, and scouted out the yellow pages for bridal shops and tailors.*

*She pretended to be a customer, and visited each one to find out what they offered, what they charged for dress design and sewing, how many fittings they required, and how long it took them to deliver the finished product. She even asked for the names of past clients as references.*

### Conduct Secondary Research

After conducting a situation analysis, many small businesses find that they can get most of their information through secondary research. However, secondary data often lead to the use of primary research to gather limited, specific information.

Typical information sought through secondary research includes market size, location, and growth patterns. You can also use it to get a better quantitative understanding of your customers: where they live, how numerous they are, their income brackets, educational level, and buying patterns.

The sources of quality secondary data are almost limitless, especially online. For more information, check out **Harris Interactive** (www.harrisinteractive.com). Be sure to subscribe to all of their free electronic newsletters on emerging trends! You can also visit **SourceLink** (www.sourcelink.com).

Here's a condensed resource list for collecting secondary data.

- Public libraries
- University libraries
- Government agencies
- Trade and industry associations
- Chambers of Commerce
- Business periodicals

For more resources, consult your ***NxLeveL® Workbook and Resource Guide.***

### Analyze Data and Prepare Final Summary

The purpose of analysis is to interpret and draw conclusions from the data you've collected. The more completely you wish to understand your market or survey findings, the more rigorous your research design and data analysis must be. The most comprehensive form of data analysis uses statistical models to test the validity of the findings. (Inexpensive computer software packages can perform this type of analysis.)

However, for most small businesses it suffices to gather the data, and work to draw reasonable conclusions from them. Here are some hints:

- Challenge the validity of your findings
- Check the information for completeness and timeliness
- Recheck to ensure the findings are representative of the larger population
- Assign value and weight to the findings
- Review your findings with a mentor or industry expert

Review your findings with a mentor or industry expert

That last recommendation is especially important. You should always seek insight and feedback from an experienced businessperson. It's also a good idea to write a brief, informal summary of your findings that explains your conclusions and your action plan.

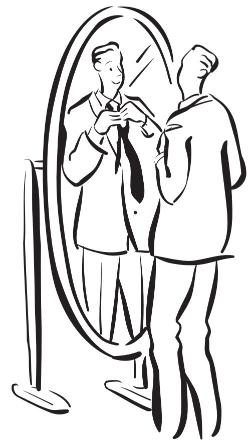
Revisit this summary frequently, and as you move forward, compare it to new conditions in your market. At the end of the market research process, you should be able to incorporate your findings into a market strategy.

Your target market and marketing mix should flow logically out of the market research process.

### Drawing Conclusions

After gathering sufficient data, you should be able to answer the following questions:

- Who are your target customers?
- Where do they live?
- What are their numbers by city, county, and state?
- How much do they earn?
- What are their spending patterns?
- What do they spend annually/monthly on products like yours?
- What amount of your product do they buy annually/per sale?
- During what time of year do they buy?
- What motivates them to buy (status, security, altruism)?
- What are their saving patterns?
- What's their family structure?
- What's their educational level?
- What are their leisure activities?
- What media do they read, watch, or listen to?
- What sort of technology do they own, and how do they use it? What are their Internet usage patterns? Are they early adopters of new technology, or are they slow to catch on to emerging tech trends?
- Who are your best prospects?
- Should you emphasize your quality offerings, your price, your environmental ethics, your customized products, or merely the existence of your business?



*The information Twila had gathered was helpful, but it wasn't enough. She needed more specific information about the needs and tastes of her prospective clients. What could she do better than her competitors, and would it add value for her customers?*

*She decided to organize several focus groups. She used non-random sampling to select her participants. She chose two girlfriends and eight other women who had been referred to her, and divided them into two separate focus groups. Twila was careful to use open-ended questions, and to encourage all of the women to participate.*

*She also made sure that the discussion stayed roughly on track and covered the following topics:*

- *What were their most important criteria in selecting a bridal boutique and wedding dress?*
- *What was the ideal environment for trying on, buying, and being fitted for a dress?*
- *How satisfied were they with their wedding and bridesmaid dresses (price, service, style, quality, selection)?*
- *What would they change about their dress buying and alteration experiences?*
- *How important were friends' recommendations in selecting boutiques and dresses?*
- *How far they would be willing to travel for a good seamstress and designer?*
- *How much would they be willing to pay?*

## NxLEVEL® TECH TIP

### BUSINESS RESOURCES AND THE WEB

One of the most promising new market research strategies is the use of customized phone cards. How does it work? Here's a typical scenario: You contact a phone card marketing company and purchase 500 customized phone cards imprinted with your company's logo. You mail them to targeted customers, along with a number they can call to activate the card.

When the customer calls, he or she is asked to respond to a survey lasting approximately five minutes. After the survey is complete, the customer has 30 minutes of free long-distance time left on the card.

It is reported that the use of phone cards in marketing surveys results in a response rate two or three times higher than that of traditional surveys. Best of all, phone cards are inexpensive and yet are perceived by customers as having a high value. Therefore, receiving a free long-distance phone card often leaves the customer with a positive feeling about your company.

Phone cards are available in various increments, ranging from ten minutes to half an hour or longer.

A good preliminary Website at which to investigate phone card marketing is **www.mhacom.com**.

## Market Analysis

Competitors, economic trends, and industry standards are the major factors that comprise a business's external environment. Although these conditions are out of your control, understanding them allows you to tailor your marketing strategy to the changing demands of your environment.

The goal of market analysis is to help you understand your environment, determine the level of attractiveness of a given market or industry, identify competitors' strengths or weaknesses, and identify your business's strengths and weaknesses.

Looking at your environment is only half the picture; you also need to look at your internal capabilities. These include experience, knowledge, skills, financial resources, and technical excellence. If you analyze your internal and external environment and devise a strategy that maximizes your strengths and minimizes your weaknesses, you'll be far ahead of the game.

### Competitive Analysis

When market needs aren't being met, opportunities arise. To identify these opportunities, businesses usually perform some form of **competitive analysis**. This means assessing your potential market's overall attractiveness. Competitive analysis comprises industry analysis, competitor analysis, and SWOT analysis.

When market needs aren't being met, opportunities arise

*Industry analysis*

**Industry analysis** identifies how attractive your industry is, and helps you compete if you decide to enter the market.

After doing some research on your industry, rate the degree to which the criteria listed below apply, using a scale of 1 to 5 (1 being the least and 5 being the most).

The criteria that determine an industry's attractiveness are:

- **Ease of entry.** This describes how many barriers there are for new businesses trying to enter the market. High production costs, long set-up times, complex technical knowledge requirements, strict environmental regulations, and logistical challenges are examples of barriers to entry. The greatest barrier is a competitor with a large marketing or cost advantage. A high score here means that your industry is very difficult for new competitors to enter.
- **Level of competition.** This describes the number of competitors in the market and the nature of their competition. When a market is mature and sales are leveling off or decreasing, competition is at its most intense, and the chance of gaining an edge (or even entering the market) is slim. Revenues might be falling, technological breakthroughs are few, and businesses may compete on the basis of price alone. A high score here means that you have many competitors.

- **Availability of substitutes.** This describes how easily customers can use substitute products from other industries to satisfy their needs. An example would be customers of rental car companies who fly low-cost commuter airlines instead of driving. A high score here means many substitute products are available.
- **Buyer leverage.** This describes the bargaining power that buyers have over businesses in the market. A high score here means that because buyers have many choices and spend comparatively little on products in the industry, their bargaining power is high. Therefore, they can drive down the price and influence the content of the product.
- **Supplier leverage.** A business that relies on a limited number of large suppliers is vulnerable to price increases, and suppliers may dictate the terms of sale. This can make a market less attractive by raising costs and reducing your ability to control your markets. A high score here means that your suppliers have a lot of leverage.

Now, calculate the total points for your industry:

- **17-25 points.** Your industry is very competitive, so be prepared for an uphill struggle. Unless the rewards are great enough to offset the risk and cost of competing in this industry, you may want to consider industries with less competition.
- **10-16 points.** Entering this industry won't be easy, but it may well be worth the trouble if challenges in some areas are offset by opportunities in others. Look before you leap!
- **5-9 points.** Do industries this attractive really exist? Yes, but not for long. If you're lucky and clever enough to have identified an industry that has low competition, is relatively easy to enter, and is in its most immature stage, you should move, and move fast!

*SWOT analysis*

Avoid challenging your competitors head-on in areas where you share core competencies

**SWOT analysis** means examining your business's Strengths, Weaknesses, Opportunities, and Threats, and comparing them to those of your competitors. This is particularly important for entrepreneurs who are considering entering a market for the first time. Unless you're looking for a long, expensive, frustrating struggle, you'll want to avoid challenging your competitors head-on by competing in areas where you share core competencies.

*Competitor analysis*

This is a SWOT analysis of your competitors, both actual and potential. You can gather information about your competitors in many ways. Call them up and ask the questions a prospective customer would. Try to find out what their strengths are, how long they've been in business, and what new products they plan to announce. You might also talk to other businesses who've dealt with them.

Regardless of how you gather your information, get it from a wide array of sources to ensure that it's accurate and up-to-date, and make sure it includes the following details:

- **Product.** What are your competitors' products? How are they unique? What needs do they meet? What types of packaging do they use? How much personalization do they allow? What service enhancements do they offer? In what stage of their life cycle are they? How green are they?
- **Pricing.** What price structures do your competitors use? How are they positioned? How do their prices fit their brand?
- **Promotion.** How do your competitors promote their products? What is their advertising message? What's their brand identity? How are they using the Internet to promote themselves?
- **Placement.** Where do your competitors locate their businesses, and why (e.g., is a supplier nearby)? What channels of distribution do they use? Will you have to use the same ones?

Answering these questions will form a picture of whom your competitors are targeting and why, and may help you predict their future plans as well as their response to your business's entry into the market. It can also yield valuable information on marketing practices your business can imitate or improve upon.

### Should You Compete in This Industry?

You've just completed your first competitive analysis. Each of the three elements—industry analysis, competitor analysis, and the SWOT analysis for your own business—has given you new insight into your core competencies.

Now, complete the process by drawing some conclusions about how and where to compete in your industry. This is the first step in creating your marketing strategy.

Review your findings (preferably with a business mentor), and challenge your assumptions, just as you did with your market research. Ask yourself if have the quantity and quality of information you need in order to invest your money confidently in your business idea.

Do you have the information you need in order to invest your money confidently in your business idea?

If you have any doubts, reassess your mission and your findings. You may want to look at your business in a new way, or look for other business opportunities.

Remember, you're choosing the direction that will guide all of your strategic marketing. Be clear, and condense it down to a simple concept that is expressible in ten words. If you can't do this, you need to beef up your knowledge of your market and your customers, and fine-tune the purpose of your business.

*Twila rounded out her research by going online and using Google to search for keywords like* ***bridal***, ***fashion***, *and* ***weddings***. *She was pleasantly surprised to find that a number of Websites gave her information on the latest wedding trends, buying patterns, and colors for dresses. She was also able to get statistical data on marriage trends in her city, county, and state.*

*Once she'd put all the data together, weeded through it, organized it, and analyzed it, she felt that the opportunity she'd identified was a viable one. Twila felt she had a solid level of knowledge on which to base a marketing strategy, and was inspired to complete a business plan.*

*Today, Twila earns a good amount of extra income as a seamstress and designer. In fact, she earns enough that she's seriously considering quitting her job, and looking into the possibility of designing other types of clothing.*

## NxLEVEL® GREEN TIP

ENVIRONMENTAL BUSINESS RESOURCES

Here are some good sources for green market data.

**Environmental Business Journal** (www.ebiusa.com) calls itself "the leading business newsletter for the environmental industry." It provides up-to-date information on competitive strategies, new business opportunities, and market trends and data. It also offers a series of useful environmental market reports, and a free weekly news update via e-mail.

**SPINS** (www.spins.com) provides "quantifiable information on Natural Product Industry sales across retail channels, and on the consumer and market dynamics underlying the industry's rapid growth." Their offerings include "retail measurement services for the natural and conventional retail channels," and a "comprehensive Product Library, including product hierarchies, segmentation and attributes for over 400,000 UPC-coded items."

**Hartman Group** (www.hartman-group.com) publishes "reports, books, magazines and newsletters on all aspects of the wellness arena," and offers "the latest thinking on a wide range of consumer behavior issues, cultural lifestyle trends and industry practices that affect innovation, design, strategy, operations and branding across a broad spectrum of industries and functions." Free newsletters and podcasts are available.

## Conclusion

The more competitive your industry, the better you'll have to be at finding ways to create value for your customers and exploit the weaknesses of your competitors. Market research and analysis provide the information you need to identify marketing opportunities and problems, understand buyer behavior, and develop marketing strategies.

This is an ongoing process, because your competitors, your industry, and your business's strengths are continually changing.

You don't have to rely solely on your intuition, or spend thousands of dollars on market research and analysis; there's a great deal of free and low-cost market information available to you. Your task is to define what you need to know, and seek answers in an organized and creative manner.

# Chapter 27
# MARKET OBJECTIVES, STRATEGIES, AND TACTICS

*About This Chapter:*
- *Marketing objectives*
- *Marketing strategies*
- *Marketing tactics*
- *The importance of persistence*

## Introduction

Suppose you believed your customers needed a better mousetrap, simply because you could build one. You might put huge amounts of time and money into designing a hand-carved mahogany mousetrap complete with digital readout, a detachable tripod, and an am/fm radio that works even in the shower.

It's safe to say that despite all your efforts, no one would buy the mousetrap. Why? Because they'd realize that an old-fashioned mousetrap works just as well (if not better), and costs a lot less!


Most successful businesses design their marketing strategies around the needs of their customers

Businesses that sell what they produce, rather than catering to their customers' needs, are said to suffer from a **product orientation**. By contrast, most successful businesses have a **customer orientation**: they design their marketing strategies around the needs of their customers. They do this by segmenting their markets, customizing their strategies to fit these segments, and choosing tactics that fit their strategic goals.

## Marketing Objectives

Your marketing objectives will be based on your market research and analysis. Suppose you estimate your market to be worth $200,000 in sales each year. You might decide that a realistic marketing objective would be to control 15 percent of that market, or have $30,000 in sales in the next 12 months. Or, because of fierce competition, your marketing objective might be to have a certain number of customers in the first six months.

Other marketing objectives might include:

- Achieving a certain percentage of growth in sales, customers, or market share
- Adding variations of existing products to existing markets
- Entering a new market with an existing product
- Introducing a green version of your product
- Diversifying into different areas of business

### Setting Boundaries

Setting boundaries around your marketing objectives will sharpen your focus. These boundaries might include specific sales targets in units, dollars, or market share. Here are some useful boundaries to consider:

Set performance goals for each marketing strategy

- **Create a timetable** for your promotional, pricing, product, and placement strategies, including the points in time at which you'll measure and reevaluate these strategies.
- **Set performance goals and standards** for each marketing strategy. How many sales will it generate? How much time or money will it save? How many new customers will it attract? How many new distributors will it attract?
- **Create budgets** for your promotional, pricing, product, and distribution strategies. Decide how much to spend on each marketing tool over a specific period of time, how to track and tally your expenses, and how much money to reallocate if the need arises.
- **Evaluate your marketing strategies** by asking how successful each element of the marketing mix has been. Is your product satisfying customer needs? Are you effectively using service to enhance your product? Is your pricing method profitable? Is your distribution network cost-effective, and does it perform as you expected? Are your promotional messages hitting your intended targets?

*In the summer of 2008, Tena Black opened a small espresso stand in the heart of Denver's financial district. She sold coffee made from the best and freshest beans, served any way you can imagine.*

*Plain coffee? Easy!*

*Double no-foam latte with almond syrup? Sure!*

*Single-shot large mocha with vanilla soy milk and no whipped cream? No problem!*

*In Tena's words, her core concept was "The best coffee in town, served any way people want it."*

*Tena's stand was located on the ground floor of a high-rise office building. She was the nearest espresso source for the 1,600 people who worked in her building and the three adjacent buildings. There was a Starbuck's a couple of blocks away, but it always had a line. Tena knew her service had to be faster and more personal than theirs!*

## Marketing Strategies

Marketing strategies guide tactics, so that you can achieve objectives. Like objectives, strategies are guided by your market research and analysis. Your strategies must fit everything you've learned about your customers, your competitors, your industry, and the political, legal, social, technological, and economic environments in which they operate.

The most basic step in choosing market strategies is to identify different market segments and their needs.

### Market Segmentation

Businesses commonly divide their market into **market segments**. These are groups of customers with similar needs and characteristics.

Unlike mass marketing, which aims to sell a single product to as broad a group of customers as possible, the purpose of market segmentation is to identify one or more **target markets**.

Here are some things to consider when assessing a target market:

- Measurable characteristics and clearly defined boundaries
- Size and sales potential
- Needs that aren't being met
- Growth rate (stable or expanding)
- Presence and strength of competition
- How well it suits your business's goals and capabilities
- Percentage of the market you can realistically target, given your budget and the efforts of your competitors
- Percentage of the market you must capture in order to break even

You should also think about the target customer's attitude towards current and emerging technology (e.g., interested or disinterested, knowledgeable or confused, positive or negative), the customer's ability to afford the technology in question, and the role of technology in the customer's career, family life, and leisure activities. This is relevant to how you approach prospects (e.g., e-mail), whether you will sell online, which features are appropriate for your Website, what tools you will use to manage customer relationships, and so forth.

Next, you should assess whether your target markets are accessible, given your goals, resources, and core competencies.

- Can you deliver better service and value than your competitors?
- Will serving this market enhance or detract from your business's brand image?
- Do you have the necessary financial, technological, and human resources?
- Can you effectively communicate your promotional message to this market?
- Do you have a supply chain in place that will allow you to serve this market?

Can you deliver better value than your competitors?

To identify market segments, you must group your prospective customers by needs, behavior, and lifestyle characteristics

*Segmentation strategies*

To identify market segments, you must group your prospective customers by needs, behavior, and lifestyle characteristics. Consumer markets can be segmented in the following ways (or by some combination thereof):

- **Demographic segmentation**. As we discussed in the last chapter, demographic segmentation is usually based on age, level of education, gender, occupation, income level, marital status, ethnicity, language, religion, and family size.
- **Psychographic segmentation** is usually based on interests, activities, opinions, values, politics, and beliefs.
- **Behavioral segmentation** is based on observations of customer browsing and purchasing behavior, and the effects of pricing, promotion, and placement on that behavior. For example, people who shop at big-box stores like Wal-Mart may have a very different behavioral profile from people who shop at specialty markets like Whole Foods.
- **Geographic segmentation** varies: it can be by continent, or by neighborhood. It can be by population size (e.g., cities with a population over 500,000), or by population density (e.g., urban, suburban, or rural). Depending on your product, you might also consider climate and topography (e.g., coast versus plains; mild versus harsh winters; floods versus tornadoes).

*Tena estimated that in the four buildings nearest to her there were a total of 450 espresso drinkers, each of whom drank at least one coffee drink per day. She had to earn these people's loyalty quickly and completely! Tena's marketing objective was to control 60 percent of this market within six months, which would give her 270 regular customers.*

*Tena did research by talking with others in the business, reading beverage industry journals, and attending a gourmet food and beverage expo. She discovered that there were many different types of customers within the espresso drinking population.*

*Based on this information, she divided her morning customers into three segments:*

- *"The high-caffeine, high-calorie Herberts" preferred traditional espresso drinks and sweet snacks (50 percent of her market)*
- *"The high-caffeine, no-calorie Susans" preferred espresso drinks with low- or nonfat milk, and healthy fruit or nonfat snacks (40 percent)*
- *"The decaf, low/no calorie healthy Heathers" preferred decaf coffee drinks with nonfat or soy milk, healthy fruit or nonfat snacks (10 percent)*

*These segments and their numbers guided Tena in stocking and promoting her coffee stand. After three months in business, it became clear that her information was on target.*

*Targeting strategies*
Once you've identified your target markets, you must decide how to target them. Here are some common targeting strategies:

- **Single-segment targeting.** This means targeting a single market segment with a single marketing mix. This can be a high-risk strategy, because your company is vulnerable to sudden changes in taste or the entry of a larger competitor, concentrated marketing along these lines has often proved to be attractive to small companies with limited funds.
- **Multiple-segment targeting** targets multiple segments with a variety of customized marketing mixes. Also known as **selective specialization**.
- **Product specialization.** In this strategy, you tailor a single product to the needs of different market segments.
- **Market specialization.** In this strategy, you target a single market segment with a variety of different products.
- **Full market coverage.** As you've probably guessed from the name, this strategy involves targeting your entire market with a single marketing message. This is a costly strategy that is usually beyond the reach of small businesses, and may also be inappropriate for their products and services.

## NxLEVEL® GREEN TIP
ENVIRONMENTAL BUSINESS RESOURCES

One good way to market a green product or service is to send a press release to online PR distribution services that specialize in environmental business news. Here are a few sites to get you started.

**E-Wire** (www.ewire.com) claims to be "the leading press release distribution service dedicated to environmental news, products and events." It can deliver your product or company information "to major news organizations, publications, government agencies, databases and environmental professionals around the world."

**CSRwire** (www.csrwire.com) aids businesses in "communicating their corporate citizenship, sustainability, and socially responsible initiatives to a global audience."

**PitchEngine** (www.pitchengine.com) is not a traditional wire service. According to the site, it's "a social platform that enables PR to effectively package stories and share them with journalists, bloggers, and influencers worldwide." Although it doesn't specialize in green business, it does target social networking apps like Facebook and Twitter, which are a good bet for many green firms.

Your business's competitive advantage comes from offering more value to your customers than your competitors

### Identifying Your Competitive Advantage

Your business's competitive advantage comes from offering more value to your customers than your competitors. Value can come from a higher quality product, lower prices, better service, or more convenient distribution. Other examples of competitive advantage include:

- Proprietary technology
- A specialized customer niche
- Unique distribution channels
- Production advantages due to better sourcing, location, or processes
- A stronger base of financial resources through cheaper debt
- Employee expertise or training
- Access to new or emerging technology
- A unique brand identity
- Environmental or social commitments (e.g., running the business on solar power)

If you are able to provide more innovative and personalized customer service, you have a competitive advantage over your larger competitors. Therefore, you might position your business accordingly (provided that you know your customers value personal service, and you actually have the ability to deliver it).

In some cases, a business may decide not to enter a given market because it cannot find a position that gives it a competitive advantage.

## NxLEVEL® TECH TIP
BUSINESS RESOURCES AND THE WEB

With the success of Internet auction firms like eBay, some entrepreneurs are test-marketing their products at auctions in order to see what people are willing to pay, and how buyers react to their products. You can sell the same item over and over again at an auction site, varying the pictures, opening bid, and description. This may tell you which marketing messages get the most response, and which prices are seen as reasonable. This is an inexpensive means of collecting feedback and gauging your customers' willingness to pay, and unlike many other marketing strategies, it can bring in money while you're doing it! The drawback? It can be hard to find any rhyme or reason in buying patterns at Internet auctions, and the information you gain can seem meaningless in the absence of any solid grounds for comparison with your target population. Still, if you find that every time you offer your product at an auction, it sells for at least 10 percent more than your tentative retail price, it's a good indication that you can afford to raise your price!

## Positioning Your Product

After you identify your ideal market segments, you must decide how to position your product within each of those segments. Basically, this means deciding how to portray your product to customers within those segments, so that it will stand out from competing products. In order to guide your efforts, it's essential to write a **positioning statement** for every market segment in which you intend to compete.

### *Writing a positioning statement*

A positioning statement comprises one or two sentences that explain exactly what you offer that your competitors don't. It presents a concise and compelling picture of who you are, and why you will meet your customers' needs better than anyone else.

Of course, you can't do this until you know what your customers' needs are, and how your competitors are meeting them. Your market research collected raw information about who your customers are, where they live, how much they spend, and why they buy. Now, condense this information into short, clear statements that clearly describe, in as much detail as possible, your customers and their needs. What attributes does the ideal product have, from their point of view? Does your product have these attributes? Do competing products have them? What value does your product offer? Why are your customers better off with your service than with someone else's? Will buying your product enhance your customer's self-image or social status? What psychological needs does it meet?

Once you've identified your customers' needs, you need to identify the most compelling reason for customers to do business with you, and turn it into a positioning statement so that it can guide your marketing and branding activities.

Shrewd entrepreneurs don't settle on the first or even the second positioning statement they come up with. They keep searching for the perfect positioning statement until they are completely satisfied. Excellent positioning doesn't come easily. It demands that you look at a lot of information and think clearly. The better you understand your market and your customers, the closer you'll come to the perfect positioning statement.

The better you understand your market and your customers, the closer you'll come to the perfect positioning statement

*Just as Tena had needed a strategy to guide her choice of product, pricing, and placement, she needed clever marketing tactics to help achieve her objective of controlling 60 percent of her market.*

*Since she'd positioned herself as offering highly personalized service, she created a database of all of her regular customers—which included the customer's favorite drink and birthday—and synchronized it to her handheld computer, so that she could check and update it throughout the day.*

*She also gave out "frequent sipper" punch cards. After ten punches, customers got a free drink. In this way, Tena earned strong customer loyalty.*

*With the help of a graphic designer, Tena created a weekly "Espresso Update." This short, easy-to-read page contained information on specialty drinks and new blends, and a coupon for a discounted drink. Tena distributed it to "subscribers" late in the afternoon, so that they could redeem the coupon first thing in the morning.*

*Tena's hard work, careful research, and creative marketing paid off. Thanks to her clear objectives, shrewd strategizing, and creative tactics, Tena built a loyal clientele that even Starbucks couldn't tempt away!*

## Marketing Tactics

Marketing tactics are the specific actions businesses take to produce, price, place, and promote their products. Tactics are very personal, and they should be as unique as you can make them. The best tactics use plenty of creativity, insight, and innovation.

Measuring the results of your marketing tactics improves the effectiveness of your marketing budget by allowing you to separate the winning tools and strategies from the losers.

Chapters 28 through 31 discuss *Product*, *Price*, *Promotion*, and *Placement* in greater detail. These chapters also outline specific marketing tactics for entrepreneurs.

**Common Problems with Strategies**

- Not sticking with the strategy long enough
- Not testing the strategy before implementation
- Not challenging the assumptions and data on which the strategy is based
- Not focusing the strategy on specific goals
- Not adequately controlling the budget for strategy implementation
- Not understanding what customers value

Give your marketing tools a chance to work!

## The Importance of Persistence

When implementing market strategies and tactics, persistence is of the utmost importance. You may be lucky enough to see instant results, but more likely, getting good results will take considerable time and effort.

Maybe those flyers you distributed last week haven't yielded any new customers, or that promotional package you sent to your distributors hasn't increased orders as much as you'd forecasted, but don't get discouraged. Give your marketing tools a chance to work! While some marketing tactics deliver instant gratification in the form of more sales, others might take six months or a year to yield their bounty. Unless you give them enough time to work, you'll never know if they *do* work.

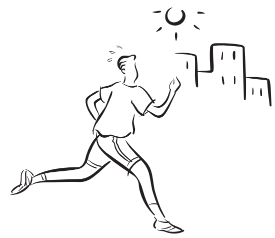
## Conclusion

Why do you need marketing? Because without it, you won't know what to sell, how to sell, where to sell, whom to sell to, or what price to charge! Researching markets, identifying your target customer, and positioning your product to maximize your competitive advantage are all crucial to marketing success. Having done these things, selling becomes much easier.

By understanding and utilizing marketing objectives, strategies, and tactics, you will create a business that can take on the competition, and win!

# Chapter 28
# PRODUCT

*About This Chapter:*
- *Product basics*
- *Where do new product ideas come from?*
- *Branding your product*
- *Entry strategies*



We buy to influence other people, and to feel differently about ourselves

## Introduction

Technically speaking, a product is a package of attributes and benefits designed to satisfy consumer needs. A product can be a service, too. Services deliver benefits like time savings, convenience, expertise, labor, or comfort. A product can even be a combination of a tangible item and intangible services.

Why do we buy products? Because they meet basic survival needs like health, safety, or shelter. We also buy products that make our lives easier, make us look or feel better, or project an image we like. We buy to influence other people, to feel differently about ourselves, and to benefit others.

Entrepreneurs must think about what their products represent to their customers. For example, a ski parka might be the warmest on the market, but how does it look and feel? How durable is it? What image does its label communicate? Does it have lots of useful pockets? How many colors does it come in? Where was it made, and what materials were used? Does the manufacturer back up the parka with a guarantee and a return policy?

Each of these aspects of the product is important to how customers perceive it, and perception is what makes customers decide to buy one product over another. A business that understands all the facets of buying behavior is in the strongest position to succeed.

## Product Basics

The first thing a business must decide is which products to offer. For the entrepreneur, this idea usually comes from a hobby, a discovery, or an area of expertise or interest.

The best product ideas are those that meet existing or new customer needs in innovative ways, improve upon an existing product, or improve its packaging or promotion. These days, many products are also created to complement existing products (e.g., carrying cases and accessories for Apple's iPod, or plug-ins for a popular software application).

### Product Lines

A **product line** is a group of products offered by a single company. Kellogg's breakfast cereals; Boeing's jets; and the gravel, seedlings, soil, and shovels at your local garden supply store are all examples of product lines. An auto mechanic who repairs Nissans and Toyotas is an example of someone who offers a line of services.

You must decide how many products to offer, whether to add new products, and how to position product lines.

Another strategic decision is the **depth** of the product line. This describes the number of different sizes, models, or flavors within the product line. A bakery that decides to add new types of doughnuts is extending the depth of its product line.

The **breadth** of the product line describes the diversity of products a business offers. A bakery that decides to offer ready-to-bake pizza dough is extending the breadth of its product line.

Revisit your business's strengths and objectives before extending a product line

Adding new products can be risky, particularly for new businesses. New products may require marketing and operational skills beyond your core competencies. It's important to revisit your business's strengths and your long-term market objectives before extending a product line.

### Life Cycle Assessment

Many small businesses are finding it useful to take a close look at every stage in the useful life of their products: resource extraction, manufacturing, storage, selling, shipping, consumer use, and disposal. The information gained from this assessment can be used to optimize each stage from an economic, environmental, or social standpoint. It can also provide a basis for product labeling and promotional claims.

Typically, **life cycle assessment** attempts to quantify the environmental impact (i.e., pollution and resource use) of each stage in the cycle. For instance, a business might use it to figure out whether disposable paper cups or reusable ceramic mugs use more energy and produce more pollution over the course of their respective lives.

While a formal life cycle assessment is beyond the capabilities of many small businesses, taking this broad conceptual approach to your product can reveal wasted effort and inefficiency, as well as consumer benefits that you might not recognize otherwise. It can also help you to find nontoxic or renewable inputs, reduce the amount of waste material (e.g., unnecessary packaging), extend product life, and reduce energy and material usage.

Furthermore, you can use data from third-party life cycle assessments of other products and materials to optimize individual stages in the life cycle of your own product. For example, if a scientifically conducted life cycle assessment shows that soy-based inks are environmentally preferable to petroleum-based inks, you might use this information to improve your own product, by switching to soy-based inks for your packaging. This in turn becomes a selling point for your product, and may even increase goodwill and customer loyalty.

There are a number of software packages available to help small businesses with life cycle assessment. If you're curious about these programs, you may want to check out GaBi Lite (www.gabi-software.com). This simplified program conducts a basic analysis of products and processes, and is designed specifically for non-experts.

*Brian Rust runs Spotless Cleaning, a small cleaning business in Gainesville, Georgia. When he started out, he had only nine regular clients, which was barely enough to support his three-person team. Although they did a careful, thorough job, and had excellent references, Brian was having difficulty winning new contracts.*

*A big part of the problem was price. Money was tight in late 2008, and a lot of businesses were cutting corners wherever they could. For some businesses, this meant cutting out cleaning services altogether. For others, it meant hiring immigrant workers, who were willing to work for a fraction of what Brian charged.*

*Just when Brian was beginning to get really discouraged, he ran into a friend who advised him to schedule a business consultation with the Small Business Development Center at the University of Georgia.*

*"I put it off for a while," Brian says. "But once things got bad enough, I took the plunge and got in touch with the SBDC. I ended up with a consultant named Alison Peirce, who asked me two questions I'd never really thought about: What do I offer people, and how much is it worth? Lots of people can clean an office, so why would they want my team instead of someone else's?*

*"All I could really come up with is that we do a really good job. I could tell from the look on her face it wasn't anywhere near enough."*

### Packaging

Distinctive packaging helps to communicate your product's identity and your business's values. Packaging also serves the basic function of protecting products, and providing information about use, ingredients, quantity, and so forth.

Clever packaging design can increase sales substantially. Many businesses achieve success by devising new ways to package existing products. By changing the packaging, they reposition the product in the minds of customers, hit new customer segments, and even open new channels of distribution.

Clever packaging design can increase sales

Wise packaging choices can also free your business from regulatory oversight, reduce shipping costs, earn goodwill, and—in the case of biodegradeable or otherwise eco-friendly packaging—improve your competitiveness in international markets.

Another shrewd packaging strategy is to choose a material that adds value for the consumer (for instance, an attractive metal or wood box that the customer may wish to keep knick-knacks in). In cases where the product is adequately protected by its primary container, you may choose to avoid outside packaging altogether. This can reduce costs, and make your product more competitive and environmentally friendly.

One of the best things you can do in regards to your packaging is to stay flexible. Things are changing quickly in many industries, and you never know when some inspired new idea for packaging will occur to you or someone else. If you can settle on a comparatively simple design with a quick turnaround time, that can be changed or improved with a minimum of expense, you'll be better positioned to take advantages of new options as they become available.

In the meantime, here are some packaging ideas to consider:

- Choose a container that can be used for some other purpose (consider the bodycare company Pangea, which packages its soaps in a small compostable carton embedded with seeds, which can be planted in a garden or flower pot).
- Change package shape to decrease package-to-product ratio.
- Use lighter materials.
- Choose recyclable or biodegradable materials, and water-based glues.
- Use soy-based inks.
- Don't use composite materials that are difficult to recycle (e.g., thermoform blisterpacks).
- Use containers and caps made from the same material.

## Where Do New Product Ideas Come From?

A wind-up toothbrush that runs for the precise length of time dentists say people should brush. A laptop carrying-case with a built-in solar panel that powers the computer and charges cell phones. A shower head that turns off at its neck, so that you can set your ideal water temperature and leave the faucets on, instead of running the water until it gets hot. Where do ideas like these come from?

It's pretty simple. The inventors of these products took something that already existed, and made it a little bit better for consumers in a particular niche market. As such, they're not revolutionary, but *evolutionary*. Through clever adaptations, they change how certain people use or perceive the product, rather than setting a new industry standard overnight.

Competitors can be a valuable source of inspiration for new products

Adaptation can also mean learning from the mistakes and successes of others. For instance, competitors can be a valuable source of inspiration for new products. In many cases, it's the second, third, or even fourth imitator who succeeds with someone else's product idea, by learning from the mistakes of those who went before.

Investigate products that your competitors have introduced and abandoned. What were the product's strengths and weaknesses? Can you create a better, sturdier, more exciting, safer, or greener version of their idea?

Alternatively, you might take a look at products that currently pose a problem for consumers or the environment. For instance, traditional battery-operated flashlights can be unreliable, and their batteries present a disposal problem. Accordingly, smart entrepreneurs have created battery-free flashlights that generate power when shaken for a short period of time. Thanks to this innovative design, consumers can be confident that the flashlight will work no matter how long it's been sitting unused, and fewer batteries will wind up in landfills.

Many entrepreneurs are also finding new uses for discarded products and waste materials. One of the best examples of this is a company that responded to the problem of electronic waste by rescuing circuit boards from TV sets and computers and turning them into eyecatching notebook covers, clipboards, and luggage tags. Other entrepreneurs are making old vinyl albums into clocks, and vintage book covers into handbags. Apart from the environmental benefits of this approach, using such materials can give entrepreneurs an almost inexhaustible supply of raw materials at little or no cost.

Many entrepreneurs are finding new uses for discarded products and waste materials

*After meeting with Brian a couple of times, and getting a feel for his situation, Alison introduced him to a local professor named Ted Calderwood, who specialized in small-business management and volunteered twice a week as a business adviser.*

*Professor Calderwood told Brian that there were no "green" cleaning services in Gainesville, and that this could be a good way to stand out from the crowd. He explained that federal and state offices had been switching over to GS-37 certification, which requires the use of environmentally safe cleaning products, and that larger companies were following suit.*

*He told Brian about studies that showed how these products had resulted in less absenteeism and unhappiness among workers, who often complained about the use of strong-smelling cleaners like ammonia and chlorine bleach. That meant that Brian could position his business not just as an exceptionally conscientious cleaning service, but also as a way to increase employee morale and productivity while doing good things for the environment.*

*Brian would be offering a service that people wouldn't necessarily know very much about, so he'd have to be prepared to explain why it was worthwhile. The first thing people were likely to say was that it would be too expensive. Professor Calderwood had a chart showing that the cost was actually competitive for most green products.*

*There was more to green cleaning than using different chemicals, though. Brian could also change the way this team did things. Instead of sweeping floors, they could damp-mop them. They could dust surfaces with a wet cloth, too. Studies had shown that these methods reduced the levels of germs and dust that make workers feel sick. They could also use a vacuum with a dust-trapping* *filter. By positioning itself as a business that was maintaining a healthy work environment, Spotless could charge more than an ordinary cleaning service. Better yet, he could make the case that maintaining optimal indoor air quality would require several service visits per week.*

### Responsible Design

As businesses around the world attempt to balance consumer demands against the health of the environment and the availability of resources, the notion of **responsible design**, which considers the needs of businesses *and* consumers within their larger social context, has become increasingly influential.

The evolving design of soda tabs is a good introduction to this topic. In the past, you opened soda cans by pulling off a metal tab attached to a ring. This design was easy to operate without thinking. Unfortunately, it was also easy to cut yourself on the sharp edges, and to throw the tab away without thinking. This meant that our beaches and parks were soon cluttered with tiny, sharp, dangerous pull tabs.

This problem was solved not by asking millions of consumers to stop littering, but by riveting the tab to the can. This makes littering more difficult, and less problematic when it occurs; it's much easier to gather and recycle discarded cans than discarded pull tabs. A few short years after the fixed tab was introduced, it had replaced the pull tab.

This is a simple example of how design can address social and environmental problems by changing consumer behavior *without* making explicit demands on them.

Responsible design can save time, energy, and money

Generally speaking, responsible design reduces the use of non-renewable resources, minimizes environmental impact, and, ideally, helps consumers to understand the consequences of their choices. While we don't know what it will ultimately achieve, we can be pretty confident that the responsible design movement will bring dramatic changes to the design, production, delivery, and use of many common products.

Even if you're not interested in the movement's specific environmental goals, the fact remains that some advances in responsible design can also save time, energy, and money, streamline the production process, and help you to avoid domestic and international regulations. Accordingly, this is a trend to which all forward-looking entrepreneurs should pay close attention.

## Branding Your Product

A **brand** is a name or symbol—or some combination of the two—that represents a product. Evian water, the Toyota car, the Bic pen, and STP motor oil are familiar examples of brands.

In a larger sense, a brand is the psychological representation of everything a business stands for. That includes the name and logo, and the products to which they refer. But it also includes the expectations and emotions that a business evokes in the hearts and minds of consumers, employees, and distribution channel partners.

### Brand Identity

**Brand identity** refers to how you choose to present your product to the world. It includes its benefits, its packaging, its advertising, and the services delivered along with it.

You can look at your brand as a promise. When customers see your name or logo, it promises them certain things. Each time you deliver on that promise, your brand is strengthened. Any time you break the promise, your brand is weakened.

In order to differentiate your products from all the similar products on the market, you must create a unique brand identity. An established brand associated with a quality product is a very valuable asset.

It's not necessary to spend millions of dollars to establish a brand identity. And the best branding strategy in the world can't make up for a lackluster product, poor customer service, or a dishonest brand identity. A firm with a strong sense of what it stands for, that consistently meets or exceeds the promises it makes, will naturally develop a good brand image.

### Brand Image

**Brand image** refers to the associations that your brand evokes in consumers' minds. Remember: Consumers don't just buy products; they buy an image of what the product will do for them.

Consumers don't just buy products; they buy an image of what the product will do for them

Your brand image should be:

- Immediately evoked
- Positive
- Unique to your brand
- Easily identifiable

You can look at it this way: brand identity is how you want to be seen, while brand image is how you *are* seen. However and wherever your company interacts with customers—and this of course includes advertising and word of mouth—that is where your brand image is established.

That's why knowing your company's personality and values—and by extension, your brand identity—is so important: it gives you the script for the role you must play every time you interact with your customers.

*Professor Calderwood's advice made a lot of sense to Brian…especially the part about the fumes. He'd noticed that his workers tended to rush things when they were working with ammonia and chlorine. If they weren't dealing with those fumes, would they take more time and do a better job? He discussed it with his employees, family, and friends, and decided it was worth a try.*

*After he made a list of every product he used, Alison told him to go to Greenseal.org, where he found a list of GS-37 cleaners and janitorial products. From there, he was able to research prices and availability. She also gave him a few articles on workplace air quality, employee morale, and the effect of seasonal allergies and illnesses on productivity, which would help him to make a solid case for his new techniques.*

*On a tip from Professor Calderwood, he also looked at how much of each product he needed to use. For instance, if it took two ounces of ammonia to clean a bathroom, compared to four ounces of a citrus-based cleaner, then Brian would only get half as much use out of a bottle of the citrus-based cleaner.*

*Also, some green disinfectants took longer to work. Brian would have to think about how this would affect his overall cleaning time. Would his crew have to slow down, or could they simply switch over to another job until the disinfectant had done its job? In the end, Brian decided that they could damp-wipe office surfaces while waiting for the disinfectant to work.*

*For the most part, Brian found that the new cleaning products would cost about the same as the old ones. Some were a little more, but others were a lot less. His biggest expense would be the new vacuums. A 10-gallon wet/dry vacuum with a top-rated HEPA dust filter cost about $800. That was a lot of money, but it was also a central part of his new brand identity. It was the most obvious thing he could point to when trying to sell his service to business owners.*

### Branding Strategy

Branding means telling the "story" of your business and your product in a compelling and colorful way

**Branding** means telling the "story" of your business and your product in a compelling and colorful way—one that will give people reasons to buy your product instead of someone else's. Although you lack the resources of larger competitors, you can create powerful branding strategies by learning from powerhouses like Proctor and Gamble, Nike, and Coca-Cola. These corporations have succeeded in part by creating products with distinct "personalities" that often become as important to the customer as the product itself.

In a sense, branding is like tuning in a radio station so that the static disappears. If you think of yourself as a radio transmitter, and your prospective customers as receivers, then branding would be analogous to getting your signal through loud and clear, without any distracting static.

Some small businesses make the mistake of thinking they don't need to have a branding strategy. The fact is, your products and services will naturally generate a brand image, whether you take a direct hand in it or not. We don't believe that something so important should be left to chance...or worse yet, to your competitors!

Don't leave your brand image up to chance, or your competitors!

### Creating Your Brand

A good way to begin creating a brand is to figure out what's at the core of your business. One possibility is to come up with a list of the words that come to mind when you think about your business, or your product.

Try to come up with ten such words off the top of your head, no matter how silly or unusual they may be. Then, try to narrow them down to one or two words that you feel have the most emotional resonance for you. This may not work, of course. If it doesn't, try something else. Think of colors, textures...anything that strikes a chord with you. It doesn't matter so much how you approach this question. What matters is that you pinpoint your strongest emotions about what makes your product valuable. Once you've done this, you have something you can try to express to other people.

At the same time, you have to know what your customers want. Your brand identity has to be one that your target customers will value, so an essential part of building a brand is understanding where customers' desires and your abilities intersect. It's not enough to make a promise; the customer has to value it, and you have to be capable of keeping it.

Consider these questions:

- What makes people buy your type of product? Is it a luxury or a necessity?
- What motivates your target customers? Are they looking for security? Are they environmentally aware? Are they budget-conscious? Are they pressed for time?
- What features do they value? Does your product's price, authenticity, nontoxicity, freshness, durability, flexibility, luxury, or ease of use attract them?

Your product's brand is also determined by your employees and your premises. What kind of business are you running? What personality do you want your business to project? What message do you want to communicate? The purpose of asking questions like these is to find those qualities that will instantly mean something to your customers, and make them the core of your brand.

#### *Choosing a brand name*

The first step in establishing a brand is usually taken—often unwittingly—when the owner chooses a name for his or her company and product. What makes a good name?

- It should be eligible for trademark protection
- It should suggest benefits (e.g., Mr. Clean, Whole Foods, Beautyrest mattresses)
- It should fit the brand identity: Nissan Pathfinder (adventure), Round Table Pizza (cozy dining for friends and families), Ding Dongs (fun snacks for kids)
- It should be easy to pronounce, recognize, and remember

*Choosing a logo*

Your logo is the graphic symbol of your brand. Over time, it becomes invested with the emotions of consumers who value your business.

Your logo will gradually take on the meaning that your firm's reputation assigns to it

You can choose a logo that reflects your product, but you don't have to. Many firms use an abstract logo, and let it gradually take on the public meaning that the firm's reputation assigns to it.

That said, the logo must fit your type of business. If you're offering financial services or consulting, you don't want a logo that looks like it belongs to an ice-cream shop. It's a good idea to get lots of feedback on your logo before you do anything with it. Get as many opinions as possible, and take them seriously. It's important that you love your logo—you'll be seeing a lot of it, after all—but it's even more important that your customers respond well to it.

Here are some characteristics of a good logo:

- Simple and instantly recognizable
- Reproduces well in black and white, and in different sizes
- Suggests product benefits (e.g., the bold white arrow formed by the letters in the FedEx logo)
- Looks equally good on business cards, packaging, mailing labels, t-shirts, billboards, and computer and cellphone screens

## NxLEVEL® TECH TIP
### BUSINESS RESOURCES AND THE WEB

Working with logo designers can be expensive, time-consuming, and complicated. Fortunately, you can now get low-cost, professional-quality logo design online by visiting **LogoYes** (www.logoyes.com).

In just a few minutes, you can use their innovative interface to build your own logo out of millions of possible design combinations.

If you'd prefer to have your logo created by professionals, LogoYes has a design team that will create up to six logos for you to choose from, for a low fixed price. The offer includes two or three revisions, depending on how many logo options you request.

Their site has a 60-second demo that explains how the do-it-yourself design software works, as well as a portfolio of logos they've created.

*Alison and Professor Calderwood had both said that once Brian switched over, he could charge a little more than he used to. Between the health benefits, the new vacuums, and the extra time involved in maintaining indoor air quality, Alison thought that Brian could add about 10 percent to his price.*

*But when Brian started researching what other green cleaning services were charging, he found that companies in Atlanta, Philadelphia, New York, and Boston were charging up to 16 percent more for their services. And unlike Brian, they had direct competition! Brian saw no reason why he couldn't charge the same amount…or even round it up to 20 percent, since he had no local competition.*

*"Alison pointed out that Gainesville wasn't Boston or New York, but I just tuned it out," Brian admits. "I fell for my own hype, I guess. I thought everyone would be so grateful to have this green cleaning service in town that they'd just fall at my feet."*

*As it happened, almost all of the businesses Brian approached did seem very interested in the idea of a green cleaning service. And all but one of them lost interest as soon as they found out what he was charging.*

*Brian was disappointed, to say the least. But Alison explained to him that "premium price" doesn't mean you get to charge whatever you want. A premium price can only be as high as the customer's perception of the product's value. Most people are willing to pay a little extra to feel like they're making a difference, but if the price is too high, it outweighs the perceived value.*

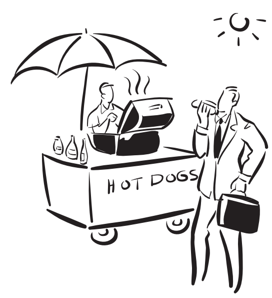
*"Why didn't you tell me that in the first place?" Brian demanded.*

*"I did," said Alison. "But you didn't want to listen to me."*

*Brian started to feel angry, but then he realized that Alison was right. He'd stopped listening to things he didn't want to hear. Now, he'd have to try again, with a new price and a better sales pitch.*

### Building Your Brand

Once you've thought about what your brand's promise is, and why your customers will value it, it's time to write your **branding statement**. For a small ice-cream maker, this might be: "Sarah's Ice Cream is about being happy, youthful, and spontaneous."




Having come up with a branding statement, make sure that this statement guides everything your company does, so that your brand identity is clear, consistent, and immediately obvious to your customers. Your company logo, company colors, packaging, labels, business cards, retail space, customer service policies, slogans, promotions, employees, and Website should communicate your brand in precisely the same way at all times.

## Brand Management

How do you keep your brand identity meaningful and relevant? That's where **brand management** comes in.

Customers, markets, and products change, and brands must change with them

Branding is a process, not an event. Customers, markets, and products change, and brands must change with them. A brand requires maintenance at all times, and adaptation when necessary.

If possible, you should put one employee in charge of brand management. But you'll also need to drill your employees on what your brand identity is, and why it's important to communicate it clearly. Ask for their suggestions; they deal with customers every day, so they're in a perfect position to know what customers are thinking.

### Brand Management Tips

- Make sure your brand is promising something customers want.
- Keep it simple! Focus on communicating a few basic points.
- Be consistent. Remember that every interaction with a customer or client is an opportunity to communicate your brand identity.
- Involve your employees. Get them excited about your brand, and they'll communicate that excitement to others.
- Whatever your brand promises, exceed it!

*"It wasn't hard to see why my sales pitch failed," Brian recalls. "All the reasons I'd come up with for why my business was a good choice, I'd pretty much forgotten to say.*

*"I was trying to make things easy, so my pitch was simple: Pay me 20 percent more than you do now, and save the world. All the other stuff about employee health and morale and absenteeism, I never really got a chance to explain clearly."*

*With Alison's help, Brian revisited Spotless Cleaning's features and benefits, its positioning statement, and its branding strategy. He practiced his sales pitch again and again, and soon he was ready to give it another try!*

*This time, he began by explaining that he was switching over to less-toxic cleaning supplies, filtered vacuuming, and other cleaning techniques that would reduce indoor air pollution.*

*He cited the studies that suggested that this would have a positive effect on employee health and morale. He talked about Gainesville's seasonal air-quality problems, which cause absenteeism and low productivity. He pointed out that hiring a green cleaning service could earn customer goodwill, and help to differentiate the business. (He found that restaurants and medical offices were particularly intrigued by this last point.)*

*Once Brian explained the benefits of his service clearly, and showed people the value they could get by paying ten percent more, the response was good.*

*A couple of businesses were skeptical that the green chemicals would actually get things clean. But Brian was prepared for that objection, because his suppliers had sent him charts showing what kind of germs the products would kill, and comparing them favorably to conventional brands.*

*Within six months, Brian had signed contracts with 26 new clients, as well as a local elementary school. In order to meet the increased demand, he took out an SBA-backed loan and bought two more trucks and vacuums, and hired four more workers.*

*And with Alison's help, he also began looking into the possibility of selling air purifiers, mold testing kits, and other allergy and air quality solutions.*

*Although he's proud of what he achieved, Brian believes that the most valuable thing he got from this experience was confidence.*

*"I know now that you can't give up when the going gets tough," he says. "If you treat adversity as an opportunity to make new connections and learn new things, you'll end up stronger than ever."*

## Entry Strategies

You've spent weeks or months developing the vision for your business, and even more time analyzing your market. You've designed your product, positioned it, and formulated just the right marketing mix to support it. But how do you introduce it to the market?

Entrepreneurs often have very slim budgets with which to introduce their offerings to the market, so they must use all their wiles, energy, and creativity at this early phase of the business. Every new product, whether it's an innovation or an evolutionary adaptation of an existing product, requires a careful entry strategy to ensure its success.

Every new product requires a careful entry strategy to ensure its success

The primary purpose of a marketing strategy is to establish a new brand or product with customers, wholesalers, distributors, and retailers. This means building a distribution network to make the product readily available to customers, and then persuading customers to try it for the first time.

When businesses establish a new product, they must use each element of the marketing mix to communicate the same message and support their efforts. This ensures a consistent, memorable message for customers.

It's exciting when a new product enters its growth period and becomes profitable. Savor your success...but not for too long! This is the time to consolidate your gains and reinforce your product's position. Focus your marketing efforts on getting repeat purchases and continuing to attract first-time users.

Successful strategies include:

- Thank-you notes to customers
- Following up on customer calls and visits to gauge satisfaction
- Newsletters with company and new product information
- Mailings to past customers, offering discounts tailored to prior purchases
- Frequent buyer programs with discounts

Such strategies remind your customers why they bought from you in the first place, and encourage them to buy from you again. Remember: It's five times cheaper to sell to existing customers than to go out and find new ones!

**NxLEVEL® GREEN TIP**

ENVIRONMENTAL BUSINESS RESOURCES

There's an incredible amount of innovative ideas coming out of the green and sustainable design movements. Here are some sites that will help you to stay informed about new green products.

- **Energy Saving Gadgets** (energysavinggadgets.net) is a blog that "showcases gadgets that are easy on our planet, help make our lives more enjoyable, and save us money."
- **D-Rev: Design for the Other 90%** (d-rev.org) "invents and develops products and services that are reliable, cost-effective and affordable, providing simple, scalable and sustainable solutions to many areas of concern, such as healthcare and energy, for the poor."
- **Treehugger** (www.treehugger.com) is a popular news site with about 30 posts per day. Its focus is primarily on green tech, green gadgets, and the design revolution.

## Conclusion

Your product strategy begins when you decide what products to offer, based on what your market research has shown you about your customers' needs and tastes. Next, find ways to make your packaging, warranties, image, and service enhance your product.

Once you identify this mix, and the unique "personality" of your product, stick with it. After you assess your customer and market with market research, committing to a shrewd branding strategy is one of your best tools for success.

# Chapter 29
# PRICE

*About This Chapter:*
- *Basic pricing concepts*
- *Pricing objectives*
- *Calculating your costs*
- *Pricing strategies*
- *Pricing on the internet*
- *Making price fit your marketing mix*

## Introduction
Pricing is the ultimate measure of marketing skill. It requires you to calculate your cost of doing business, the psychological and financial impact of price on your target customers, and the response of your competitors.

Competing solely on the basis of price is not an option for small businesses!

It wasn't long ago that price was the most important element of the marketing mix for many businesses. But today, things are different. Competing solely on the basis of price is no longer an option for many small businesses. Globalized competition, the ever-increasing practice of outsourcing American labor to foreign workers, and the growth of big-box stores have lowered prices for many goods to a point where most small businesses are simply unable to compete.

Fortunately, you have many other competitive advantages. Shrewd branding, high quality, green and sustainable products or business practices, excellent customer service, and a user-friendly Website can differentiate your business, and decrease the importance of price to your customers.

Always remember: Your goal is not to set a price that will make consumers want to buy, but to make a product that consumers will want to pay for!

## Basic Pricing Concepts
Let's start by defining our basic terms.

- **Cost** is what you spend to produce your product.
- **Price** is the amount you charge customers for the product.
- **Value** is what your customer believes the product is worth.

Note that in this list, price falls in between cost and value. That's as it should be, because pricing strategy means finding the point between cost and value that will enable you to meet your sales goals.

### Between the Floor and the Ceiling

In pricing, cost is often called the "floor." Obviously, your product must sell for more than it costs you to manufacture. (The exception is in cases where you temporarily pursue a short-term "loss leader" strategy in order to enter a market.)

Value is the "ceiling"; it's the maximum amount your customers will pay, based on their perception of what your product is worth. Note that the highest price for a product in your market may not be the ceiling price.

Perceived value depends to a great extent on intangibles like goodwill and brand image. It isn't an inherent quality of your product; it's something earned by good business practices, and created by good marketing strategies.

Keep your costs low, and your perceived value high!

An important goal of marketing is to ensure that you have the widest possible range of pricing options between your floor and your ceiling. Your costs should be as low as your quality standards and business ethics permit, and your perceived value should be as high as possible.

### Demand

**Demand** refers to the amount of your product that customers are willing and able to buy at a specific price. For instance, a customer who has ten dollars to spend might be willing to buy two pillows if your price is $5.00 per pillow, but only one if your price is $7.00 per pillow.

Note that the ability to afford the product is an essential part of demand. Desire for the product doesn't count as demand.

Of course, many factors affect demand—including personal income, aesthetics, and the cost and availability of competing brands or substitute products—and these factors vary from segment to segment.

As a general rule, higher prices lead to less demand, while lower prices lead to more demand. (There are exceptions, which we'll discuss below.)

### Price Elasticity

Very simply put, **price elasticity** refers to the sensitivity of your customers to the price of your product.

If you increase the price of your product by one dollar, and your sales volume stays the same or increases, then the demand for your product is relatively inelastic in relation to that price increase.

On the other hand, if you increase your price and customers flock to your lower-priced competitors, the demand for your product is elastic, because it changes as your price changes.

*Sam Granville knew a great business opportunity when he saw one.*

*One hot day in July, he passed a newly constructed house on the Eastern Shore of Maryland. The house stood out starkly on the large, nearly barren lot. The small maple and pine saplings around the house accentuated how empty the land looked. Sam thought that the property needed a mature shade tree to give it a sense of hominess and history.*

*That's when the idea struck him. He could expand his small landscaping business into a tree-relocating business. His target customer would be owners of new houses and developers of subdivisions. His product would be beautiful, healthy, mature trees that would add badly needed charm to new construction sites.*

*It seemed ideal. He had the expertise, the equipment, and the reputation. And best of all, he had no competition! The main thing he had to do was figure out how many prospective customers he had, how much it would cost him to move trees, and what he could charge.*

*He started working on these problems the moment he got home.*

## Pricing Objectives

Setting your price begins with considering your pricing objectives. Are you primarily interested in undercutting or matching your competitors' prices, or in building customer demand and loyalty? Or are you aiming to achieve a particular return on your investment?

Setting your price begins with considering your pricing objectives

Your pricing objectives depend on a variety of factors, including your production costs, the competitive environment, your ability to achieve economies of scale, your branding strategy, your use of hazardous or environmentally friendly components, and so forth.

Here are the most common pricing objectives:

- **Maximizing profits.** This objective leads you to pursue high short-term profits (e.g., in order to recoup development costs quickly). It may result in lower long-term profits, and it may also attract competition.
- **Maximizing sales volume.** This may lead you to sacrifice a certain level of short-term profits in order to attract customers, gain market share, or meet sales targets.
- **Return on investment.** This objective requires you to set prices that will allow you to reach a targeted return on investment.
- **Meeting or beating the competition**. This objective requires you to set a price that matches or undercuts those of existing competitors, or discourages new ones from entering the market.
- **Quality leadership**. Price often implies quality, so a premium price may support your business's brand image as the quality leader in a given market.

## Calculating Your Costs

What does your product cost to produce and deliver?

It doesn't matter how good your intuition is. Before you make any decisions about what to charge your customers, you need to know precisely what it costs to produce and deliver your product. This is especially important for sole proprietors who may have additional people working for them at some point.

### Basic Cost Concepts

- **Fixed costs** are expenses that a business has regardless of the quantity of units it produces. For example, the cost of installing a commercial oven is the same regardless of the number of loaves of bread baked over the lifetime of the oven.
- **Variable costs** are expenses that vary in direct relation to the amount of products produced (for example, the cost of labor and raw materials used to make the product, plus the cost of sales and distribution).
- **Total costs** are the total expenses of producing and marketing a product. Total costs are the sum of total fixed costs and total variable costs.

| Typical Variable Costs | Typical Fixed Costs |
|---|---|
| • Inputs and supplies | • Salaries and wages |
| • Depreciation on equipment | • Payroll taxes |
| • Overtime wages | • Vehicle leases and maintenance |
| • Sales commissions | • Office supplies |
| | • Office equipment |
| | • Machinery and equipment |
| | • Marketing expenses |
| | • Land |
| | • Rent |
| | • Insurance |
| | • Utilities |

**Break-even analysis** pinpoints the level at which total revenue equals total cost. As the volume of units sold increases beyond this **break-even point**, a business begins to earn profits. To identify your break-even point, calculate your costs and your revenue. Below are the basics of price calculations:

**Total revenue** = *Price* x *Quantity*
**Total cost** = *Total fixed costs* + (*Average variable cost per unit* x *Quantity*)

The break-even point occurs when:

*Price* x *Quantity* = *Total fixed costs* + (*Average variable costs* x *Quantity*)

Looking at the same equation a different way, the break-even amount is:

$$\frac{\textit{Total fixed costs}}{(\textit{Price} - \textit{Average variable costs})}$$

Once you've identified your pricing objectives and your break-even point, you can explore various price strategies.

Once you've identified your pricing objectives and your break-even point, you can explore various price strategies

*Two weeks later, Sam had completed his preliminary market research. He began working on his marketing plan, and calculating the costs and prices for his services. He knew what the market would bear in terms of price, but what would it really cost him to relocate half-ton trees?*

*Sam began by calculating the cost of moving a single tree. He estimated that on average, it would take him two to four hours to move a single tree. He figured that in his first six months, he would be able to move 30 trees a month. His costs broke down as follows:*

| **Variable Costs (per tree moved)** | |
|---|---|
| Labor (1 helper, 4 hours per tree @ $15.00/hour | $60.00 |
| 1 tree spade and tractor operator (3 hours @ $30.00/hour) | 90.00 |
| Biodiesel fuel for crane and tractor (15 gallons per job @ $2.25/gallon) | 33.75 |
| Organic fertilizer & burlap | 250.00 |
| Tree | 250.00 |
| Miscellaneous office expenses (phone, fax, supplies) | 20.00 |
| **Total Variable Costs** | **$703.75** |
| **Fixed Costs (per month):** | |
| Miscellaneous landscaping equipment (shovels, mini-tractor, winches) | $2,000.00 |
| Office equipment (computer, desk, chair, etc.) | 3,000.00 |
| Rent | 300.00 |
| Tree spade lease payments | 250.00 |
| Tractor lease payments | 200.00 |
| **Total Fixed Costs** | **$5,750.00** |
| | |
| Total cost of relocating 30 trees a month ($5,750 + 30 trees x $703.75) = | $26,826.50 |
| Total revenue for relocating 30 trees ($1,500 x 30) = | $45,000.00 |
| **Net Profit** | **$18,173.50** |

*Note that Sam's fixed costs remain the same regardless of how many trees he moves. He has already leased his mechanized tree spade, and bought his computer and his landscaping equipment. However, his total costs rise over time because his variable costs (labor, biodiesel, and trees) go up as he moves more trees.*

*Next, Sam calculated his total revenue for a given price level. If he charged $1,500 per tree, and moved 30 trees a month, his revenue would be $45,000 per month. At 20 trees a month, his monthly revenue would be $30,000. Thus, Sam reaches his break-even point when he relocates between seven and eight trees. After that point, he begins to earn profit.*

*Sam's calculation for break-even quantity is below:*

$$\text{Break-even quantity} = \frac{\text{Total fixed costs}}{(\text{Price} - \text{Average variable costs})}$$

$$\text{Break-even quantity} = \frac{\$5{,}750.00}{(\$1{,}500.00 - \$703.75)} \qquad \text{7.22 trees/month}$$

**NxLEVEL® TECH TIP**

BUSINESS RESOURCES AND THE WEB

One of the benefits of the Internet is that it lets you search for products similar to yours, so that you can check out your competitors' pricing strategies. (You can even pose as a customer, and e-mail pertinent questions to your competitors!)

For more general information on pricing strategies, try the following Websites:

**Pricing Your Products** (www.sba.gov/idc/groups/public/documents/sba_homepage/pub_fm13t.txt). This document from the Small Business Administration provides good, basic advice on pricing strategies.

**Market Driven Pricing Strategies** (asbdc.ualr.edu/bizfacts/4516.asp). This article presents a controversial and thought-provoking view on pricing.

**Business Owners' Toolkit** (www.toolkit.com) has a great deal of information on pricing strategies, as well as links to sources of important secondary data.

## Pricing Strategies

Businesses often experiment with several different price levels before settling on a pricing strategy

Some of the most common pricing strategies are described below. You should understand each of them, and the impact that they will have on your customers and competitors.

Pricing is not an exact science. Often, businesses experiment with several different price levels before settling on a pricing strategy. They also may adjust their prices frequently (though not so often as to frustrate customers). Many entrepreneurs combine several of these approaches to reach the optimal pricing strategy.

### Cost-Plus Pricing

This is the most common and simple pricing method, because it is based on the known factor of cost. **Cost-plus pricing** requires you to total all of your fixed and variable costs, and add a target return to determine your sale price. A target return is usually expressed as a percentage of total costs.

Cost-plus pricing ignores the impact of consumer demand on prices, as well as your brand image and market positioning. Thus, it can lead to a price that's out of sync with your market, or doesn't fit your branding objectives. Also, it's very easy to miss hidden costs! Cost-plus pricing tends to work best in industries where consumer demand and competition are stable and predictable.

### Competition-Based Pricing

Businesses often alter their prices based on competitors' prices. This is particularly common in large, highly competitive industries like airline travel, soda pop, and crude oil. The risk in this type of strategy is that your competitors' cost structure might be significantly different from your own.

**Follow-the-leader pricing** sets prices at the level of an industry's price leader. This pricing structure is common in industries that sell highly standardized products—like farm commodities, or industrial raw materials—because these industries tend to be dominated by a few large companies.

**Pegged pricing** establishes a business's prices in line with industry-wide norms. It tends to occur in industries in which there is no clear price leader. Businesses using this method might use the industry norm as a starting point, then offer a slightly higher (premium) or lower (economy) price to establish a niche. Having done this, the business works backwards to calculate if it can make an acceptable profit at that price level.

In pricing based on projected responses by competitors, businesses consider the response of their competitors prior to taking action. Businesses may set very low prices to discourage new competitors from entering the market, or they may set their prices at mid-range levels in order to discourage competitors from starting a price war.

You may want to develop some "what if" pricing scenarios based on anticipated competitor responses. For example: "If my competitor responds by lowering its prices, I can afford to lower prices by ___ percent."

Experimenting with different price levels can be difficult for new businesses; it can take time and resources that the business just cannot afford. However, you do have a few options. For instance, you might try setting slightly different prices in different geographic areas, or creating intermediate models of your products so as to test the price sensitivity of your customers and competitors. You can also offer short-term discounts to see how the price affects demand for your products, or experiment with different price structures at online selling venues like eBay Stores.

### Value-Based Pricing

This strategy requires you to determine how much your product is worth to your customers, based on their perception of the value of the benefits it delivers. The goal is to charge an above-average price, while leaving customers with the feeling that they've gotten a good deal.

Here are some reasons why consumers may pay more for your product:

- They like and trust you
- You were recommended by someone they like and trust
- You offer convenience
- You offer security or reduced risk
- You offer faster service
- You offer green, sustainable, or socially beneficial products
- Your products confer social status or distinction
- Buying from you aids a cause or supports a philosophy
- Your products are unique
- Your products are artistic

*Branding and perceived value*

Your branding strategy affects your ceiling price

Branding is an essential part of creating perceived value, and perceived value is at the heart of value-based pricing.

As we discussed earlier, perceived value is subjective; it's something you earn through good marketing practices, good design choices, and good customer service.

Think about the headache tablets at your local drugstore. A name-brand tablet sits right next to a generic tablet that costs half as much, and yet the name brand often sells as well as—or better than—the generic. The two tablets have exactly the same ingredients, in exactly the same dosage. But the name brand is familiar; it offers security and confidence, and people are willing to pay extra for it. These brands succeed by creating a perception of value that withstands competitive pressures.

Every branding choice you make affects the perceived value of your product, which in turn affects your ceiling price.

*Value in use*

When dealing with certain customers, it's necessary to communicate your product's **value in use**. This refers to the overall savings that a customer will realize by paying a bit more for your product.

Does your product last longer than a less-expensive competing product? Does it offer a savings in time or effort? Does it reduce shipping or disposal costs? If so, show your customer how paying a little more in advance can save a lot down the road.

*Premium pricing*

**Premium pricing** means pricing above market value, in order to evoke perceptions of quality, prestige, luxury, or rarity in market segments that are less price-sensitive.

There are five primary reasons that customers are willing to pay a premium price:

- **Quality.** They believe that a premium price indicates impeccable quality that can't be found elsewhere at a lower price.
- **Extravagance.** They want to give themselves a treat, or reward themselves for achieving a particular goal.
- **Status.** Premium-priced items demonstrate that buyers are members of a discerning, exclusive group (e.g., organic food buyers).
- **Uniqueness.** You are first in the marketplace with a unique product or service.
- **Altruism.** They believe that buying the product is worthwhile because it benefits society or supports a worthy cause. Green, American-made, and cruelty-free products are classic examples.

These can all be powerful motivators, but they shouldn't guide your pricing strategy unless you're very sure that you understand your customers' psychology. Remember that a premium-pricing strategy that misfires can have negative consequences in your other target markets.

A premium-pricing strategy that misfires can have negative consequences in your other target markets

When possible, it's best to give customers as many reasons as possible to pay a higher price. Consider the Toyota Prius. It uses less gas, of course, but that's only part of the reason for its popularity. It also confers green status, and demonstrates the buyer's altruistic nature. And the dashboard and controls have a unique design that makes it appeal to connoisseurs of automotive technology, style, and quality.

While each of these factors may be attractive in itself to different drivers, it's the combination of them that has made the car so successful.

*Sam was confident that he had a leg up on any prospective competitors. He'd grown up on a fruit farm, and knew just about everything there was to know about caring for trees.*

*He knew from his market research that he could charge an average of $1,500 per tree. But he wanted to calculate a price based on his costs and his target profit margin of 40 percent.*

*After calculating his costs, he decided to use cost-plus pricing for his services. This was the simplest method he knew, and he figured if he needed to change his strategy later, he could.*

*Here are his calculations, which he based on moving 30 trees in one month, with a target profit margin of 40 percent, which is expressed as 1.40 (i.e., the break-even amount, plus the profit margin of 40 percent or .40):*

$$\frac{(\textit{Units x Average variable costs per unit}) + \textit{Fixed costs x Profit margin}}{\textit{Units}}$$

$$\frac{(\textit{30 trees} \text{ x } \$703.75) + \$5{,}750.00 \text{ x } 1.40}{\textit{30 trees}}$$

*As a result of this calculation, Sam arrived at a price of $1,254.00 per tree.*

## Skimming

**Skimming** is a means of maximizing your profit margin by setting a higher price in the short term, and tailoring it to the price sensitivity of your market segment(s). This strategy may be advisable when your product is unique or innovative enough to attract buyers who will pay top dollar to get it right away.

As demand from these buyers drops (and competition increases), prices are gradually reduced. This is what distinguishes skimming from premium pricing, where a high price is consistently maintained.

Here are some of the benefits of skimming for firms that are offering something new or unique:

- Innovative products typically have high development and promotional costs. Skimming may help you to recoup these costs before competitors enter the market.
- When you start with a higher price, you can respond to competition by reducing it. If you start with a lower cost, you'll limit your ability to raise prices if needs be.
- Skimming can be adjusted to a variety of market segments, so that you earn the maximum revenue from each segment.

## Penetration Pricing

Penetration pricing can create goodwill among new customers

**Penetration pricing** means setting a low price in order to enter a new market, or to increase your market share. Usually, the goal is to attract new customers. This can be a better strategy than maximizing short-term profits, provided you can sustain a low profit margin long enough to reap the benefits.

Penetration pricing can create goodwill among new customers, which may lead to word-of-mouth sales, and it may also act as a barrier to entry for your competitors.

The downside is that your customers may reject your product when you raise your prices. Also, you run the risk that competitors will follow your lead by lowering their prices. In the worst-case scenario, this can lead to a price war.

### Retail Pricing

Although retailers do not produce the goods they sell, they still have labor costs and overhead. Their selling price must cover these costs and offer an acceptable level of profit. **Retail price** is generally set by multiplying the wholesale price by a given percentage. A contractor using a 25% mark-up would buy Sam Granville's trees at $1,254.00 and sell them at $1,254.00 + $313, or $1,557.00. Many retailers double or triple the wholesale price.

### Price Adjustments

**List price** is the "official" price that businesses charge, from which they subtract any discounts. The list price is seldom the same as the final selling price. Adjustments are usually made for trade or distribution channel partners, and for the final customer.

Businesses offer discounts of all types to buyers who meet criteria that reduce selling costs. Strategic discounting can increase sales or even out seasonal demand. Here are the most common forms of discounts:

- **Quantity discounts** are offered to customers who buy in bulk. This can be a powerful way to increase the amount of units you sell.
- **Trade discounts** are given to distributors or representatives when they perform some of the marketing functions—such as advertising, promotions, or technical support—ordinarily performed by the manufacturer. Trade discounts are often used as a leveraging tool for new products in distribution channels or retail outlets.
- **Seasonal discounts** can encourage customers to make purchases during off-peak selling times, which helps to lower inventory levels when demand is down.
- **Cash discounts** are offered to customers who pay for purchases with cash rather than credit. This is often used by manufacturers and their distribution channel partners to encourage speedy payment of bills and to minimize accounts receivable.

Quantity discounts can increase the amount of units you sell

*Sam's pricing worked out well. It was high enough to cover his expenses and meet his profit goals, and affordable enough to attract developers and homeowners. Also, it was flexible enough that he was able to negotiate a discount with the local golf club for moving multiple trees. That job alone got him to his break-even point.*

*That's not to say that he didn't have pricing problems. After a few jobs where he came in well over budget, he learned by trial and error to adjust his quotes based on terrain, distance, and types of trees.*

*For the sake of promoting himself, he agreed to accept a lower price for prestige jobs like the mayor's historic mansion. He reasoned that this sort of flexibility and visibility would keep would-be competitors at bay. It was good thinking: the local newspaper ran a front-page story on the relocation, which brought in several more jobs.*

*His expansion into tree-relocating also brought him more landscaping work, which was something he hadn't bargained for. Clients who were pleased with his efficient, careful work and his use of organic gardening materials often asked him for quotes on other landscaping projects.*

*As Sam's business grew and his reputation spread, he moved away from cost-plus pricing and towards value-based pricing. He had come to realize that what made him special was not the basic service he offered, but his reputation.*

*In essence, he was selling his clients peace of mind that they couldn't get anywhere else. Many of them had a strong emotional attachment to their trees, and were willing to pay extra for the feelings of security and confidence Sam inspired.*

*Eventually, of course, Sam did face competition, and the first thing they tried to do was undercut his price. But they found that Sam's stellar reputation trumped their lower prices nine times out of ten. And if Sam has anything to say about things, it always will!*

**Common Pricing Errors**

- Basing price on current, artificially low overhead costs instead of anticipating how overhead might rise over time.
- Assuming that because you are the newest competitor on the block, you must have the lowest prices.
- Trying to compete head-to-head on price with larger competitors. Try instead to offer higher quality, or more attentive service.
- Basing prices on manufacturing costs instead of the value of your product to consumers, which may be quite a bit higher!
- Failing to include in the price an allowance for warranty costs, future service, research and development costs, cost of capital, dealer discounts, and sales commissions.
- Ignoring the way customer demand for the product will change at different price levels. Would sales volume increase if you lowered prices by 10 or 20 percent?
- Failing to use some form of market skimming, in which you enter a market with a high price until you have satisfied demand or attracted competitors, then lower the price gradually.

## Pricing on the Internet

The Internet has affected pricing strategies in a number of important ways. First, it has increased international competition, which has tended to increase consumer choice and drive prices down for many types of goods.

Second, it has brought about an unprecedented degree of **price transparency**. Buyers can either look for the lowest price by visiting multiple Websites, or visit "shopbot" sites like **www.bizrate.com**, which compile price comparison data from a wide variety of online retailers.

The Internet has brought about an unprecedented degree of price transparency

Third, it has led to a new era of **dynamic pricing**, in which price fluctuates according to supply and demand, consumer purchase history, and other variables. Unlike conventional retailers, online sellers can respond quickly or instantly to customer feedback, and adjust prices accordingly, which has made various types of dynamic pricing attractive.

Some sites are experimenting with letting consumers set their own prices through the use of online services like PriceWhispers (www.pricewhispers.com). This system allows consumers to name their preferred price, and set an expiration date for their offer. Participating retailers have the option of accepting or declining the offer within that time period.

While this is a comparatively new approach to online selling, initial response suggests that it may boost sales, and can even increase the retailer's understanding of the comparative price sensitivity of their target markets. This trend is likely to intensify.

A more controversial form of dynamic pricing involves selling the same product at different prices, depending on who is buying it. Typically, a retailer will offer lower prices to customers who've spent more, or bought similar items, in the past. Although it's really not that different from offering a rewards program, or aiming specials at a particular customer segment, consumers sometimes perceive it as unfair or confusing, so it's wise to be cautious when implementing such programs.

### Offering Value Online

As we've said many times, the customer's ceiling price depends on perceived value. Online, the credibility of your business and the quality of your service are particularly important.

If you do a search for a given product, and look at the first ten sites that appear, you'll probably find that some of them look far more professional than others. They have a clean, nicely designed interface with high-quality pictures of the item, detailed technical information, a clear return policy, and a toll-free number for customers who need questions answered right away. They also have customer reviews that praise their quality and service.

If you'd prefer to deal with a business like that, even if the price is a little higher, you're not alone. Studies have shown that features like these can coax online buyers to pay up to 20 percent more for identical products.

It's important to keep your online pricing structure in line with your offline brand identity

That said, it's important to keep your online pricing structure in line with your offline brand identity.

If your business offers the best prices in town, it needs to maintain that image online. If you offer high-quality, green, or otherwise unique goods, your online prices should reflect that. Sending mixed pricing messages is likely confuse customers and undercut your branding strategy.

Here are some basic ways to increase the perceived value of your online offerings:

- **Make your site easy to read and navigate.** Make sure your contact information is clearly displayed, and include a one-click e-mail link. Post as many sharp, full-color photos as it takes to display your product at its best, and allow customers to view enlarged photos if necessary. If you sell many items, break them down by category, and include a search function. Also, avoid the temptation to use lots of fonts and colors, capital letters, underlining, and multiple exclamation points.
- **Accept customer feedback.** Customer reviews and rating systems, or a blog that welcomes consumer comments, can be a powerful way to increase consumer confidence and sales. You may get some negative feedback, of course, but as long as you handle it properly, that's not necessarily a bad thing. Online customers tend to respect transparency and the ability to resolve conflicts fairly. Furthermore, if you intend to create a customer-driven business, you need to be prepared to listen to and learn from negative feedback.
- **Promote your green or social business ethics.** Some Internet retailers make a point of donating a certain percentage of online sales to a worthy local, national, or international cause (obviously, this strategy works best if it's a cause you have reason to believe the vast majority of your customers will value). Other sites highlight their solar-powered facilities or computer servers, their biodegradeable shipping materials, or their use of carbon offsets. Studies consistently show that customers will pay a little more to make a difference, and may be motivated to buy more often.
- **Make purchasing secure and simple.** The fewer steps it takes to buy from you, and the more secure your payment system is, the higher the perceived value of your site. The more hoops customers must jump through, the more likely they are to go elsewhere. We recommend that you visit the checkout pages of as many sites as possible in order to get a feel for what does and doesn't work, and then seek professional help in designing a simple, secure, and streamlined checkout system. Even something as simple as a one-page order form can give you the edge over an e-tailer who requires customers to click through multiple screens.

## Making Price Fit Your Marketing Mix

No matter which pricing strategy you use, it must be consistent with all the other elements of your marketing mix.

- **Product strategy.** Is your price in line with your customers' perception of quality? If not, then you should consider lowering your prices, improving your quality, or increasing your efforts to educate customers about your product's quality.
- **Distribution strategy.** Is your product's price consistent with the image of your distribution channels? High-priced, premium products should be distributed selectively, while economy products should be distributed intensively to maximize their availability to larger, price-sensitive markets. Are you using discounts as an incentive for your distributors?
- **Promotional strategy**. Is your advertising consistent with your product's price? If you sell a premium product, is your advertising image one of quality and service? If it is an economy product, is your advertising image one of value? Are your sales promotions undercutting your pricing strategy and profitability? Are coupons or price discounts encouraging only short-term business by fickle customers?

Is your price in line with your customers' perception of quality?

### NxLEVEL® GREEN TIP
ENVIRONMENTAL BUSINESS RESOURCES

As part of its shift towards environmentally preferable products, Wal-Mart has created an ongoing consumer research initiative called the **Live Better Index** (www.livebetterindex.com), which offers "insights on how American consumers are saving money and living better in important areas such as value, sustainability, and health and wellness." Among other things, the site tracks Wal-Mart customers' adoption rate of green products by state, by product category, and over time. (Anyone who believes that green products are largely a coastal concern may be surprised to see particularly strong adoption rates in Oklahoma and Texas.)

In a recent report, Wal-Mart also surveyed customer attitudes, and uncovered these interesting statistics, which are worth considering when pricing green goods:

- 43 percent of respondents think they will become "extremely green" in the next five years, but only 11 percent described themselves as "extremely green" at the time of the survey.
- 62 percent said they would buy more green products if there were no price difference.
- 78 percent stated that they need more information to think about how to help solve environmental issues, and 30 percent said that they do not know where to get this information.

## Conclusion

Pricing is a difficult task that requires a complete understanding of your customers, costs, and competition. It's no wonder that businesses spend so much time measuring costs, checking on their competitors, and tracking their customers' reactions to different prices.

For entrepreneurs, the most critical element of pricing is understanding costs. Once you know exactly what your fixed and variable costs are, you can select the pricing method that is best for you. Different industries demand different pricing strategies, and different approaches to maximizing perceived value.

Try to understand the most common and effective practices in your industry, then tailor your strategy to fit your business. Pricing your product need not be intimidating—you can learn the basics and build your skills as you go!

# Chapter 30
# PROMOTION

*About This Chapter:*
- *The basics of promotional strategy*
- *Advertising*
- *Customer engagement*
- *Sales promotions*
- *Public relations*
- *Managing your promotions*

## Introduction

If you're starting or growing a business, you must use promotion to catch and hold people's attention. Even the best product won't sell if people don't know it exists.

A good promotional strategy lets consumers know what your product is, what it does, why it's better than anyone else's, and how they can buy it.

A great promotional strategy does much more than that. It communicates your brand and your values. It doesn't just tell consumers why they need your product; it tells them why they should want to be associated with you. It inspires their goodwill, trust, admiration, respect, and loyalty.

A great promotional strategy communicates your brand and your values

## The Basics of Promotional Strategy

Like every other element of the marketing mix, successful promotion requires a strategy.

How do you go about creating a promotional strategy? By selecting the best mix of promotional tools to communicate your message. The **promotional mix** comprises advertising, sales promotion, and publicity.

First, set your promotional objectives. If you're introducing an original product, your objectives will be quite different than if you're adding another product to your line, or competing in an established product category.

Most small businesses introduce new products, or create a new spin on an existing product.

## Push and Pull Strategies

There are two primary promotional strategies:

Pull strategies target the end consumer, in an attempt to generate demand

- **Pull strategies** target the end consumer, in an attempt to generate demand. Consumers then "pull" the product through the distribution channel: they request it from retailers, who request it from wholesalers or distributors, who request it from the producer.
- **Push strategies** target wholesale and retail distribution channel members, instead of the end consumer. The members then "push" the product through the distribution channel: the producer promotes the product to wholesalers, who promote it to retailers, who promote it to consumers.

Most businesses use a combination of both, depending on their product, markets, competitors, and distribution channels.

## Promotion and the Product Life Cycle

The promotional strategies you'll choose depend to some extent on which stage of the **product life cycle** your product is in.

- **Introduction.** When launching a product, your goal is to inform your target market of its availability. You'll almost certainly use a combination of push and pull strategies during the introduction phase. This is typically the most costly stage for promotions.
- **Growth.** As your product becomes accepted by your target market, the goal is to encourage loyalty while reaching new customers. Capitalizing on the goodwill of existing customers and distribution partners is an important part of promotion during the growth stage.
- **Maturity.** At this stage, you're likely to face competition. Communicating brand image and differentiation messages remains very important, as consumers look for reasons to choose your product over competing brands.
- **Decline.** At this stage, the goal of promotion is to keep the product selling while it remains acceptably profitable, without spending a fortune to "resuscitate" it. Other options include discontinuing it, cutting production levels, or selling or leasing the rights to another business. By this time, most promotional efforts will be expended on newer products.

## Advertising

Advertising is the most common method of communicating promotional messages about a product, company, or brand. You can use advertising to:

- Introduce a new product
- Increase sales (e.g., through special promotions)
- Differentiate the product through features and benefits
- Communicate company values (e.g., donation to charities, schools, or disease research; use of environmentally preferable or American-made materials; and so forth)
- Change attitudes about your brand (e.g., explain why your more expensive product offers better long-term value)
- Make an emotional connection (e.g., link your product to something or someone else about which the consumer has a good feeling)

Of course, these goals are not mutually exclusive. Advertisers often pursue several of them at once. However, they don't do it at random; they know which messages are appropriate in which circumstances.

### Planning Advertisements

Creating an effective advertising message can be expensive and time-consuming. Once you've decided to advertise, you must decide what message to convey, which image to project, how much to spend, which media to use, and how often to run your message. To get the most out of your advertising dollars, you should:

- **Identify your target audience.** Your market research and analysis identify your target audience, and these findings should guide the content, style, and placement of your advertising. Review Chapter 26 *Market Research & Analysis*.
- **Set your advertising budget.** How much you allocate depends on your objectives and your resources. It also depends on how widely and how frequently you want your message to be heard.
- **Set your objectives.** Typical advertising objectives are to reach a certain percentage of the target market, increase the target customer's awareness of your product or business, or achieve a certain level of sales. Setting clear goals will let you gauge whether you have gotten your money's worth. Industry sources, newspapers, and radio and television stations can provide good estimates of the monthly sales patterns for your industry. They know what their demographics are, which can help you to set realistic objectives.
- **Design your advertising strategy.** This is the most creative part of advertising management, and it relates directly to your positioning strategy. How will you encourage your customers to buy? What will your message and your medium be? Will you use humorous short radio spots to highlight how speedy your service is? Or will you use a simple, elegant color image to convey premium quality?

Setting clear goals will let you gauge whether you have gotten your money's worth

*Vance's Vans and Trucks bought and sold used vehicles in Cheyenne, Wyoming. Business was always slow in the summer months, so Vance relied heavily on the traditional big influx of used trucks in fall.*

*In the spring of 2008, Vance decided he'd do things differently that summer. Instead of spinning his wheels 'until fall, what he needed to do was come up with a sales promotion that would not only jack up his cash flow during the slow summer months, but make room for the new fall inventory.*

*He thought about it hard for a while, and it dawned on him that the people in his town were essentially his suppliers. What did they have that he could use, and how could he get it?*

*One thing that struck him was that Cheyenne is the kind of town where tractors and snow plows are very common. But changing demographics, and the ups and downs of the farming life, often turn them into excess baggage.*

*Suppose he were to invite customers to bring in their used tractors, trailers, and snow plows as trade-ins on the purchase of a truck?*

### Selecting Advertising Media

The main criteria for choosing an advertising medium are cost, speed, reach, and effectiveness

Media are the outlets that carry advertising messages, such as television, radio, magazines, newspaper, billboards, direct mail, and the Internet. Today, businesses have more choices of media than ever before. All of these options have distinct benefits and drawbacks. For most small businesses, the main criteria for selecting an advertising medium are cost, speed, reach, and effectiveness.

- **Online advertising** is increasingly popular because of its low cost, its ability to target customers in niche markets, its potential for viral marketing, and its ability to create customer engagement. For more information, see Chapter 34 *E-Commerce*.
- **Television ads** on cable TV can target viewers who have very specific interests, and their advertising rates are relatively low.
- **Radio** provides flexible coverage of a wide range of audiences. You can choose the best time, day, and station to reach your target audience, and then hit them with multiple ads. Radio stations can help you produce ad spots, but be sure to write your own message; you don't want to sound just like everyone else.
- **Newspapers** are great for running short-term price promotions and coupon offers to very specific audiences. They reach a relatively upscale audience, and target specific geographic regions. By placing different coupon ads in various local papers, you can measure which is most effective. Newspaper ad salespeople can advise you on the best placement, day, size, and length of run for your ad.

- **Magazines** are a very effective way to reach a narrow target audience. There are magazines for just about every special interest you can imagine, and they are often read more than once by more than one person. Small businesses can often negotiate to use lower cost "remnant" space in magazines.
- **Direct marketing** is one of the least expensive (per sale generated), most flexible, and fastest growing advertising methods. It includes direct mail, door-to-door sales, telemarketing, mobile coupons, and online marketing. Any direct marketing strategy must begin with the right list of recipients. These lists can be bought from brokers or generated in-house.
- **Signage.** Billboards, buses, parking meters, gas pumps, and even turnstiles at sporting arenas can display your advertising message. These are among the least expensive media. Messages must be clear, short, and eye-catching.
- **Yellow Pages.** Advertisers are increasingly favoring online Yellow Pages over print editions. However, the printed version may still be a good choice, depending on your business, your location, and the technological abilities of your target customers. One advantage of this medium is that small businesses can appear to be as big as their larger competitors.
- **Classified ads** are less expensive than traditional ads and can contain more information. Classified ads are often offered at a discount to advertisers who use frequent listings. If you see classified ads in your local paper or favorite magazine for your type of business, you could profit from placing ads there too.

Traditionally, media are assessed in terms of the access they give you to your target customer. **Reach** describes the percentage of your target market that sees your message. **Frequency** describes the number of times individuals in your target market see your message.

Different advertising media have different impacts, depending on your audience and advertising content. By using reach and frequency information, you can estimate how much it costs to advertise per customer. This gives you a standard with which to compare your advertising choices.

Consider the reach and frequency of your advertising message

Once you've selected your advertising tools, you need to decide when to use each one. If you offer a seasonal product, you should coordinate your message with your customers' purchase cycles. You might air advertising messages in a few large bursts at scheduled intervals, or spread them over a period of time to maintain awareness.

For businesses that wish to introduce a new product, frequency is more important than reach. It takes several exposures to a message before people absorb it, much less take action on it. Thus, businesses use a **burst strategy** when they want to create an early and intense impact on customer awareness. Seasonal businesses and short-term sales promotions often rely on this strategy.

*Vance had a cousin in the tractor business, so he knew he could resell the equipment more easily than his customers could. His cousin had never sold used equipment before, but he was enthusiastic about the idea. He thought it could be a pretty good way to expand his business.*

*Vance thought he could increase his summer sales while pulling in a different line of saleable items. The sale would last three days on the weekend following the Fourth of July. After all, there was no sense competing with the endless holiday automotive advertising!*

*The only restriction he put on the trade-ins was that they had to be less than five years old and in good running condition. His target population would be men between the ages of 18 and 50.*

Seek legal advice before you engage in telemarketing!

### Telemarketing

**Telemarketing** is a form of direct marketing in which a salesperson uses the telephone to contact prospective buyers. Although it can be effective in certain situations, many consumers view it as a nuisance at best, while others associate it with identity theft and other forms of fraud.

Because of its unpopularity, and its potential for abuse, telemarketers are subject to strict regulations. Perhaps the most important of these is the Do Not Call Implementation Act of 2003, which created a National Do Not Call Registry for residential phone lines. As of 2009, almost 75 percent of American residential phone numbers are listed in the Registry.

For more information, see Chapter 15 *Government Regulations and Taxes.*

### E-mail Marketing

Most people who have e-mail accounts are overwhelmed with junk mail, or **spam.** Those who aren't usually have filtering systems that block mail from unknown senders. That said, the low cost of e-mail, and the ability to target niche markets, makes it a very valuable promotional tool, particularly when it comes to reaching existing customers.

The key to successful e-mail promotions is to target prospects as narrowly as possible, and give them the choice of opting in to receive e-mails. You might do this by placing a link on your Website that people can click to receive updates, bulletins, and special promotions. Another popular method is to add an opt-in link to online order forms and account creation pages.

Your opt-in rate will be much higher if you offer consumers something valuable in return for their attention. Discounts and free shipping are obvious choices, but information can be valuable, too. If you've done your market research properly, you should have a pretty good idea of what your customers will value. But beyond that, think about your own situation: As an entrepreneur, you're a busy person with a limited amount of time, and you probably get a lot of e-mails. What kind of attraction or reward would convince you to add your e-mail address to a promotional mailing list?

For more information on laws and etiquette pertaining to e-mail communications, see Chapter 15 *Government Regulations and Taxes* and Chapter 34 *E-Commerce.*

## Customer Engagement

As the trend towards personalization erodes the effectiveness of traditional interruption-based advertising practices, many businesses are moving towards a customer engagement model that focuses on giving customers an emotional incentive to receive promotional messages and share them with other consumers.

Consumers increasingly control when, how, and whether they will receive promotional messages

Here of some of the arguments for this approach:

- **Consumers increasingly control when, how, and whether they will receive promotional messages.** They can already block ads on digital TV, digital radio, and on the Internet, and are more likely to ignore or mistrust the ads they *do* see. The obvious solution is to create promotional messages that offer some sort of return on the attention that the consumer invests in it.
- **Consumers are able to interact and compare notes online.** As more and more people participate in groups, chat rooms, and other online communities, businesses must create communities of brand advocates to help counteract misleading and malicious information, and to increase the likelihood of positive word of mouth.
- **Consumers trust other consumers.** Engaged customers offer highly credible advertising for comparatively little expense. They can also offer valuable suggestions for improving your design, quality, and service.

Instead of trying to create awareness by maximizing reach and frequency, customer engagement strategies tend to allow consumers to tailor their own promotional messages by opting into or out of specific types of messages. Where traditional advertising focuses on one-way communication, customer engagement requires a dialogue. The Internet is an ideal way to enable and manage this process.

Here's an example. Amazon allows individual customers to create lists of books, music, and films, which are then displayed to consumers whose buying habits suggest they'd be interested. In effect, this allows like-minded customers to recommend titles to each other; Amazon's technology simply enables this dialogue. As users create lists, reviews, and other original content, and get feedback, they come to feel that they belong to a community. And as current and prospective users are drawn in by this user-generated content, this customer engagement drives sales and benefits Amazon.

## Sales Promotions

There are two types of sales promotions. **Consumer promotions** comprise short-term incentives to increase consumer demand or product availability, or to gather customer data. **Trade promotions** are incentives that businesses offer to retailers and wholesalers for stocking their products.

Typical consumer promotions include:

- Coupon mailings or booklets
- Online or mobile coupons
- Discounts, sales, and 2-for-1 offers
- Rebates
- Contests and giveaways
- Frequent shopper cards

Redemption rates for mobile coupons are much higher than those for traditional coupons

Mobile coupons—which are sent directly to the customer's cellphone, usually as a text message—are an especially interesting type of consumer promotion. Studies show that redemption rates for mobile coupons are much higher than those for traditional coupons. And because cellphones are equipped with geolocation technology, companies are able to send coupons based on the customer's location.

Some companies are also basing their promotional efforts on camera phone technology. For instance, one business offered rewards to consumers who brought in cellphone photos of its outdoor advertisements. As cellphones become more versatile, it may be possible for them to scan barcodes, and receive discounts at the point of purchase. The allied trend towards payment via Internet-connected cellphones could put customers in charge of the entire checkout experience. Cellphones could soon become a feature-rich, interactive version of a debit card, offering instant price comparisons, instant promotions and discounts, and product scanning and checkout capabilities.

### Trade Promotions

Here are some common strategies for increasing sales to retailers and wholesalers:

- **Trade allowance.** This is a short-term incentive that leads retailers to stock up on a product.
- **Trade contest.** This is a means of rewarding retailers who sell the most product.
- **Point-of-purchase displays.** This means providing displays to retailers, for use in their stores.
- **Training.** Knowledgeable, well-trained employees can help to boost sales.
- **Push money.** This is a cash premium, prize, or extra commission paid to retailers to get them to push products and increase sales.

#### Importance of Different Promotional Elements in Different Industries

| | Consumer Goods | Services | Industrial Products |
|---|---|---|---|
| **Advertising** | Med/High | Med | Med |
| **Sales Promotions** | High | Med | Med |
| **Personal Selling** | Low | High | High |
| **Publicity** | Low/Med | Low/Med | Low |

## Public Relations

**Public relations** refers to the organized efforts that businesses undertake to present themselves in a positive way to customers, government officials, stockholders, lenders, stakeholders, and other businesses.

### Publicity

**Publicity** is unpaid communication about a business or its product in the mass media. Because it's unpaid, publicity is one of the most credible promotional sources. This makes it an excellent promotional tool for small businesses.

Because it's unpaid, publicity is one of the most credible promotional sources

How can you generate publicity? By preparing a press release for radio, newspapers, magazines, or local TV stations. Join your local trade associations, Chamber of Commerce, and community clubs; and take or make opportunities to speak in public or write articles for newsletters. Other great ways of generating publicity include:

- Writing or contributing to a blog, or some other industry-related Website
- Using Twitter, Facebook, or YouTube to attract a community of followers for your company
- Co-sponsoring local sporting or charity events
- Participating in local fundraisers by donating prizes or time
- Donating money to clean up highways, parks, and beaches
- Hiring local students as interns
- Installing a new, cleaner energy system (e.g., solar, wind power, geothermal), and offering public tours or demonstrations
- Remodeling a building or improving a piece of land
- Giving lectures to local trade organizations or Chambers of Commerce
- Sending your small-business story to your local newspaper or trade association

### Trade Shows

One of the best ways to promote your offerings is by participating in trade shows, exhibits, or industry fairs. The people who attend these events are serious prospects who have come to do some pre-purchase information gathering. This is also a good way to find out what your competitors are doing.

### Word of Mouth

Word of mouth is a positive reputation spread from person to person. Products that perfectly satisfy your customers' needs—complemented by creative, excellent service—make a lasting impression that your customers will gladly pass on to others. This is also known as **viral marketing**.

User-generated promotional messages may be more credible than traditional forms of advertising

Word of mouth can be strongly amplified by customer reviews, blog comments, social networking sites, and online customer reviews. User-generated promotional messages like these may also be more credible than traditional forms of advertising. According to a study by Forrester Research, company-sponsored advertising is the least-trusted source of product information. Online reviews from customers, and recommendations from friends and family members, are much more credible to most consumers.

### Networking

As an entrepreneur, you have the ability to interact with a wide variety of people. Use it! Continually widen your circle of contacts to include possible investors, customers, consultants, bankers, employees, vendors, distributors, and other entrepreneurs. Thanks to social networking sites like LinkedIn, Twitter, and Facebook, this is easier than ever before, and your potential access to prospects and partners is much wider.

Take every opportunity to speak publicly. When you do, give out lots of business cards and collect lots of business cards. Always follow up on new contacts with a brief note, then a phone call. You can even create a networking schedule for yourself that includes lunch dates, follow-up notes and calls, lectures, charity events, trade shows, classes, and seminars. Set aside some time to work on these things every week. Over time, this process will pay off with increased sales.

### Newsletters

In order to be effective, newsletters should be published regularly and consistently, contain important information and up-to-the-minute news, be easy and enjoyable to read, communicate your image, and provide solutions for your customers' problems. Even businesses on small budgets can use software templates to help create an inexpensive, attractive newsletter that can be printed, or distributed electronically. (The latter option is much cheaper, and also saves a considerable amount of paper, time, and resources.)

### Brochures

Brochures allow you to go into greater detail about your business than almost any other promotional medium. People expect detailed information in brochures, so be sure to deliver it to them in a compelling way. You should also:

- Include color photos of your products, or of jobs you've completed
- Describe your product's features, and sell the benefits to the end user
- Describe your team's experience, skills, and training
- Include your telephone and fax number, physical address, business hours, Website addresses, and e-mail addresses

Like newsletters, brochures can either be printed, or offered for download as an environmentally friendly alternative.

### Video Marketing

Online video marketing is an increasingly popular tactic, due to its low cost and potentially high impact. The main factor driving this trend is Google's YouTube (www.youtube.com), which combines streaming video with social networking tools. Videos that have been uploaded to YouTube can be viewed on their site, or embedded on your Website or someone else's. The ability to create searchable tags, send e-mail alerts and bulletins, create YouTube channels for subscribers, and form networks and groups makes the site an ideal tool for viral marketing. Best of all, YouTube is free.

In order to upload your promotional clips to YouTube, you'll need to register (preferably under your business name). Once you're registered, you should choose a specific type of account. This will help to define your offerings and drive traffic to your channel. When setting up your account, be sure to include a link to your Website.

Promotional videos should be short (two to five minutes), interesting, creative, and informative. Instead of overwhelming viewers with technical information or your life story, you should inspire them to visit your site and learn more. Humor can be an effective tool, as can clever visual demonstrations. You might also consider creating how-to videos that will help viewers to learn a skill or solve a problem. For instance, if you run a men's clothing store, you might demonstrate all the different ways to knot ties.

Uploading videos to YouTube is simple, as is embedding them on other sites. The site contains guides and tutorials that explain the process in detail. One of the most important aspects of this process is titling, tagging, and categorizing your videos. This makes it easier for viewers to find your content. If in doubt, search for similar products and businesses, and see which tags and categories they're using. The more closely your video's tags match those of existing, related videos, the more likely it is to be recommended in YouTube's sidebars. As for your title, it should include your company name and a brief description of your product or service.

In order to aid promotional efforts, YouTube offers an e-mail service that allows you to spread the word when you post new videos. You can also create bulletins to keep users informed about your business, and to recommend other sites and content.

That last point is very important. It's usually unwise to focus solely on self-promotion when using social media as a marketing tool. You're much more likely to drive traffic to your site if you participate in groups and networks, comment on and recommend other videos, and so on. Remember: The fact that anyone can create and upload videos on YouTube is a weakness as well as a strength. Standing out from the pack will take thought, talent, effort, and persistence. As with other Internet-based marketing techniques, don't assume that the medium is some sort of magic wand that will solve all your problems. In the end, video marketing is only as good as you can make it, and that depends on how much time, money, equipment, and skill you have.

Don't focus solely on self-promotion when using social media as a marketing tool

*Crowdsourcing*
Some businesses are using **user-generated content**, by inviting tech-savvy users to create and submit ads for the business, a brand, or a specific product. This tactic can give you access to skills you lack, and provide you with a wide variety of ideas that you probably couldn't have come up with on your own.

Crowdsourcing can lead to greater interest and engagement on the part of consumers

In recent years, consumers have created ads for Heinz, KFC and Mastercard, and assisted in product development for IKEA and Nokia. Typically, businesses who favor crowdsourcing post all the ads they receive online, and let viewers vote for the best one. This approach can lead to greater interest and engagement on the part of consumers.

On the other hand, it can also mean that the winning ad will be selected by whichever designer can mobilize a larger network of followers. Because crowdsourcing can conflict with your brand, it may be best to choose three to five videos that you feel are appropriate, and let people choose between those.

Many companies have set up sites that allow consumers to act as advisors on everything from product and service improvements to marketing to new product ideas. Dell's IdeaStorm (www.ideastorm.com) is typical: users make comments and suggestions to Dell, and these comments and suggestions are in term commented on by other users. In this way, ideas that most users do not find helpful or practical can be winnowed out.

Many entrepreneurs will prefer not to be distracted from their basic ideas and competencies, and probably won't have the time or inclination to pursue crowdsourcing until they've established a firm presence in the marketplace.

That said, crowdsourcing can be useful during beta testing, or as a promotional tactic, provided you're careful to choose ideas that make sense for you, your product, and your target market.

Obviously, the issue of compensation must be addressed from the outset, along with assignment of intellectual property rights. Your lawyer can help you with these issues.

*All Vance needed now was an advertising medium. Everyone listens to the radio in Cheyenne, so that seemed like the way to go. He called the local FM country music station, and they told him he could run three spots a day for $300 apiece. He also called a smaller AM station that broadcast farming and agricultural news. Their price was significantly lower, and their listeners were likely prospects.*

*Vance knew that most of his target population would be country listeners, and that with three spots a day he could probably hit at least half his target audience during the week before the sale. He ended up buying three days' worth of ads on the FM station, and three days' worth on AM. He ran the AM ads first, and then the FM ads, so that he'd get more bang for his buck. He* *didn't bother with newspaper ads, because he didn't think the people he was trying to reach were regular readers. The ads cost him $4,500, but he figured that wasn't a big price to pay if his deal worked out.*

*It did work out. In fact, it was better than he'd hoped for! By the end of the sale, he'd nearly cleared his lot of trucks, and he'd made a deal to sell his cousin 20 snow plows, 13 trailers, and a lawn mower.*

## Managing Your Promotions

Because small businesses have less money to spend on promotions, they must get the most out of what they *do* spend. Here are the necessary steps in managing promotions.

Get the most out of your promotional budget!

### Set a Promotional Budget

This entails allocating funds to each element of your promotional strategy. You can either decide on your total budget, then divide it among each of your promotional tools; or set the spending levels for each element, then total them to arrive at your promotional budget.

First, you need to prioritize each of the elements you intend to use. First, tally up the total cost of your ideal promotional budget. Next, decide which of these promotional elements are most important, and estimate how much money you can afford to allocate to each. If the amount seems too low, don't despair! Chances are, you can make your money go further than you think.

**NxLEVEL® TECH TIP**

BUSINESS RESOURCES AND THE WEB

Want to learn more about mobile coupons? Here are some sites that explain how it works.

**Cellfire** (www.cellfire.com) offers mobile coupons on behalf of a wide variety of retailers. You can watch a demo at **www.cellfire.com/howitworks.php**.

**MobiQPons** (www.mobiqpons.com) is a location-based mobile coupon provider for users of the iPhone, Android, and Blackberry. As of this writing, coupon delivery is free, and targets consumers within ten miles of your business.

**NetInformer** (www.netinformer.com/advertising/coupons.html) is a provider of wireless media and mobile marketing services, which also allows retailers to send location-based coupons.

### Create a Promotional Calendar

This enables you to use your budget more efficiently, and prevent gaps in your promotional efforts. Usually, a promotional calendar lists when promotions and events will occur, how long each will last and what its purpose is, and the total budget for each event.

### Measure the Effectiveness of Your Methods

The best way to know what worked and what didn't is to ask customers how they heard of you

The best way to know what worked and what didn't is to ask customers how they heard of you. You can also gather information about effectiveness by counting coupons, measuring the number of participants in contests or sweepstakes, and computing sales levels during short-term promotions.

Having done so, ask yourself these questions:

- Does my promotion communicate the right message?
- Does the message fit my product positioning strategy?
- Does the message fit my branding statement?
- Have I reached my target audience?
- How does each element of my promotional mix affect sales?
- How do my customers feel about my message?
- What can I do better next time?

## NxLEVEL® GREEN TIP

ENVIRONMENTAL BUSINESS RESOURCES

Most of us routinely receive promotional ballpoint pens, keychains, coffee mugs, and baseball caps from companies interested in winning or keeping our business. A fair amount of them don't end up getting used, and many of them end up in the landfill within a year.

If you're pursuing a green brand image, promotional items like these tend to undercut your message. Instead, you might consider offering things like seeds, biodegradable golf tees, and reusable shopping bags. (Note that even if the materials are green, you're still better off handing out useful items than meaningless trinkets and novelties.)

Here are a couple of companies that can supply memorable green gifts for your customers.

**EnviroPromo** (www.enviropromo.com) sells everything from recycled plastic yo-yos, to green USB drives and recycled license plate frames.

**Green Promotional Items** (greenpromotionalitems.com) offers environmentally preferable promotional items made from recycled, biodegradable, and organic materials.

### Alternative Promotion Methods

**Barter** allows you to trade your products for ad space. For instance, even if your local newspaper doesn't want your product, it might need something else for which you can trade. Trade with the person who has what the newspaper needs and you'll get some ad space for less than you'd pay ordinarily. (Keep in mind that radio and television advertising space is almost always negotiable.)

Businesses that use **cooperative advertising** receive cash fees from larger companies for mentioning brand names in their promotional efforts (e.g., a painting contractor who puts the name "Dutch Boy" or "Sherwin-Williams" in his or her brochure).

You can also save money by designing print ads yourself. Keep them clear and concise, and be sure to test them out with family and friends before using them. Perhaps you can't afford a high-impact, full-page ad, but great copy and ad design can pack just as powerful a punch in a half- or quarter-page ad.

Personal letters are a great way to introduce yourself to carefully researched prospects. Write a customized letter for each of your prospects, and include specific information about what you can do for them. Follow up with a telephone call or visit.

Fliers are a very economical way to spread the word about your business to people in your area. Use your unique style or humor to present the facts and inform your customers why they should buy your product. Select a basic idea, combine it with an appropriate photo or image, then explain more fully what you are offering.

### Be Creative!

Now that you understand the basics of promotional strategy, throw out your traditional thinking about how businesses promote themselves. Start looking for short cuts. For entrepreneurs, textbook techniques are just the jumping-off point to more unconventional, low-cost techniques. The only things that should constrain your creativity are your budget and time restrictions.

## Conclusion

Look for the most creative, cost-effective, and efficient ways to promote your products. Be sure to choose methods that are consistent with your positioning and branding, and tools that communicate the same message as the rest of your marketing mix.

Remember: even the best promotional strategies won't help a business that offers poor quality, bad service, or unwanted products. Start with a great product, a good understanding of your customer, and let your passion for your business fuel an inspired promotional campaign.

# Chapter 31
# PLACEMENT

*About This Chapter:*
- *Distribution strategy*
- *Distribution and small businesses*
- *Selecting distribution channels*
- *Creative placement strategies*

## Introduction

The final element of the marketing mix is **placement**, or **distribution**. Distribution describes all activities involved in moving goods from producer to customer. In the broadest sense, it includes taking orders, packaging, inventory management, storage, transportation, and follow-up service.

All businesses rely on some form of distribution network to sell and deliver their products. They might take care of distribution themselves, work with intermediaries, or use some combination of the two.

This chapter will introduce you to the basics of distribution, and help you to choose the right **distribution channels** for your product.

## Distribution Strategy

Distribution strategy means choosing the most convenient and efficient means of delivering the product to your customer, while maximizing your profitability and reinforcing your brand identity.

It's very important to select the right form of distribution from the outset, because distribution channels can be difficult and expensive to change once they're in place.

Needless to say, your distribution strategy must fit your product, price, and promotion. Imagine trying to place premium handcrafted jewelry at K-Mart, or offering maple syrup through an auto parts catalog, or trying to sell kerosene door-to-door. It wouldn't be long before you were out of business! Your distribution strategy must be guided by your understanding of customer behavior, and by your branding statement.

Your distribution strategy must fit your product, price, and promotion

Service businesses must also distribute their offerings. Where will you serve your clients? Will they contract with you directly? Will you set up an office? Will you use the Internet, e-mail, and the telephone to deliver services?

Choosing a distribution strategy requires you to assess your capabilities and resources. Can you handle large-scale warehousing and shipping operations? If not, you may need a wholesaler or distributor. Can you afford to hire and train a sales team? If not, you may need to work with sales agents. Do you offer green or sustainable products? If so, you may need to green your supply chain by seeking environmentally preferable channels and partners.

Your brand image and market research guide your distribution strategy

Earlier, we explained that every interaction with a customer communicates something about your company. This remains true when you're choosing distribution channels and partners. How does the channel fit your brand identity? How does your partner affect customer service? You need to strike a balance between moving product out the door efficiently, and maintaining control of your brand. Consider the extent to which you're willing to cede control to intermediaries.

*"Four cracked, two crumbled, five missing altogether."*

*Benny Canales, the founder and owner of Ixta Tile, was taking stock of how many crates of tiles had been damaged in transit from the company's headquarters in Albuquerque, New Mexico to its distributor in Los Angeles.*

*Actually, the four crates of cracked tiles represented an improvement over the previous month's count. But five missing crates...that was Ixta Tile's worst loss on a single shipment!*

*Benny had founded Ixta Tile in 2006, in order to design and sell traditional hand-painted Mexican tiles for gardens, bathrooms, and kitchens. The tiles were custom-made for each of their buyers, most of whom were local.*

*Three years later, Ixta Tile couldn't have been more different. They'd stopped making hand-painted tiles; instead, they were producing large quantities of bulk tiles—painted with stencils or stamped with designs from a press—and shipping them to large distributors in Los Angeles, Phoenix, and Houston. More tiles meant more shipping, more shipping meant more breakage, and the breakage was getting very expensive.*

*While counting the broken tiles, Benny thought about how different things had been when his company was first starting out. How—and why—did Ixta Tile change so drastically?*

## Distribution and Small Business

It used to be that small businesses seldom had the time, money, or expertise to deliver their products directly to their customers. Instead, they hired professional distributors, or outsourced certain distribution tasks. Some even hired other companies to package, store, and deliver their goods, leaving them free to focus on customer service, product design, or promotion.

These are all viable strategies, of course. But today, the rise of e-commerce has made it much more common for small businesses to sell directly to customers...including international customers. Customers can buy at all hours, from the comfort of their homes. Websites can answer technical questions, provide testimonials, and calculate shipping costs and delivery time.

We'll discuss e-commerce at great length in upcoming chapters. For now, we'll concentrate on finding distribution partners. Bear in mind, though, that all of these partners may use the Internet to promote or even deliver your product.

### Distribution Partners

Businesses in every industry rely on **distribution partners**, who help them move their products through the distribution channel. These partners act as intermediaries to help buy and sell, assemble, store, display, and promote products.

*Retailers*

Retailers buy products from manufacturers, distributors, and wholesalers, then mark up the price to cover their costs and make a profit. A good retailer will promote your product, and be knowledgeable enough to answer customer inquiries and market the product effectively.

*Wholesalers*

Wholesalers buy and sell bulk merchandise to other wholesalers or retailers. They never sell directly to the public. Their expertise lies in repackaging, storing, and reselling. An example would be a wholesaler that buys all types of dried fruits and nuts in bulk, repackages them into smaller bags, and sells them to grocery chains.

Wholesalers often have close relationships with regional or national retailers, and they may have their own system for transporting your goods. And wholesalers often buy in bulk, which can reduce warehousing and other overhead costs. On the other hand, you'll get a lower per-unit price from a wholesaler than from a retailer or direct sales.

*Distributors*

Distributors buy merchandise from manufacturers and resell it to wholesalers, retailers, or sometimes directly to the final customer. A good example of a distributor is the Northern California coffee company, Peet's Coffees. They buy coffee beans direct from growers and roast the beans themselves. Peet's then sells to wholesalers, who repackage and relabel the coffee to sell to retailers. Peet's also sells directly to customers in their own coffee shops.

Here are some cases in which your business may need a distributor:

- Customers are scattered geographically and require speedy, small-quantity deliveries
- Products require little or no technical selling
- Basic repackaging or customization is required to fit local customer needs
- Distributors are traditionally used in your industry

*Agents*
Agents charge a commission to facilitate sales between manufacturers and their final customers. Agents do not take title to the products they deal with; they simply represent businesses and their products.

- **Manufacturers' agents** sell a business's product in a specific geographic region, usually on an exclusive basis.
- **Sales agents** are different in that they often have more control over setting prices and terms of sale. It is not uncommon for them to take over all or part of the marketing effort for a product, including promotion and distribution strategy.

*Brokers*
Brokers specialize in particular product categories and have the least amount of direct involvement with the manufacturer and end users. Brokers unite buyers with sellers, and have only short-term relationships with each. Like agents, they do not take title to the products they broker.

*The changes at Ixta Tile came about during a period of explosive demand for hand-painted tiles. Wealthy New Mexicans in Albuquerque and Santa Fe wanted tiles for bathrooms and kitchens, as did the ever-growing community of expatriate Mexicans in cities like Los Angeles and Phoenix.*

*Ixta Tile was soon overwhelmed. Benny hired more artists and operational staff, and his business flourished.*

*Then, an amazing thing happened. The largest distributor of ceramic and clay tiles in the western United States called, and urged Benny to create a line of tiles for large-scale production.*

*The tiles would be similar to Ixta Tile's bestsellers, but simpler, with colors and designs that were neutral enough to appeal to a wider range of buyers.*

*If Ixta Tile could do this, at a competitive price, the distributor offered them a great deal: it would be the exclusive representative for Ixta Tile in the United States, In exchange, Ixta Tile would get high-volume orders, and a generous percentage of the proceeds.*

*The distributor's carrier, which operated out of Phoenix, would handle all shipping.*

*The offer was too attractive to pass up, and Benny accepted it gladly!*

### How to Evaluate Your Intermediaries

Once you've decided to use intermediaries, your next task is to evaluate their:

- Selling ability
- Record for paying bills on time
- Promptness and accuracy in handling orders
- Compatibility with your business's culture and operations
- Willingness and ability to offer marketing feedback
- Professional reputation in the industry
- Dun & Bradstreet credit rating

You must manage your intermediaries carefully, and evaluate their efforts

### Managing Your Intermediaries

Begin with a clear, simple contract that covers the following:

- Sales staff and quotas
- Pricing policy—flexibility in offering discounts, etc.
- Minimum reorder and inventory quantities
- Geographical territory
- Handling of house accounts
- Training and technical support for the distributor
- Terms of payment
- Management of service and repairs
- Return policy
- Reports and feedback from distributors on sales and market conditions

### Intensive Versus Selective Distribution

The goal of **intensive distribution** is to get a product into the widest possible number of outlets. This strategy makes sense when customers have an immediate need for a product and make no distinction between one brand and another (e.g., ballpoint pens, shoelaces, safety razors). The consumer's primary interest is convenience; he or she will buy whatever brand is available at the nearest outlet.

In **selective distribution**, the product is offered at a limited number of outlets. Consumers have to work a bit harder to find the product, or travel a longer distance to buy it, either because they're willing to seek out a favorite brand, or because the product is unique or innovative. This is the most common distribution strategy for small businesses, because they tend to target niche markets.

Also, selective distribution is required by certain types of products. Consider the cost to a retailer of offering ten packages of shoelaces, versus the cost of offering ten terracotta birdbaths weighing fifty pounds each. When inventory costs are higher, businesses are often obliged to limit their offerings in a given market, so that retailers will be more likely to earn a profit.

The natural focus of small business on selective distribution can be leveraged into a competitive advantage through shrewd branding and marketing. Sometimes, a product that seems to be rare or special is more desirable, and commands a higher price; green and organic products are the most common examples, but there are many others.

To an entrepreneur, everything is an opportunity!

Remember that to an entrepreneur, everything is an opportunity! If you're forced by circumstances to have limited distribution, you may be able to brand your product as "exclusive" or "sought-after."

The most limiting form of selective distribution is **exclusive distribution**. In this arrangement, a single wholesaler, retailer, or distributor is granted the sole legal right to offer a product within a specific geographical area. This is most commonly used for luxury items and expensive machinery, but it's also a fairly common strategy for specialty items aimed at a niche market.

Exclusive distribution deals can be great if you have the right partner. Otherwise, they can be disastrous! You'll want to do plenty of research before agreeing to an exclusive distribution deal.

## NxLEVEL® TECH TIP

### BUSINESS RESOURCES AND THE WEB

In the eyes of many experts, the most important aspect of a successful e-commerce business is maintaining excellent warehousing, distribution, and fulfillment functions. If you're not in the best position to do this, you may wish to consider outsourcing these functions.

If you need help with inventory, tracking sales and shipments, or hooking your system to a warehouse or fulfillment center, it's best to turn to a systems integrator, a consultant who specializes in building retail or business-to-business Websites.

You can get referrals for systems integrators and warehouse companies from the **Information Technology Association of America** (www.itaa.org), or the **Council of Regional IT Associations**, which is accessible from the same site.

For more information on the best ways to set up the back end of your Website, visit **www.clearcommerce.com/eguide**, a comprehensive guide designed to help merchants, financial institutions, commerce service providers, ISPs, and others conduct business electronically.

*Though he didn't realize it at first, Benny had fundamentally changed his business by accepting the distributor's offer. The new distribution strategy had a profound effect on their product and pricing and marketing strategies. It seemed as though the rules had changed overnight!*

*Representatives of the distributor explained that Ixta Tile had previously been offering a luxury item—their tiles might appeal to wealthy buyers, but they wouldn't necessarily appeal to shoppers at mass retailers like Home Depot and Tile World, who tended to be more conservative and price-conscious. To be competitive, Ixta Tile would have to simplify its designs, and discontinue its handcrafted products.*

*Accordingly, Ixta Tile's designers began choosing milder colors, cheaper ceramics, and simpler designs for the mass market. The company also began the process of retooling so that they could scale up production. There was no doubt about it: the days of hand-painting tiles were gone!*

## Selecting Distribution Channels

Like any business strategy, distribution strategies require you to know your objectives, your customers, your time and budgetary constraints, your brand, and the pros and cons of your alternatives. Distribution objectives might include achieving service goals, increasing speed to market, ensuring safety and reliability, or reducing costs.

Do your customers need on-time delivery? Do they expect you to have a green supply chain? Does your product require technical support? Do you offer customization or personalization? Do you need to retain complete control over the handling and delivery of your product? These are the type of questions you should ask yourself in order to identify which distribution channels are best for your product.

In some cases, traditional distribution channels might not be feasible, and you will have to seek more entrepreneurial methods. Here are some things to consider when choosing distribution channels:

- **Product.** Perishable products like foods and chemicals often require direct sales in order to keep them viable. Fragile products may not survive certain types of distribution (as in this chapter's story about Ixta Tiles). Low-cost products manufactured in bulk may be ideal for wholesalers, so as to reduce your warehousing needs. Also, note that there may be transportation restrictions on certain types of goods, based on weight, size, materials, or purpose.
- **Profit.** Which channels will allow you to meet your sales and profitability goals? Intermediaries cost money; the more intermediaries you have, the more units you must sell to make a profit. On the other hand, if you sell direct, you take on the duties associated with delivering the product. That can be expensive, too.

The more intermediaries you have, the more units you must sell to make a profit

- **Customers.** Psychographics and demographics are crucial when choosing distribution channels. What do your customers value, and how do they view themselves? If your target customer doesn't shop at malls, there's no sense in selling to a mall-based retailer.
- **Competition.** How do your competitors sell? Are they regional, local, national, or international? Will your products be handled by the same stores, wholesalers, distributors, or agents? If so, will you get equal treatment? What about online competition? What channels will give you a competitive advantage?
- **Technology.** Your distribution strategies must reflect your customers' access to and attitude towards modern technology. Clearly, if your target customers don't buy online, e-commerce will not be a good option. If your distribution channel requires some sort of technological know-how or equipment, you must ensure that your customers have it and are willing to use it.
- **Confidence.** Are you confident in the competence and honesty of your intermediaries? Remember that how they display and deliver your product will reflect on you! Also, they may have a great deal of control over your cash flow. Can you afford to have all your eggs in one basket? If they pay slowly, or not at all, what's your contingency plan?

Your distribution strategies must reflect your customers' access to and attitude towards modern technology

Your distribution strategy will also vary according to whether you produce consumer goods, industrial goods, or services. This next section reviews the basics of each.

*A year into the new distribution agreement, Benny Canales felt like the only thing he did anymore was oversee the packing and shipping of tiles.*

*Several times a week, the tiles were painted, fired, cooled, and packed in large wooden crates, each of which held three thousand tiles. The containers were packed by color and labeled, and then picked up by a shipping company. From there, the tiles were trucked to Phoenix, loaded on trains, and carried to distribution centers.*

*Ixta Tile was not involved in this process. Nonetheless, their contract terms specified that they were responsible for broken or lost tiles. This was running at 35 percent of total sales! The situation was bad, and Benny was worried about it.*

*On top of all his other headaches, Benny was frustrated artistically. What had his company become? A producer of ordinary, inartistic ceramic tiles that competed solely on the basis of price. His creative vision was gone. And that had been what made the tiles sell in the first place.*

*Sales were up, certainly...but so was breakage. Ixta Tile's liability for broken and lost tiles was taking a substantial bite out of the profits. And although the company had increased its sales, it had lost the business of the wealthy customers who had once sought Ixta Tile out.*

## Distributing Consumer Goods

Consumer goods include everything we buy in the supermarket, as well as things like bicycles, running shoes, kites, accordions, and tinsel.

*Direct marketing*

Some businesses avoid intermediaries altogether by marketing their products directly to their customers through door-to-door sales, their own retail stores, telephone or catalog orders, or the Internet.

By selling direct, you control how your products are sold and serviced. You can remain on top of changes in your market, and respond quickly to customer needs. Direct selling can also be faster and cheaper (in the case of telephone, catalog, and Internet sales) than any other distribution method. One of the most important elements of direct selling is keeping a database of past, present, and prospective customers.

By selling direct, you control how your products are sold and serviced

*Manufacturer to retailer*

Most producers of consumer goods rely on intermediaries. However, manufacturers that sell to large retailers like K-Mart or Macy's may bypass wholesalers entirely. They choose this strategy because retailers often provide storage and logistical support more cheaply and effectively than wholesalers. Also, this gives retailers more control over their transaction with the manufacturer.

Other businesses distribute their goods to retailers through wholesalers or other intermediaries. This strategy is used by larger manufacturers that sell to many small retailers. Wholesalers can be particularly helpful to businesses introducing new products. They can use their leverage and expertise in the industry to push the product into retail outlets. Businesses can also use agents and brokers to sell to wholesalers or retailers. These intermediaries operate on commission only, and can be a handy replacement for a small business's in-house sales team. They can present a line of products professionally, coordinate in-store promotions, and share their expert knowledge of markets and customers.

## Distributing Industrial Goods

Industrial goods are products that are sold as inputs to businesses who make them into finished products.

*Direct marketing to other businesses*

This type of distribution is much more common in industrial markets than in consumer markets. Most industrial manufacturers have only a few, very large customers to whom they sell directly. Many industrial products are more expensive and complex than consumer products. They also figure prominently in the production of other products, and must meet certain quality standards and be delivered on time. In short, buyers and sellers in industrial markets are tied together closely in a partnership. In-house sales forces, telemarketing, and the Internet are the major ways that industrial manufacturers market direct to their customers.

*Manufacturer to intermediary*
Wholesalers and agents can provide a more cost-effective way of selling many small industrial products to smaller customers. Intermediaries can also help get a new product established among industrial customers. They can even provide technical and promotional support, depending on the terms of the contract.

*Benny felt that he badly needed to reevaluate his goals. Could he make money by selling what he actually wanted to sell? He decided to take a hard look at the current state of his market.*

*He knew that expatriate communities of wealthy Mexicans were still growing in the Southwest, and they were building and buying like crazy. This represented a great market for Ixta Tile.*

*He also knew that interest in ethnic style and Mexican folk art was booming in the United States; word had spread about Ixta Tile's hand-painted tiles, and the company often received calls from people who were looking for the older, customized tiles in which Ixta Tile used to specialize.*

*Also, Ixta Tile's new customers had a tendency to mix and match designs; they might choose a Ixta design for the kitchen, and use some other company's tile in the bathroom. Earlier customers had wanted a consistent look in every tiled room, and thus had bought larger amounts of tile. Also, profit margins had been much higher on the handcrafted tile.*

*Benny began to suspect that the company was in a position to shift back to what it did best: producing gorgeous, unique, hand-painted tiles.*

### Working With Sales Representatives

A professional representative can be the best friend a small business has

A professional representative can be the best friend a small business has. They're easy on a business's cash flow, because they add no fixed costs to the business. They're usually paid on commission, or when they make a sale; they may even pay for products in advance. They're specialists in the product category and geographic region in which they operate, and are likely to know the industry and prospective customers better than you do. Also, outside reps may have special technical knowledge of products and be able to offer better technical support or service than you can. They can also help shoulder the responsibility of promotions and advertising.

Of course, there can also be disadvantages to using sales reps. Your product might be just one of many product lines that the rep carries; unless you offer the right incentives, yours might get lost in the shuffle. Some representatives require a great deal of support to sell effectively. Last, sales representatives can be difficult to train, monitor, and motivate. It may take a strenuous effort to get your money's worth.

### What You Should Do for Your Reps

- **Give them some breathing room.** Don't micromanage your reps. Instead, hire bright people with good references, and let them prove themselves.
- **Contact your representatives at least once a week.** Check on progress, resolve questions, or just chat to keep each other in the loop.
- **Give each representative a sales manual** containing product specs and photos, competitive comparisons, customer references, reprints of articles and endorsements, and samples.
- **Create an informal newsletter or blog.** Use it to announce winners of sales contests, highlight new product developments, answer commonly asked technical questions, and show territory sales volumes.
- **Use social networking tools to stay in touch.** Using services like Twitter can help you to monitor progress, share leads, and discuss strategy with your reps.
- **Give them immediate support.** If they have questions or problems, give them swift, personal attention. Be prepared to attend initial and major sales calls.
- **Always pay your commissions on time.** Be reliable, accurate, and speedy!
- **Give your sales representatives lots of quality sales leads.** The more prospects they have, the more product they can sell.
- **Follow through on product promises.** If your reps know that the product lives up to its promises, they will sell more confidently.

### What Your Reps Should Do for You

- Give weekly updates on prospects and sales efforts
- Prepare regular expense reports and receipts
- Call for product or technical expertise when needed
- Stay current on industry and market trends
- Communicate any customer problems or complaints
- Offer regular feedback on the sales territory
- Be honest and positively represent your business

*Finding and recruiting reps*

The first step in building a first-rate sales team is finding the right people to staff it. Trade journals and Websites can provide information about who the major reps are, and what types of customers they serve. There are also national and local representative and dealer associations, and lists of reps maintained by local and state Chambers of Commerce.

The first step in building a first-rate sales team is finding the right people to staff it

Business-oriented social networking sites like LinkedIn can help you find qualified reps in your area. Also, businesses that deal in products similar to yours might be able to recommend a good rep in a given territory.

Here are some hints for selecting reps:

- Evaluate their selling techniques, contact base, and technical know-how
- Make sure the rep's personality is compatible with your business
- Review his or her track record, and get reliable references
- Clearly define your sales expectations
- Hire each rep for a three- to six-month trial period, and assess results

### Licensing

Licensing is an arrangement whereby one business sells another the right to produce or market its product. This allows manufacturers to reap the benefits of a product's reputation and brand without the risk of investing in new products. It effectively transfers the responsibility of marketing, production, and distribution to the licensee.

## Creative Placement Strategies

Unconventional distribution methods can be very effective and inexpensive. Many small businesses have successfully differentiated themselves by using such methods, such as "piggybacking" one product with another.

Unconventional distribution methods can be very effective and inexpensive

Your goal is to break away from precedents in order to devise a cost-effective and unique distribution strategy that complements your product positioning (as well as the other elements of your marketing mix), and delivers value to your target customers.

You may find that your best placement ideas come from rethinking how your product is used. Perhaps it has another use you haven't thought of yet, or perhaps it could easily be adapted to some other purpose. Either case may lead to new placement opportunities.

Another possibility is redesign. Can you make changes that will give your product a wider appeal? Can you make it meet more needs by giving it additional functions? Can you replace a cheap plastic shell with highly polished bamboo, or stainless steel? If so, your product may be one step away from acceptance by a prestigious retailer or distributor.

The more competition you face, the wiser it is to find ways of differentiating your product. The appetite for innovative reworkings of existing products is getting stronger all the time. Catering to it can win you lucrative and unusual placement opportunities, especially on the Internet.

*Benny suspected that to solve his problems, he'd have to be bold and brave enough to take a step backwards.*

*But could Ixta Tile really go back to hand-painted tiles without downsizing drastically, or going broke? Benny calculated that since the new tiles would be custom-painted, and use a higher grade of ceramics, he could charge between $2.00 and $12.00 per tile.*

*He did some research, and found that if Ixta Tile sold direct through design showrooms that took a 15% commission on sales, it would get fewer but more profitable orders, and have more control over its entire sales and delivery process. Higher prices would allow him to pack the tiles more carefully, and reducing breakage would have a strong effect on the bottom line.*

*Though the numbers looked good, he still worried that it was too risky to cut production quantities, raise prices, and limit distribution.*

*But as much as it worried him, it also excited him. Creating unique hand-painted tiles was, after all, what he had started the business to do. He decided to take the plunge.*

*There were problems and issues to sort out at first, but slowly the process came together. Interest in the United States steadily climbed. Ixta Tile's custom designs got good press in Metropolitan Home's ethnic-design issue, and word of mouth began to work its magic. Within a year, orders were up, and the tiles were arriving intact and on time. By going back to its roots, Ixta Tile had taken a giant leap forward!*

## Conclusion

The success of your business depends on reaching the greatest possible number of your target customers, so a great deal of thought and research should go into selecting the best method of placing your product.

A distribution strategy that fits your product positioning and the rest of your marketing mix will bring you one step closer to achieving success. As with every other component of the marketing mix, the solution lies in knowing your customers, and finding imaginative ways to differentiate your product.

# Chapter 32
# THE ART OF SELLING

*About This Chapter:*
- *Traits of successful salespeople*
- *The psychology of buying*
- *Six steps to sales success*

## Introduction

Sales techniques have changed a great deal over the last century. Perceptions of salespeople have shifted dramatically; many people used to consider selling a profession for shifty people who used deceit and manipulation to make the sale, even if the customer didn't need the product. A good salesperson was one who could "sell ice cubes to an Eskimo."

Fortunately, things are different now. Today, good salespeople listen, understand their customers' needs, and provide solutions. They sell quality products that are guaranteed to perform, and back them up with excellent customer service. They offer a value-added approach, which means providing a service or an association that customers value as much as, or more than, the product itself.

Enlightened salespeople understand that long-term success means keeping customers satisfied after the sale; it costs more to get a new customer, or to win a disgruntled customer back, than it does to sell to an existing customer.

This chapter presents some of the best sales techniques for entrepreneurs.

## Traits of Successful Salespeople

No matter who you are, you can learn to be a confident, effective salesperson. With practice, you can develop an approach that fits your personality, highlights your expertise, and is as comfortable to you as a well-worn glove.

To become successful, you must develop and hone your own selling style

But regardless of your personal style, or the type of business you're in, certain traits are fundamental to successful selling:

- **Persistence.** Successful salespeople are tenacious, dedicated, and resilient. They see the positive side of problems, and the opportunities posed by obstacles, and they don't get discouraged by prospects who don't agree to buy. This is probably the single most important trait a seller needs to have.

A confident salesperson knows when to walk away and pursue other opportunities

- **Confidence.** Salespeople believe in their products, and are confident in their ability to get other people excited about them. They're also not afraid to ask the customer to buy, when the time is right. This doesn't mean that they are arrogant, or that they bully people into agreeing with them. On the contrary, a confident salesperson knows when to walk away and pursue other opportunities.
- **Empathy.** Successful salespeople are willing and able to relate to each customer's unique situation. They don't pressure prospects to buy more than they can afford, or try to impose a one-size-fits-all solution on a variety of different clients. They intuitively understand when to give customers more breathing room. Empathy also helps salespeople to identify motivations and concerns that pose obstacles to making a deal.
- **Ability to adapt.** Salespeople may have to deal with many different people to close a deal, all of whom may have different demands, different concerns, and different styles of negotiation. For this reason, the ability to adapt to and keep pace with prospects is essential.
- **Quick thinking.** Salespeople will inevitably hear objections they didn't anticipate, or offers they need time to evaluate. Therefore, they need to be able to think on their feet, whether they're answering an objection or explaining why they can't make a decision on the spot.
- **Excellent listening skills.** Good salespeople ask relevant questions, and listen respectfully while customers answer. They frequently summarize what they've heard, in order to confirm that they've understood it.
- **Technical knowledge.** Salespeople should understand everything about their product or service. If there's a question they can't answer, they should know exactly where to go to get the information they need, so that they can pass it along quickly to the prospect.
- **Superior communication skills.** No matter what personal style they favor, the best salespeople make their points clearly and directly, using language that is appropriate for the social context of the sale. More than that, their language communicates their confidence, their empathy, and their willingness to listen and learn from their customers. (Note that body language can be a very important part of communication.)

*On Robert Chavez's 55th birthday, he decided to make some changes in his life. For twelve years, Robert had been working in the service department of a large office equipment manufacturer based in Tempe, Arizona. He was responsible for all service follow-up activities in the Phoenix area, so he knew that the biggest customer complaints involved service response time, equipment reliability, and price. Robert and his office manager, Anna Gambera, felt they could meet customers' needs better than their employer could.*

*Their plan was to become independent sales representatives for a competing office equipment business, and sell and manage their own service contracts. At a trade show they attended, Anna and Robert had been impressed by the people they met from a large American copier manufacturer; the product was high in quality, and the company was aggressively expanding into the western states.*

*Anna drew up a proposal to the company, defining the territory and the terms of their customer service contract. Meanwhile, to hone his skills, Robert enrolled in a five-week copier repair course. They decided to call their new business "Copiers West."*

## The Psychology of Buying

If selling were a simple matter of explaining features and benefits so that people can make a rational, informed decision, there'd be nothing to it. But in fact, buyers have many different motivations, and not all of them are rational or obvious. They may also have anxieties or conflicts relating to the buying decision. (This is particularly true if you're selling to a business customer.)

Here are a few aspects of buyer psychology that you should bear in mind:

- **Buyers often make decisions based on emotions or instincts, and then look for rational arguments with which to justify them.** If a prospect hasn't bought into the product emotionally, it's unlikely that facts and figures will change his or her opinion. Once the prospect has bought in, however, the discussion of features and benefits is likely to be reassuring.
- **Buyers respond to stories.** Information that might seem dry or abstract in the form of raw data is often more compelling when it's presented as a story. Instead of detailing technical specs, consider explaining how those specs solved a problem for a previous customer.
- **Buyers often mistrust sellers.** Our popular culture is full of stories about dishonest salespeople who take advantage of naive buyers. More than ever, you should be able to back your case up with facts, test results, and testimonials, particularly if you're offering green or sustainable products.
- **People like to talk about themselves, and they want people to listen.** Listening and asking questions can provide you with useful information, but that's not the main reason it's worthwhile. The main purpose of listening is to give the customer the experience of being listened to by someone who's curious and engaged. That's an important part of building a relationship, and building a relationship is vital to selling.

Buyers often make decisions based on emotions or instincts, and then look for rational arguments with which to justify them

**Cold Calling Tips**

- Focus on the reason for your call (i.e., making a sale, or setting an appointment)
- Know your product, and research your market and your customer
- Develop a well-prepared opening statement
- Prepare a "script" for the perfect call
- Speak in an upbeat, pleasant manner
- Be persistent—don't give up!

## Six Steps to Sales Success

Whether you handle sales yourself or work through an intermediary, you must understand the six steps of selling.

### Step 1: Prospecting and Prioritizing Accounts

Before proceeding, determine:

- Your target customer profile's size, location, needs, problems, goals, and values
- What unique value your business offers target customers
- Why your offerings are better than those of competitors
- What resources you have to encourage consumers to buy your product

Consider all the possibilities. If necessary, seek advice from associates who are familiar with you and your business. Think about sales possibilities locally, nationally, and globally. Next, step back and sort your list of sales prospects into the following categories:

Creating a timeline that outlines each step of the selling process can keep your sales efforts for long-term prospects on track

- **Short-term/long-term prospects.** This list includes prospects you can develop immediately. Long-term prospects are larger organizations that require more time to build relationships. (Note: Creating a timeline that outlines each step of the selling process can keep your sales efforts for long-term prospects on track.)
- **Most profitable/least profitable.** Analyze each prospect's profitability. You may find that larger accounts provide less profit per unit of sale, but more profit overall. Small accounts may provide more unit profit, but require greater effort and time.
- **Prestige accounts.** High-profile accounts provide great exposure for your business. Unfortunately, everyone else wants these prestigious accounts too! You may decide to make less profit on some of these accounts, just to get your name associated with them.

Next, develop your sales targeting strategy. Which accounts should you target first? Which are critical to your long-range goals, and which are the bread-and-butter accounts?

*The value of networking*
There's no doubt that networking often has a negative connotation—each of us has been the target of someone's obnoxious networking scheme!  However, positive, unobtrusive networking is critical to a business owner's success.  The key is to network in a respectful, professional, mutually beneficial, and genuine manner.

Joining organizations or clubs in your field is an excellent way to meet new people and prospects.  If you are a sole proprietor, these organizations can introduce you to like-minded people, and give you an opportunity to keep up with new business developments. LinkedIn (www.linkedin.com) is another excellent way to expand your circle of contacts.

Join organizations or clubs in your field

*The value of the computer*
Computerizing sales information saves money and streamlines sales activities. Entrepreneurs can develop prospect and account information on computer software, and update sales targets as priorities change.  Good account information makes your efforts more professional and organized.

*By June, Robert and Anna were in business, and the battle for customers was in full swing. Most businesses in the Phoenix area already had copiers and service contracts with larger competitors.*

*Robert and Anna were confident that their higher-quality copiers and superior customer service would convince their prospects to switch.  The problem was getting in the door.*

*They decided to target businesses with less than 100 employees.  Then, they began cold calling in person.*

## Step 2: Preparing for Sales Calls
Before you approach your first target customer, you need to do your homework.  Whether for a simple sale (a call on one person who is capable of making the buying decision), or a complex sale where multiple buying influencers take part in the decision, proper sales-call planning is the biggest part of the selling process.

Face-to-face selling time is very short. Planning allows salespeople to maximize their time with buyers by asking the right questions and presenting relevant information.  It allows them to sell their products by solving problems.

*Analyzing buyers*
Before you making a sales call, you should  understand the different types of people who participate in the buying process.

- **Decision-maker.** This buyer will be able to say "yes" or "no" to your proposal. In a simple sale, the buyer usually makes the decision. In a complex sale, the decision-maker may not be readily available or identifiable. The decision-maker is often swayed by several other buying influencers.
- **Gatekeeper.** Gatekeepers don't make the final decision (though they may want you to believe they do). Their purpose is to screen prospective suppliers and gather information. This role is often played by administrative assistants, purchasing agents and attorneys.
- **Guide.** This buying influencer is interested in your product, and is therefore an ally who can provide inside information about the buying process. If there isn't a guide available, develop one!
- **User.** This is the person who uses your product. The user may not make the final purchase decision, but usually has strong influence over purchase decisions.

These influences are interconnected. For example, you may have a great relationship with the decision-maker, but the user will kill the sale if he or she doesn't like the way your product performs. Alternatively, if the gatekeeper denies you access to the decision-maker, you can concentrate your promotional efforts on the user, who has the power to activate the purchasing process.

Sell from the customer's point of view

*Buyer orientation*

Buyers have different motivations for their buying decisions. Salespeople must try to understand these motivations, and use them to sell products from the customers' point of view.

Here are some common motivations you should expect to encounter regularly:

- **Security.** This buyer has a desire for stability, and does not want any risky propositions. You should minimize his or her exposure to risk, and make him or her feel comfortable.
- **Power.** These buyers want to be recognized for their position and influence, and may abrasively assert their authority and knowledge. They may not be very much fun to call on, but they do make decisions and get things done.
- **Relationship.** This buyer likes people, and tends to be very open and friendly. Relationship buyers expect you to socialize a bit prior to getting down to business. This is great if they can make a decision, but not so great if they waste your time!
- **Enlightened.** This type of buyer makes informed decisions by gathering facts and weighing the alternatives. Being well informed and knowledgeable about your product will serve you well when calling on this buyer.

### Step 3: First Contact

Your first contact with prospective customers should make a positive impression, pique their interest, and glean information that will help you make the sale.

To this end, you should prepare open-ended, probing questions. Here are some suggestions:

- Find out about customers' business issues, and any discrepancies between their current and desired state.
- Uncover desires, values, and intense feelings about issues related to your product.
- Use confirming questions to verify whether you've made the proper assumptions, or drawn the correct conclusions.
- Ask questions to obtain agreement on an action that will close the sale.

Generally speaking, it's wise to adapt your personality to that of your counterpart. If the person you're talking to is cheerful and friendly, you should be, too. If he or she is quiet and serious, you should attempt to project the same image.

Note that this isn't a matter of putting on an act, or being deceitful. It's a matter of showing respect for the other party.

*In their initial visit, Robert and Anna focused on gathering the following information about prospective customers:*

- *Their type of business*
- *How satisfied they were with their copier and service arrangement*
- *The name of the decision-maker*

*During negotiations, Copiers West demonstrated:*

- *Knowledge of the prospect's copier needs, problems, costs, and concerns*
- *Knowledge of their competitors' offerings*
- *Their expertise, and the quality of their product*
- *Their ability to deliver excellent customer service and maintenance*
- *The savings in cost from switching to Copiers West*

### Step 4: Make the Presentation

After listening carefully to your customers' needs and problems, begin framing the concept of your product.

Buyers often buy concepts about products, rather than the product itself. For instance, a man who buys a new red Ferrari is not buying a car; he's buying an image of power and prestige. If he simply wanted a car for transportation, he would buy an economy car, like millions of other car buyers.

You should also present information about your product's features and benefits. **Features** describe how the product looks and performs. **Benefits** describe how the product meets a need or solves a problem. Develop your own features and benefits statement for your products, your service, and your business. Remember to sell benefits, not just features!

What should a professional presentation look and sound like? Here are some basics:

- **Appearance counts.** Wear clothing appropriate to your industry. If you are in the golf business, a polo shirt and casual pants will do nicely. If your clients are bankers, a suit is in order.
- **Attitude counts.** A professional, sincere, honest, and energetic approach is best.
- **Your first comment counts.** Begin with a direct question or strong statement—based on your research—that shows your client how your product will solve his or her problems.
- **Benefits count.** Show your clients what's in it for them.
- **Creativity counts.** Canned sales pitches don't go far with today's sophisticated buyers. Use your creativity to develop a unique presentation.
- **Rehearsal counts.** Don't go in cold; practice ahead of time.

### Step 5: Objections

Anticipate customer objections, and have an answer ready!

If life were perfect, every client would immediately purchase everything you pitched. Unfortunately, clients invariably have some objection, or a reason they don't wish to buy. A good salesperson anticipates customer objections, and is prepared to respond to them.

Some typical objections are:

- Your price is too high
- I need to talk this over with my team
- I don't think your program will solve my problem
- I'm satisfied with my current supplier and don't want to change
- Your competition has better delivery times
- Your company hasn't been around very long
- I had a bad experience with your company last time

There are four steps to overcoming such objections.

1. Listen carefully to gather information on the problem.
2. Acknowledge the customer's concerns.
3. Explore the problem by asking questions and clarifying meaning.
4. Respond to the objection by recommending a solution.

You may have to repeat this process many times in the course of a sales call. Persistence pays off, but only when matched with civility, empathy, and an honest desire to solve your clients' problems.

*Robert and Anna followed up each cold call with a telephone call to set up a meeting with the office manager. They'd gathered information about the prospect's copier needs; now was their chance to demonstrate their expertise and grab the decision-maker's interest.*

*Robert and Anna had a great success rate. Four times out of ten when they followed up over the phone, they got an appointment with the office manager, their prime target.*

*With their preliminary information in hand, Robert and Anna approached the appointment with a confident attitude. In every meeting, their rule was to ask questions and listen more than they spoke. They used professionally photographed pictures of their copiers and a simple chart to present the comparative cost savings of their service contracts over their competitors'. They also made a point of knowing what their prospect's objections might be ahead of time, and preparing solutions for them.*

| ***Customer Objection*** | ***Copiers West's Solution*** |
|---|---|
| • *The hassle of switching equipment* | • *Free installation and training, first month free* |
| • *Lost time for copier upgrades* | • *Same day installation and training* |
| • *Need to see copier before committing* | • *Nearby showroom with all models and equipment* |
| • *Fear of using more complicated equipment* | • *Demonstrate that Copiers West's equipment is easier to use* |
| • *Concern about service delays from smaller provider* | • *Money-back guarantee if longer than two-hour response time* |

*By presenting their information confidently, and offering benefits that solved their prospect's problems, Robert and Anna earned the respect of office managers. Once they had this, they would listen as the prospect asked questions and raised objections. They always probed for more information when met by an objection. Their goal was to be responsive to the prospect's concerns and needs, and let the prospect gradually arrive at the realization that Copiers West was the obvious choice for cost savings and better service.*

*With their warm personal style and expert approach, Robert and Anna were able to get a foot in the door. They asked the right questions, listened carefully, and presented solutions. Their business grew and grew. They had become truly successful salespeople!*

## NxLEVEL® TECH TIP

### BUSINESS RESOURCES AND THE WEB

Your Website is like a salesperson that represents your business to the entire world, so you want to make sure that it targets the right customers, makes a good first impression, is able to answer any question about your product or services, and does its utmost to complete the sale. Here are some tips that will help make your Website the perfect electronic salesperson.

- **The name and address of your Website are extremely important, so choose them carefully.** Go with a short, striking name that is easy to remember and easy to spell.
- **Rapid response is the most important factor in attracting and retaining online business.** Reply to your customers' questions and comments within 24 hours.
- **Keep things simple.** Avoid complicated or cluttered sites. Everything the customer needs to know about your business should be easily accessible.
- **The more links you have to complementary sites, the better.** Try to find free links, or "trade-outs," where you offer a link to a site and they provide one in return. Make sure all links appeal to your target audience.

## Step 6: The Close

The biggest reason for lost sales is the failure of salespeople to ask for the order.

Why is this? Well, the two major reasons most people won't ask for orders are fear of failure and fear of rejection. Nobody likes to feel like a failure, or to be rejected by other people. However, in all likelihood your client isn't rejecting you personally, nor have you failed personally. There are many reasons why clients don't buy, especially during the first try. They may not have the authority to sign a purchase order, they may have bought a month's supply of your product the day before, or they may want to get to know you better before doing business with you. There are almost as many reasons as there are customers.

Remember, if you have a quality product or service that is fairly priced, you have no reason to fear the reactions of the buyer.

Here are a few of the many methods that you can use to close a sale:

- **Basic close by using an application form.** Begin by asking the customer a question from the application. Write in the answer. Proceed to the next item. As long as the customer does not stop you, you've made a sale.
- **Close by offering choices.** Offer alternatives: "Do you prefer green or blue?" "Would you need two of these, or three?" When a prospect makes a minor decision, the major decision is close.
- **Close by constructing a balance sheet.** For indecisive prospects, remark that a tally of the reasons for and against the concept will make the decision for them. Take a sheet of paper, draw a line down the center, and help the prospect to list the reasons for and against buying your product. You can address negatives after the list is complete.
- **Close by asking questions.** If your prospect is reluctant to make a commitment but won't tell you why, ask questions: "Is there something you don't understand about my company or our product? Is there anything I didn't make clear?"
- **Close by citing examples.** People will listen to stories. Describe the experiences of customers you've satisfied in the past.
- **Close by isolating the objection.** Change a prospect's "I'll think it over," to a specific objection. Remark that the prospect obviously wouldn't spend time thinking it over unless he or she was seriously interested. When that is confirmed, say "Just to clarify my thinking, what aspect of this decision do you want to think over?" Then probe until the objection is isolated.
- **Close using your prospect's objection.** Hear your prospect out, and get a full explanation of the objection. Get the prospect to agree that this objection is the only thing standing in the way of a sale. Then, overcome the objection with facts.

Uncover the underlying problem preventing the sale...and solve it

**Hi, It's Me Again!**

You made eight personal sales calls on the prospect, sent twelve e-mails answering technical questions, met seven people on the purchasing team, and spoke with the vice president in charge of the project. You revised your formal offer three times and the last one—finally!—was accepted. Congratulations!

Now it's time to get back to your customer and say, "Thanks for your business." Ask whether there are any problems. If there are, give them your immediate attention. A satisfied customer is the best source for new business. In fact, your new customer is a hot prospect right after making a purchase. This is an excellent time to sell something to go along with the previous sale. Remember, it takes a lot less to get a reorder or an add-on than it does to get a new customer!

## NxLEVEL® GREEN TIP

ENVIRONMENTAL BUSINESS RESOURCES

Although most consumers like the idea of green products in theory, they may have any number of objections to buying them, especially if the price is higher. This means that you may have special challenges to overcome when selling a green product. Here are some suggestions for dealing with them.

- **Focus on the traditional benefits first, and then use the green component to seal the deal.** Is your product more durable? Does your service offer convenience and time savings? If so, hook the customer with those benefits, and present the green elements as an attractive bonus. If your product can't compete on other levels than its environmental friendliness, it's not likely to succeed.
- **Be prepared to defend your case.** Although green products have made incredible gains in recent years, you will still encounter people who believe that green means "not as good." If you sell a green cleaning product, you may run into buyers who worry that it won't perform as well. You need to anticipate objections like these, and gather the data you need to overcome them. Providing documentation or certification, and offering demonstrations, are good tactics.
- **Accentuate the positive.** Does your product help to solve an environmental problem? If so, focus on the solution, not the problem. Customers should feel that they are helping or protecting the environment, rather than paying for someone else's sins or trying to ward off a looming disaster. Studies consistently show that frightening or depressing consumers makes them apathetic and less willing to buy.

## Conclusion

Very few people are born to sell, but anyone can learn to be good at it. Selling should be fun, challenging, exciting, and financially rewarding. By learning selling skills, doing your homework, and developing your own style through practice, there is no reason why you can't ask for the order, and get it.

# Part VII
# The Internet and E-commerce

## Chapter 33
## THE INTERNET

*About This Chapter:*
- *The history of the internet*
- *Getting online*
- *Online trends*
- *Online security*
- *The future of the internet*

### Introduction

The Internet is such a huge part of our daily lives that it's hard to believe it's only existed as a commercial network since 1992. Since then, it's had a revolutionary effect on the world of business...several times over! For today's businesses, continuous adaptation to changing Internet capabilities and usage is an absolute necessity.

Continuous adaptation to changing Internet capabilities and usage is an absolute necessity!

In the next chapter, we'll discuss e-commerce advantages and strategies. For now, let's take a brief look at the history—and probable future—of the Internet.

### The History of the Internet

When you connect two or more computers so that they can share data, you have a **network**. When you connect two or more networks so that they can share data, you have an **internet**.

What we call *the* Internet is a linkage of tens of thousands of computer networks into a global internet.

The Internet has its origins in an experiment begun in the 1960s by the US Department of Defense, which wanted to create a computer network that would continue to function in the event of a nuclear war. This network was called ARPANET (Advanced Research Projects Agency).

In 1985, the National Science Foundation (NSF) created NSFNET, a series of communication networks for research and education. NSFNET was a national backbone service based on ARPANET. It offered free access to US research and educational institutions. At the same time, regional networks cropped up to link individual institutions with NSFNET.

NSFNET grew rapidly as people discovered its potential for fast, low-cost communication and networking. Soon, new software tools made using the network easier, and the NSF eased restrictions on commercial use of the Internet.

Today, the number of worldwide Internet users is about 1.6 billion, which is roughly a quarter of the world's population! And although the computer is still the primary means of getting online, access has spread to televisions, cell phones, handheld devices, and other appliances.

*In June of 2008, Alexine Marais took over Sairam Textiles from her father, who was ready to retire. Sairam manufactures luxury monogrammed linens and towels. Its customers include resort hotels, spas, cruise lines, and restaurants.*

*When Alexine came on board, the business was faltering. Many former clients were buying linens and towels from Southeast Asia, where labor costs were as low as a dollar per day. Alexine knew that Sairam couldn't compete with those prices, and she didn't intend to try. Still, she had to do something. While Sairam's exquisite quality and excellent service had kept a few big-name clients on board, Alexine worried that the troubled US economy might cause even her most loyal customers to look overseas for bargains. In short, Alexine needed to find new markets for Sairam's products, and fast!*

*About a year before her father retired, a buyer from a large department store had expressed interest in some of Sairam's towels. But Alexine's father preferred to focus on the company's core business. Beyond that, he'd been unwilling to accept the payment terms.*

*Alexine hoped that smaller retailers might accept more favorable payment terms. She needed to promote Sairam Textiles to small boutique retailers across the country, and Internet marketing seemed like the best way to go about it.*

### The Birth of the World Wide Web

The World Wide Web: a collection of linked pages containing multimedia content that is presented via the Internet

Although the terms "Internet" and "World Wide Web" (WWW) are interchangeable in everyday speech, they mean different things. To put it very simply, the Web is a collection of linked pages containing multimedia content that is presented via the Internet.

The Web was invented at CERN (European Organization for Nuclear Research) by a young British scientist named Tim Berners-Lee. In 1990, Berners-Lee created a navigational Web interface called a **browser**. He also devised an addressing system for Web pages called the **Uniform Resource Locator (URL)**, as well as the programming languages **HTML** (which allows users to specify the appearance and functionality of Web pages), and **HTTP** (which allows users to jump from one page to another). These four inventions form the basis of the Web as we know it today.

Remarkably, Berners-Lee decided to offer his inventions to the world free of charge. He declined to patent them, and sought no royalties for their use. His new technologies were available to anyone, at any time, for any purpose. This contributed greatly to the growth of the Web, because it meant that programmers could develop new servers and clients independently, without being subject to licensing restrictions.

Although Berners-Lee's initial version of the Web was able to display images as well as text, it couldn't display them on the same page. That capability came about in 1993, thanks to Marc Andreessen's Mosaic browser.

Commercial Web browsers made the Web interface increasingly user-friendly, and opened up the Web to the masses. The number of Websites quickly grew from 130 in June of 1993 to more than 22 million in October of 2000. That number has roughly doubled every year since then!

*Sairam Textiles already had a very basic Website, which Alexine's teenage nephew had designed with off-the-shelf software. It offered contact information, a list of noteworthy clients, and a few pictures.*

*While looking at the site, Alexine realized that it wouldn't be enough for her to build a better promotional site. If Sairam were going to expand, it needed to automate its ordering process in order to accommodate its new target market.*

*Most customers heard about the company through word of mouth, and placed orders by fax and e-mail. Sairam would follow up these orders with a confirmation call, then e-mail the designs to the customer for approval. Sometimes this process had to be repeated several times, resulting in unnecessary additional costs. Alexine estimated that for a 500-towel order, it took an average of three hours to close the deal.*

*The more Alexine thought about it, the more she realized that there was no point in seeking new business unless Sairam gained the ability to answer customer questions, customize designs, and accept orders and track shipments online.*

## Getting Online

To access the Web you need a computer with a **modem**, a Web browser, and a connection to the Internet. If you already have a computer at home, the way to start is by researching the **Internet service providers (ISPs)** in your area. These services include all of the set-up software you need for unlimited Internet access, as well as an e-mail account and free space for hosting a small Website.

Most telephone and cable companies offer package deals for Internet service, which can be convenient and cost-effective. On the other hand, when you rely on a single company for your phone, cable, and Internet service, you become more vulnerable to technical problems and outages. In addition, deals like these may limit your ability to take advantage of better offers for a specific part of your service.

For some business users, it may be wiser to have different providers for these services. As regards Internet service, you may want to do some research and find a small, local provider with a helpful technical staff. Such providers often have a faster overall connection, and a *much* faster response time to technical inquiries or problems.

Research ISPs carefully, with growth in mind!

Here's something else to consider: Even if you currently have an ISP, will it meet your future needs? Remember that a personal account may offer very different features from a business account. For instance, a personal site may allow less traffic to your Website, offer fewer file-sharing options, and impose other restrictions.

One of the best things you can do is ask your friends and business associates which ISPs they use. It's wise to ask as many questions and get as much advice as you can before signing up with an ISP, because many ISPs will charge substantial penalties for early termination.

**Choose Your ISP Carefully!**

Here are some important criteria for selecting an ISP:

- Do they have different packages based on usage needs (e.g., number of e-mail boxes, speed of connection, size of Website)?
- What hardware do they require? Can they use an existing phone or cable line, or will they have to install a new one?
- How accessible is their technical support team by e-mail, instant message, and phone? How quickly do they respond?
- How fast and reliable is the connection to the Internet?
- What kind of customer support do they offer?
- How much do they charge, compared to their competitors?

### Internet Connectivity

The speed of an Internet connection is measured by its **baud rate**, which refers to the number of bits transmitted per second.

Dial-up modem connections range from 28K-56K per second, "K" being shorthand for "thousand." **Broadband** connections typically range from 768K to 50Mbps (million bits per second). This makes it possible to watch movies, play videogames, listen to CD-quality audio, and engage in file sharing. As of this writing, broadband accounts for about 90 percent of residential Internet connections in the United States.

There are several types of broadband available:

- **Digital Subscriber Lines (DSL)** use a "splitter" to connect to the Internet over an existing telephone line, using frequencies that aren't used by voice calls. Although DSL service is normally much faster and more reliable than dialup, DSL signals are vulnerable to electromagnetic interference, which can result in connection failures and slower speeds.
- **Very-High-Data-Rate Digital Subscriber Lines (VDSL)** offer extremely high data rates (between 51 and 55Mbps). Some companies currently offer VDSL service in selected areas. VDSL 2 is an even faster connection, with speeds up to 100Mbps. As of this writing, it's not yet available in most areas of the United States.
- **Cable modem.** This is a device that allows you to connect to the Internet over cable TV lines, which offer far more bandwidth than telephone lines. Because many homes have existing cable service, this has been a popular choice for high-speed Internet hookups.
- **Wireless Internet Service Provider (WISP).** As the name indicates, WISPs are ISPs that use wireless networks. They are typically found in remote rural areas that lack access to DSL and cable. Usually, they're based at an elevated point in the center of the service area; customers access the signal with an antenna or dish.
- **T1.** A T1 line produces an extremely reliable high-speed connection, with download and upload speeds of up to 1.5Mbps for multiple users. Typical T1 users include smaller colleges, and small and medium-sized businesses that need to ensure that their customers and employees will have fast, uninterrupted access to data. Initial costs for T1 equipment and installation are comparatively high, and monthly fees can range from $250 to well over $1,000.

## Networks and Intranets

Once your business invests in a broadband connection, the next logical step is to network all the computers in that facility, so they can share the broadband connection (as well as printers, scanners, and files).

Another option is to set up an **intranet**. This is a sort of private mini-Internet designed to be used within the confines of a business or organization, which can be accessed only by authorized personnel. Intranets are usually run from a company **server**. Some of them are accessible to authorized users via the Internet, while others are completely private and cannot be accessed online.

There are numerous benefits to setting up a corporate intranet. First and foremost, it ensures that everyone receives the same information. For instance, when you need to make changes to an employee handbook, the updated version will be instantly available to all your employees, whether they are at work, at home, traveling, or in multiple office

There are numerous benefits to setting up a corporate intranet

Moving away from paper-based documentation can have serious economic and environmental benefits

locations. In addition to streamlining communications, moving away from paper-based documentation can have serious economic and environmental benefits.

More complex intranets can facilitate virtual teambuilding, education, meetings, and collaboration, all of which can reduce transportation and other costs.

*Alexine began exploring ways of redesigning Sairam's Website to make it easier for customers to use. She wanted a site that would give customers the ability to upload, check, and approve designs, and to make changes as necessary. In addition, the site needed to have promotional qualities that would attract the business of specialty boutiques. There was no point in fixing the old site. It was time to start from scratch, and do it right!*

*Alexine was very interested in working with GlassyEssence, a five-person design team based in Cincinnati, Ohio. GlassyEssence had created a site for one of the largest hotel chains in the region. It was one of the best sites Alexine had seen...stylish, uncluttered, and effortlessly interactive.*

*Alexine talked with a few of GlassyEssence's other clients, and found that they came highly recommended. She wasn't quite ready to approach them for a quote, though. First, she had to figure out what she wanted the site to do.*

### Browsers

Browsers are software applications that locate and display Web pages on the Internet, or on a private or local network.

Browsers have different capabilities, which means that Websites may display differently—or not display at all—depending on which one you're using. Accordingly, Website designers must take care to ensure that site features, and third-party applications, will function properly on the widest possible range of browsers.

Popular browsers include Internet Explorer, Firefox, Safari, Google Chrome, and Opera.

### Searching the Web

With tens of millions of Websites comprising over one billion pages, you'd think that finding information online would be like looking for a needle in a haystack.  Luckily, **search engines** make it relatively easy to find information online.

Some of the most popular search engines include Google, Yahoo!, FAST Search, Excite, Infoseek, Lycos, DogPile, and Microsoft's Bing.

You can learn more about searching the Web at Internet.com's Search Engine Watch (www.searchenginewatch.com). This site includes search engine ratings, Web searching tips, and other resources.

### E-Mail and E-Mail Clients

An **e-mail client** is a software application that allows you to send, receive, filter, and organize e-mail. E-mail clients access your mail from a server, and download it onto your computer. Popular e-mail clients include Windows Live Mail, Thunderbird, Apple Mail, and Eudora.

You should choose your e-mail client carefully. Many of the best clients are free, so you can experiment and find one that's secure, powerful, easy to use, and equipped with a fast search feature (so that you can locate archived e-mails quickly).

You can also use Web-based e-mail programs—like Hotmail and Yahoo mail—without installing an e-mail client. There are many differences between these programs and an e-mail client, but the most obvious one is that you must be online to use them. The virtue of e-mail clients is that they allow you to access and answer your mail, or search archived messages, while offline. Web-based mail is limited in other ways that make it inappropriate for most business use. However, it may be useful to create Web-based accounts when conducting market research, partly so that businesses will not recognize you as a competitor, and partly because this will reduce the amount of junk e-mails you'll receive in your business account.

You should assume that your company's e-mails are not secure!

#### *E-mail security*

Generally speaking, you should assume that your e-mails are not secure. Think of them as postcards rather than sealed letters. Most e-mails are not encrypted, which means that they can be intercepted and read by third parties. Also, some ISPs store copies of your messages for a few months, even if you delete them from your mailbox. In addition, there is no law that prevents an employee at your ISP from reading your e-mails!

It's also very important to understand that in certain types of legal conflicts, your e-mail can be used against you in court. Accordingly, you should tell your employees that e-mails on company computers are *not* private. This may discourage them from writing things that could cause problems for you later. Because of the legal importance of e-mails, you should back up your company's e-mail archive regularly, to avoid losing it in the event of a system failure.

For more information on privacy considerations, you can visit the Electronic Frontier Foundation (www.eff.org).

### Where to Learn More

Learn the Net (www.learnthenet.com) offers information on just about every conceivable aspect of the Web. It has detailed, user-friendly information on using search engines, e-commerce, and countless other topics. It also has a number of tutorials, and a helpful glossary of Internet terms.

## Online Trends

Online trends change quickly and constantly, and it would take an entire book to describe them adequately. Here is a brief introduction to some major trends, which we hope will inspire you to do your own research and stay alert to changing conditions.

### Remote Access and Collaboration

The Internet is both driving and reflecting globalization by creating new ways of collaborating and sharing large files across borders, industries, and traditional corporate hierarchies.

Thanks to the Internet, a graphic designer in India can produce a brochure for a company in Wisconsin, and send it to a printer in China. And an accountant on vacation in Hawaii can resolve problems or answer questions by remotely accessing spreadsheets and files stored on her office computer.

*Online office suites*

As noted in our chapter on team building, the Internet has led to a new era of decentralized, virtual teams that can instantly share files, ideas, knowledge, and skills, no matter where they are.

Online office suites are a third-party software service that facilitates this process. They offer a standardized virtual workspace that allows people worldwide to collaborate at any time. These systems also allow for fast and efficient backup of important data, and may offer better security than your business could otherwise afford.

On the other hand, if the service goes down, you and your employees will temporarily lose access to the most current versions of the data. There may also be speed and connectivity issues, depending on where a given user is located.

Also, constitutional privacy protections may not apply to your data if they're stored on another company's system. Consult your lawyer for more information.

*Backup and storage*

Data stored online are protected by their remote location and the backup systems of the storage company

The Internet also offers a low-cost solution for backup and storage of documents, accounting data, and so forth. Unlike external storage devices, which may be destroyed by local disasters, data stored online are protected by their remote location and the backup systems of the storage company itself.

Better yet, these companies can back up your files as you work, and some even offer system restoration in the event of crashes and malware attacks.

Service terms, guarantees, recovery options, and liability vary from one provider to another, so we strongly recommend due diligence before entrusting all your data to another business.

### Buying and Selling Online

There are three basic methods of making money on the Internet:

- **Commerce** involves offering products and services online. These can be delivered online, by mail, or in person.
- **Content** comprises experience-based offerings like news, opinion, music, games, and multimedia. Some content is available for download (e.g., a television program, a song, or an e-book), and some is offered online only (e.g., multiplayer role-playing games, streaming media).
- **Connection** means giving people a forum or an opportunity to interact or collaborate. One good example is LibraryThing (www.librarything.com), a social networking site for book-lovers that creates connections between people with similar collections.

Note that consumers often use the Internet to gather information about products, before buying in a traditional store. Thus, whether you engage in e-commerce or not, your Website is likely to be an essential part of your marketing plan.

*Whether you engage in e-commerce or not, your Website is likely to be an essential part of your marketing plan*

### Cloud Computing

**Cloud computing** is a broad descriptive term for any method of delivering hosted services (like accounting programs) over a Web browser. It's called cloud computing because the data and applications exist on a "cloud" of Web servers that are available on demand to external customers, who are usually charged by the minute or the hour.

The appeal of cloud computing is that it gives consumers access to tremendous computing power on an as-needed basis. Instead of buying expensive software licenses, and computers that are capable of running the programs you need, you simply access the cloud service, and pay for the amount of time or storage space that you actually use. This allows small businesses to have computing power that rivals that of much larger competitors, while shifting the technological burden from the user to the provider. Rather than buying computers and software (and upgrades) for each employee who needs them, you'd outsource those needs to the provider. Among other things, this would ensure that everyone on your team was using the same version of a given program, because the provider would upgrade its software globally and instantly.

There are two primary types of cloud computing:

- **Infrastructure as a service.** These services typically offer storage capacity or computing power on demand; they can scale their offerings up or down as circumstances dictate. Amazon's Elastic Compute Cloud (EC2) is probably the best-known example. It allows business to run their applications on Amazon's fast, stable, and massive hardware infrastructure.

- **Software as a service.** In this arrangement, the vendor hosts the application and the data, and the user accesses it through a browser. Salesforce.com, which offers customer relationship management tools through a cloud-computing model, is a famous example.

The basic concept is not new. If you've ever used a Web-based e-mail service like Yahoo Mail or Hotmail, or uploaded photos to Flickr, you've used a cloud computing system. Your mail, and the software that allows you to send, receive, and read it, are located on the provider's servers, instead of on your computer; you simply access it through your browser. What makes the current trend different is the variety of the offerings, and the unprecedented amount of computing power it puts at the disposal of small businesses.

Of course, there's a downside. First, and most important, this is an emerging technology. Common sense dictates that you shouldn't outsource tasks and data that are critical to the day-to-day operations of your business until all the bugs are worked out (and possibly not even then).

Also, bear in mind that when you sign up for cloud computing, you're effectively outsourcing the security and integrity of your data. You'll want your provider to have excellent security measures in place, and you should be reasonably confident that they're a stable company who'll be around for a while.

Above all, you need to study the fine print in the contract. Is the provider liable for any business loss you suffer if their system fails? Can they seize and hold your data if you don't pay your bill? How much redundancy is built into the system for backup purposes? Who owns the stored data, and what are they allowed to do with them? Don't overlook these questions; check and doublecheck the terms of your service contract.

### Social Networking

Social networking is an inexpensive way of connecting with customers, employees, partners, and fellow entrepreneurs

As a "network of networks," the Internet has always been a tool for collaboration and conversation. However, in recent years technology has expanded the possibilities for making connections, sharing information, and forming communities.

Social networking sites like Facebook, MySpace, and Twitter allow users who have specific interests or backgrounds to join online communities by posting profiles, and to expand their circle of connections by accumulating "friends." There are usually multiple communication options, from e-mails and instant messaging to blogs and bulletins.

For small businesses, social networking is an inexpensive way of connecting and communicating with customers, employees, partners, and fellow entrepreneurs. If you want to expand your list of contacts, find independent contractors for a specific project, manage customer relationships, target niche markets with highly specific promotions, or simply chat with people about business topics, social networking can be an ideal tool. For instance, if you're looking for a graphic designer, you could do a search on LinkedIn.com, which has over 40 million users in over 200 countries. It can also be a useful customer relationship management tool: once customers opt in, you can easily keep them informed about new products, provide technical help, and offer promotional coupons.

"Opt in" is the operative phrase. Online communities are based on trust, and trust generally has to be built over time. Aggressive promotional tactics are frowned upon, as is feigning interest in a community in order to advertise to its members. You can safely assume that users will not appreciate being treated as a captive audience for your marketing message. They usually prefer to decide when and where to pay attention to advertising. That's why it's so important to allow users to opt in (e.g., by becoming a follower on Twitter, or a friend on MySpace). We'll discuss these issues in more detail later in this book.

Online communities are based on trust, and trust generally has to be built over time

In response to the social networking trend, Opera (www.opera.com) has created a program called Opera Unite, which turns individual computers into Web servers. Their goal is to take social networking to the next level by eliminating the need for third-party applications, and letting users link their computers directly. If you're interested in the rewards and risks of social networking, you'll want to keep an eye on this project.

## NxLEVEL® GREEN TIP

ENVIRONMENTAL BUSINESS RESOURCES

Social networking and crowdsourcing sites have been very important to green designers and consumers. They've made collaborative problem-solving easier, and they've also allowed consumers to weigh in on the positives and negatives of green ideas. Since the free exchange of information is essential to optimizing the efficiency of products and services, and to encouraging greener lifestyles, this trend is certain to continue.

Here are a few sites that draw on "the wisdom of crowds" to improve how products are made, marketed, sold, and recycled.

**Do The Right Thing** (dotherightthing.com) is a site that allows consumers and businesses to collaborate on making products more sustainable and efficient.

**PESWiki** (www.peswiki.com) is a collaborative, community-built site "on the topic of cutting-edge energy technologies that move us away from dependence on fossil fuels and toward cleaner, greener, more reliable, safe and affordable energy solutions."

**Green Options** (greenoptions.com) is a network of environmentally focused blogs that offers a broad spectrum of information and guidance on making sustainable choices.

**SustainLane** (www.sustainlane.com) "connects interested consumers with tools and information on everything related to green, including consumer-generated how-tos, news and product reviews of new green offerings in the marketplace."

### User-Generated Content

One of the most important online trends in recent years is the rise of user-generated content like podcasts, blogs, and customer reviews, which have made it easier than ever before for business to understand and respond to consumer needs. Some businesses are even allowing online consumers to help design and advertise their products.

Customers are far more likely to trust fellow consumers than advertisements!

Customer reviews, in particular, are becoming especially important for online retail sites. This is partly because studies have shown that customers are far more likely to trust fellow consumers than advertisements, but also because it can create a perception of transparency, honesty, and self-confidence.

Accordingly, third-party software providers like PowerReviews (www.powerreviews.com) are springing up to offer low-cost turnkey systems that can be added to existing Websites. This trend will certainly continue as such systems become easier and more affordable to install and maintain. In fact, almost 40 percent of major US retailers opted into this trend during 2008.

### Voice Over Internet Protocol (VoIP)

VoIP allows voice conversations over the Internet or any other computer network, which requires much less bandwith than traditional telephony. For this reason, VoIP is usually low-cost or free, especially over long distances, and is becoming a popular alternative to traditional telephone service.

Perhaps most interesting is the fact that VoIP allows users to have a conversation, transfer files, and display images simultaneously. This makes it an ideal tool for virtual meetings using shared data, as well as teleconferencing. The looming advent of mobile VoIP on handheld devices is likely to accelerate these trends.

You can use VoIP over your existing broadband connection by subscribing to a third-party service like Vonage or Skype. Some cable companies also offer a special VoIP service based on PacketCable, which is usually superior to traditional connections. An increasing number of third-party suppliers offer hardware and software that will integrate VoIP with an existing office phone system.

That said, VoIP carries with it the risk of all converging technologies: a single failure may affect multiple functions. For instance, traditional phones will usually operate during a power failure. VoIP doesn't, unless you install a backup system. Also, as of this writing, some VoIP providers do not offer an emergency dialing service.

### Localized Searching

As part of the personalization trend, many efforts are underway to localize search-engine results for individual users. This benefits consumers because it offers more relevant results, and it benefits businesses because it lets them target the customers who are likeliest to buy their products with personalized ads or content (this is known as **geotargeting**).

Localized results based on the user's IP address have been common for some time. However, these addresses usually belong to the ISP, which may be sited miles away from the computer user. What's different about the new methods is that they're based on global positioning (GPS) technology, which means they target users wherever they may be. Where IP-based **geolocation** might identify your location at the county or city level, GPS geolocation can identify your actual coordinates, whether you're in your house, your office, a coffee shop, or a park.

Localized searching is particularly useful for people who are traveling. If you're looking for food in a foreign city, for instance, localized searching would call up the top consumer-rated restaurants that are within walking distance of your current location.

A variety of localized searching systems are currently available. Google's Gears is an open-source plug-in that includes a geolocation module. Mozilla's Geode, Yahoo's Fire Eagle, and Opera offer similar features. By the time you read this, all the major Web browsers will probably already have added geolocation as a basic capability. It will be up to individual users to specify how much geographical information they're willing to share.

*After visiting a number of sites she liked (and a lot of sites she didn't), Alexine created a list of the features she wanted:*

- *Price calculator for embroidery jobs*
- *Color palette for textiles and threads*
- *Company contact information*
- *Online order and tracking capability*
- *Company and production information*
- *The ability to accept customer reviews*
- *Secure payment tool*
- *E-mail forms*

*She e-mailed this information to GlassyEssence, as well as to six other Web design firms she'd found online or heard about from business associates, and crossed her fingers.*

*Within two weeks, she had quotes from all seven designers. At first, she was disappointed to find that GlassyEssence's price was slightly higher than she had budgeted for. On the other hand, it was lower than the quotes several other companies had given her. And although she'd found a couple of less expensive firms whose designs had been perfectly competent, they weren't as striking as GlassyEssence's.*

*There was the question of turnaround time as well. All the other companies had told her the job would take six to nine months. GlassyEssence claimed they could do it in four. A faster turnaround time, combined with great business references and a style that Alexine loved, was worth the extra money. Alexine decided to give the job to GlassyEssence.*

## Online Security

Increasing awareness of online crime, as well as some highly publicized instances of corporations that misused or compromised their customers' personal information, has made consumers less comfortable with e-commerce in recent years.

A recent survey commissioned by RSA Security Inc. showed that security concerns had led one out of four respondents to limit their online shopping, and one of five to avoid online transactions with their financial institutions. The survey also found that nearly half of American consumers refuse to give out personal information to online merchants.

While this trend might seem like bad news for online businesses, that view may be an oversimplification. Other studies show that online consumers are more aware of online security, and more sophisticated about avoiding crime. This consumer awareness is a necessary step towards making the Internet a safer place for business.

### Spyware and Other Malware

**Spyware** refers to software programs that some Websites download surreptitiously onto people's computers, without the user's knowledge or consent. As the name implies, the purpose of this software is to gather information about the user's online activities.

Protect your computer network from malware!

Spyware is one of many forms of **malware**, a broad term that includes viruses, worms, trojan horses, and other malicious programs. **Adware**—which shares many characteristics with spyware—is not really malware, but it can still cripple your computer's performance.

**Botnets**, networks of virus-infected computers, are used to send about 80 percent of spam. Spam comprises as much 94 percent of all e-mail sent, which has understandably resulted in a great deal of anger among consumers.

One of the most troublesome forms of malware will "hijack" your Web browser. Browser hijackers usually include spyware. Some even go so far as to employ **keylogging** programs, which gather everything you type, including passwords and credit card information. Hijacks can also cause system slowdowns, so that the simplest computer tasks take five to ten minutes. The worst of these programs can actively fight back against spyware-removal programs, by blocking installation or preventing them from running.

Malware is an extremely serious problem for small-business owners. An office infected with malware may be unable to perform any of its normal functions. If you've never fallen prey to a malware attack, it's hard to describe just how disruptive and frustrating it can be. Repairing a hijacked computer can be very difficult and risky unless you know exactly what you're doing. It tends to be well beyond the capabilities of most novice users. Worst of all, if not handled correctly, malware can lead to the corruption or loss of all your data.

#### *Dealing with malware*

There are a few ways of reducing your vulnerability to malware. Many have found that the Firefox, Safari, and Opera browsers tend to be less vulnerable. Alternatively, you can use Macintosh or Linux, both of which are not currently susceptible to most malware (although this will almost certainly change in years to come).

Social networking sites are a growing focus for malware attacks, so be careful about what kind of personal and business information you post on such sites. Also, review each site's security settings and features, and learn how to use them. Bear in mind, too, that the explosion in user-created content presents countless opportunities for spamming, malware installation, and identity theft. You should always exercise caution when downloading files, watching videos, and launching browser-based applications.

Exercise caution when downloading files, watching videos, and launching browser-based applications!

Security experts predict that the advent of Internet-connected phones and handheld devices will lead to a new era of phone-based malware and data theft, so don't make the mistake of thinking that such devices are secure. As we move towards greater interoperability, we inevitably increase our vulnerability.

Even if you choose one of the secure browsers listed above, there are several free protective programs that most PC users need to install.

- **ZoneAlarm** (www.zonelabs.com) is a free firewall program that protects your computer from surreptitious downloads.
- **SUPERAntiSpyware** (www.superantispyware.com) locates and removes programs that can invade your privacy and affect your computer's performance.
- **Spybot Search and Destroy** (www.safer-networking.org) locates and removes spyware and related malware, including browser hijacks. It also removes stored data about your online activities, so that spybots can't transmit it.

In addition, you need to install a good anti-virus program, like Norton AntiVirus (www.symantec.com), and keep it up to date.

You should make it your business to familiarize yourself with all these programs. Follow the tutorials carefully, and use the products religiously, at home and at work. Above all, be sure to install the updates and patches that allow the program to address emerging threats, using the manufacturer's guidelines. Too many businesses buy security products, and then fail to update them regularly.

You may find yourself infected with malware that doesn't respond to these programs. Luckily, there are many support forums dedicated to helping people recover from hijacks. Tech Support Forum (www.techsupportforum.com) is a good place to go for advice. Their "Virus/Trojan/Spyware Help Forum" contains detailed instructions on how to post information about your particular problem, after which you will receive individualized advice from expert volunteers. Using such forums requires a solid base of computer skills. If you lack these skills, you may be better off consulting your computer manufacturer.

*Scareware*

Just to make matters worse, the Internet is teeming with fraudulent anti-spyware programs. Some of these programs are themselves spyware, while others cause problems that they then charge a hefty fee to solve. These **scareware** programs are often advertised to victims by means of banner ads or pop-up windows that claim to have detected a virus or spyware on the user's computer. Needless to say, you should never click on these links!

When in doubt, do a search online for the name of the software; a number of sites keep track of fraudulent programs. Even if the program seems to be legitimate, and is free, research it thoroughly before you even think of installing it. Always look for customer reviews, as well as reviews from reputable tech sites.

### Phishing and Pharming

One of the most common and dangerous forms of online crime is known as **phishing**. Some phishers send out e-mails that mimic the content and appearance of legitimate online businesses like eBay and Amazon, and threaten the recipient with account suspension unless they submit credit card numbers or passwords. Others pretend to be charitable or political organizations seeking donations for whatever cause is currently in the news.

Phishers often target the customers of banks and online payment services like PayPal. These targeted attacks are called **spear phishing**. Social networking sites are an increasingly common target of spear phishers, because of the huge amount of personal data that is stored on these sites.

**Pharming** is a more sophisticated form of attack. Unlike phishing e-mails, which require you to click a link, e-mails from pharmers contain malware that runs automatically, and redirects your browser to a fraudulent version of some legitimate site (even if you type the correct URL into your address bar). This bogus site harvests any personal and financial information that you enter into its forms, which pharmers can then use for fraud and identity theft. The ever-increasing sophistication of pharming attacks, and the difficulty of detecting and avoiding redirection, make this one of the most serious security threats on the Internet.

*Dealing with phishers and pharmers*

You should avoid clicking on links contained in e-mails

How do you avoid phishers? First, and most important, you should never enter personal data of any kind into an e-mail. You should also avoid clicking on links contained in e-mails. If you receive an e-mail from a known company that asks you to click on a link, it's always wise to contact the company to ensure that the e-mail is legitimate.

Another option is to go to the company's legitimate Website and check your account or other details. As spear phishers becomes more sophisticated, they may include personal greetings or other details in an effort to seem legitimate. Again, if an e-mail asks for data like passwords, account numbers, and so forth, you should always call the company in question before proceeding.

Popular browsers maintain blacklists of known phishing sites, and will warn users when they attempt to visit a harmful site. While the absence this warning doesn't mean that a site is safe, its presence should be taken seriously.

It's a good idea to ask your bank what steps they've taken to thwart phishers, pharmers, and identity thieves. And of course, you should regularly check your bank, credit card, and debit card statements to confirm that all transactions are legitimate.

If you believe that you have been a victim of phishing or pharming, you should forward the entire, original e-mail to the following addresses:

- Federal Trade Commission at spam@uce.gov
- The "abuse" e-mail address at the company the phisher is trying to spoof (e.g. spoof@ebay.com)
- The FBI's Internet Fraud Complaint Center (www.ic3.gov)
- Your ISP

## NxLEVEL® TECH TIP

### BUSINESS RESOURCES AND THE WEB

Thanks to the advent of low-cost videoconferencing technology, it's now possible for individuals in multiple locations to have face-to-face meetings on short notice. When you think about the cost of flying an employee to a different city, and paying for lodging, food, and a rental car, you can see how easily this technology can pay for itself!

Using VoIP services like **Skype** (www.skype.com) with desktop videoconferencing software can be a particularly cost-effective means of videoconferencing. More feature-rich "telepresence" systems like **Halo** (www.hp.com/halo) and **Vidyo** (www.vidyo.com) are also available. The combination of videoconferencing technology with social networking sites is already underway, which will have enormous consequences for online marketing and customer service.

Videoconferencing is not without its flaws, however. Being on camera, and watching someone else onscreen, is very different from real, face-to-face communication. Body language and facial cues may lag slightly, creating an off-kilter effect, and eye contact is absent, which can create an unpleasant impression on some viewers.

Like many other new communication media, videoconferencing is creating a need for technology-specific expectations and etiquette. Learning to communicate effectively, and to interpret other people correctly, may require time and practice. At the same time, the firms that provide these services are working to create a more lifelike and interactive experience. As people and technology adapt to each other, and the financial and environmental benefits become clearer, videoconferencing will likely become a standard way for businesses to communicate with customers and each other.

*Alexine knew nothing about producing Websites, but she did know how her customers liked to make purchases. First, they wanted to gather information on their own. Then, they wanted to review different design, fabric, thread, and color combinations. Next, they wanted to upload their own designs, or get a quote on an in-house design. And having placed their order, they wanted tracking information. Her site would have to offer all these capabilities in as streamlined and simple a form as possible.*

*She explained all of this to Andy Chau, GlassyEssence's creative director, during their first meeting. In turn, he explained GlassyEssence's three rules of design for e-commerce sites:*

- *First-time visitors should feel as comfortable as repeat visitors.*
- *If you have to provide instructions on how to use your site, it's too complicated.*
- *Every page should allow the user to do anything he or she needs to do in two clicks or less.*

*That sounded great to Alexine! In the following months, she was able to watch the evolution of her site online, by accessing it through GlassyEssence. Once the structure of the site was in place, she was able to make suggestions, have elements removed and added, and so forth.*

*Finally, fifteen weeks after their initial meeting, the site was finished.*

### Legislative Responses to Online Crime

Unfortunately, online security threats adapt to changing conditions much faster than the laws that are intended to prevent and punish them. Even in case where existing laws are adequate, most experts agree that enforcement falls far short of what's necessary.

Some lawmakers have attempted to make online consumer information less accessible to criminals. The Sarbanes-Oxley Act of 2002 mandates that public companies must certify to the Securities and Exchange Commission that they have security measures in place that will protect consumer information from hackers and viruses. And the Identity Theft Penalty Enhancement Act of 2004 imposed stricter penalties on people who commit identity theft in order to commit other crimes.

In 2005, the New York State Attorney General's office brought a civil suit against a California-based company called Intermix Media, Inc. which was distributing spyware. In addition to ceasing its illegal activities, it agreed to pay $7.5 million in fines. In addition, a few high-profile spammers have been shut down and fined, and some states have criminalized some forms of spyware. But so far, more comprehensive cyber-crime bills have stalled in Congress.

Computer users are largely responsible for their own safety online

What all this means is that computer users are largely responsible for their own safety online. This is why it's so important to have someone on your team who understands online security, and can reduce the number of threats you'll face.

### The Internet: A Permanent Record

It's important to understand that information you delete from the Internet does not necessarily vanish. First, Google's caching system creates a persistent archive of Web content. Second, sites like Wayback Machine are compiling a permanent record of online photos and text (including content from sites that are no longer online). Last, and most important, once information is made available online, it can travel around the world in a very short time, and be stored on dozens or thousands of computers. Suppressing it at that point is effectively impossible.

For these reasons, it's wise to think very carefully about what you post online. Everything that makes the Internet a viral marketer's dream makes it a nightmare for people who post something that makes them look silly, corrupt, rude, or incompetent. This warning is especially timely given the rise of social media, the format of which encourages people to say things, or post photographs, that they may regret later.

Think very carefully about what you post online!

This advice also applies to things people say about your business. While you may have legal recourse in cases of libel, trying to shut down critical sites or delete unflattering comments will usually cause more problems than it solves. It's best to develop a thick skin, and avoid conflicts where possible. Other suggestions for online conflict resolution are discussed in Chapter 2 *A Customer-Driven Philosophy*.

In particular, you should avoid making legal threats unless your lawyer feels strongly that you do in fact have a legitimate case. Posturing and bluster will almost always attract more negative attention. Again, remember that anything you say in the heat of anger may end up being archived forever!

*Once the site was finished, GlassyEssence arranged a package deal with a firm that would give Sairam Textiles an e-commerce site, monthly hosting, and e-mail accounts for one monthly fee. There was also a per-transaction fee that would decrease as online sales increased. For an additional fee, GlassyEssence agreed to manage the online promotion of the site. This meant search engine listing and optimization, updating metatags and keyword registrations, and linking to key industry sites.*

*In September of 2009, the Sairam Textiles site went online. GlassyEssence had already tested the commerce engine to make sure that the price calculators and credit card functions worked flawlessly and securely.*

*Meanwhile, Alexine was working to get the word out about her site. She added the new URL to all company letterhead, business cards, e-mail, and fax communications. She sent press releases to home decoration and textile industry magazines, and to a number of textile and design blogs. Most important, she sent e-mails to everyone on Sairam Textiles' opt-in list, and made them a great introductory offer: for a limited time, Sairam Textiles would give its customers a 10% discount for orders placed online.*

## The Future of the Internet

What will the future of the Internet look like? Perhaps the most interesting development (from the perspective of small business) is the trend toward a portable Internet. Wireless connectivity is growing by leaps and bounds, and becoming more affordable. Upcoming breakthroughs will provide wider wireless range and remarkably fast connections. At the same time, handheld devices are becoming more powerful and functional, enabling users to access the Internet on the go, and even to view streaming media like newscasts, movies, and videoconferences in real time.

### Unified Communications

Simply put, unified communications (UC) allows a message to be sent in one format (e.g., a voice message) and received in another (e.g., e-mail). This is an example of **convergence**, which refers to the increasing integration and interoperability of technology. Convergence happens when the functions of various devices are made compatible with one another, or when various functions are combined in a single device.

Experts believe that mobile devices will be the primary connection tool to the Internet for most people in the world by 2020

The classic example of convergence is cellphones. Most current cellphones can take photographs, store and play music, and access the Internet. Some experts believe that mobile devices will be the primary connection tool to the Internet for most people in the world by 2020.

Unifying communications has a strong potential to improve customer and supply-chain relationships, by ensuring that all communications are streamlined, organized, and easily accessible. It can also improve collaboration between co-workers, especially in the case of virtual teams, where tracking and archiving all communications becomes an essential part of project management.

### Personalization

The goal of most of current Internet trends is personalization. Examples include radio stations that play music that's tailored to your taste, sites that recommend products based on your likes and dislikes, and so forth. But in coming years, this trend will affect the most basic online interactions. For instance, search engines will tailor their results based on your browsing habits, location, type of industry, and so forth. Many sites, such as NetFlix and Amazon, already offer many of these features.

### Browsers as Platforms

As Web applications become more powerful and ubiquitous, the Web browser is essentially becoming an application delivery system. Unfortunately, this is not what browsers were designed to do, and their various proprietary features don't always work smoothly with complex online applications. Accordingly, some experts believe that future browsers will have to function more like an operating system that will allow users to run and manage multiple applications at once.

Google Chrome and Mozilla Firefox are already moving decisively in this direction, and the other major browsers are likely to follow suit.

### Internet2

Internet2 is a nonprofit consortium comprising universities, corporations and government agencies, the purpose of which is to develop and deploy revolutionary new high-speed networking technologies. It transmits data at speeds above 100 gigabits per second, which is 100 to 1,000 times faster than the current Internet.

This is creating new opportunities for virtual collaboration and distributed research. For instance, NASA has created a virtual medical clinic that allows doctors from all over the world to perform virtual surgery using high-resolution 3D imaging. The research being conducted by Internet2 is creating the standards that will be used by consumers and businesses tomorrow. To learn more, visit **www.internet2.edu**.

### The Semantic Web

The Semantic Web is an ongoing project of Tim Berners-Lee and the World Wide Web Consortium (www.w3.org). The Semantic Web project hopes to revolutionize the Internet by making Web pages "understandable" by machines. What this means in practical terms is that computers would recognize the meaning of words and images found on Websites, and the conceptual relationship between them, instead of relying on word matches to retrieve information.

Here's an example. Suppose you're a birdwatcher, and you want to find national parks where you can see unusual birds. If you search the Web for the words "national parks," and "birdwatching," your search engine will pull up sites in which both terms are highlighted, which may include novels, online diaries, book descriptions from Amazon, and other useless information.

The Semantic Web, by contrast, would recognize the nature of the request you were making, and would also recognize that in this context, a search for "national parks" should include a search for "wildlife preserves" and "wildlife refuges." In essence, the computer would "know" that birdwatching is a human activity that involves looking at birds, and that wildlife preserves and refuges are other places where birds can be seen.

This could also lead to highly individualized searching, in which a search engine could deliver results that are tailored to your interests, your location, your past browsing history, your career, your age, your health status, your preferred method of online payment, and so forth. (Of course, you'd have to be comfortable sharing these data to take advantage of these features.)

The Semantic Web doesn't currently exist. Some skeptics say it never will, and that it might be preferable if it didn't, given the opportunities such a system presents for crime, abuse, and automated political censorship.

However, the attempt to reach this goal has already led to innovations in the organization and accessibility of online information, and will surely lead to more. These innovations are important to small businesses, in that semantic searching allows them to design pages that will more efficiently reach their target audience.

*After the first month, good feedback began to come in by e-mail and customer reviews. Unfortunately, complaints came too! The most common complaint was that the site wouldn't accept price-quote queries. Several of the links to other pages routinely crashed, too. Alexine was concerned. After all that hard work, how was it possible that the site wasn't working?*

*Alexine spent a good deal of time on the phone with GlassyEssence, making sure that quick fixes were made to the site. Slowly, complaints dried up and queries and orders started coming in. Customers seemed eager to order online, but first they wanted some human contact. Alexine was happy to oblige. She set up teleconferences with prospective customers, answered all questions promptly, and often took orders over the phone for leads that came in from the Web.*

*It took time and money to maintain the site, and Alexine still had to manage new customers. But orders were coming in quickly from places that Sairam Textiles had never sold to before. A large fine-dining restaurant chain in Chicago placed an order for 4,000 custom napkins and matching tablecloths. Four different home-design boutiques ordered a total of 1,600 embroidered pillow-cases, and Alexine was negotiating with luxury hotel chain for sole sourcing of all their linen needs for 22 hotels. By the end of the year, Sairam Textiles had sold nearly 8,000 items on the Web!*

## Conclusion

The Internet offers a variety of tools for you to consider as you research, create, build, and sell your business idea. Faster connection speeds mean that you can access more information more quickly than ever before. It also means that more of your customers are online than ever before.

These are the questions you should be asking yourself as you get more familiar with the Internet:

- How can I learn about my customers online?
- How can I communicate with them online?
- How can I deliver more value to them?
- How can I use the Internet to earn more revenue, cut costs, and increase profits?

The answers to these questions are constantly changing as technology evolves. Therefore, you should think of this chapter as a jumping-off place for your own ongoing research on Internet capabilities and trends.

# Chapter 34
# E-COMMERCE

*About This Chapter:*
- *Planning your first website*
- *Requirements for building a website*
- *Basic e-commerce capabilities*
- *Customer service online*
- *Online marketing strategies*

## Introduction

On the Internet, a tiny start-up can sell to customers all over the world—most of whom it would be unlikely to reach by any other means—without having to invest in multiple store locations and inventories. You can be located in a small town in northern Wisconsin and find that customers living in Japan and France are interested in your niche product.

For little or no cost, simple online stores can test marketing mix strategies without a brick-and-mortar retail space. Discussion boards and blogs are perfect forums for testing ideas, and for getting support and feedback from other entrepreneurs.

Even if you decide not to sell online, a promotional Website can be a terrific marketing tool, providing pre- or post-sale information to consumers.

These are all examples of how the Internet is simultaneously a powerful business platform, marketing tool, and information resource for entrepreneurs.

E-commerce benefits customers, too. They can shop at any time of the day or night, without waiting in lines, or driving around in search of a parking place. In fact, studies indicate that a good percentage of Internet shopping takes place after 10pm. Websites also offer more information about products than most stores, and they offer it to thousands of prospective customers at once!

The advent of e-commerce doesn't mean offline business models are outdated, though. You still need to know your customers, manage your finances, and sell your goods aggressively and intelligently.

The Internet is a powerful business platform, marketing tool, and information resource

## Planning Your First Website

Building a Website or a Web-based business begs the same questions as building a business offline. Consider:

- Short-term and long-term business objectives
- Attractiveness of target market
- Marketing mix
- Competition
- Customer needs
- Your business's strengths and weaknesses
- Your budget

The budget question is an important one. There's a wide range of costs for Web development. Depending on your needs, and those of your customers, you could design and launch your own site almost for free, or you could hire professional designers and spend hundreds, thousands, or tens of thousands of dollars.

*Michael Maier runs Bee's Knees, an online grocery business based in Portland, Oregon. Bee's Knees specializes in home delivery of locally grown organic produce, and environmentally responsible household goods from around the world.*

*Their first Website was a checklist form that offered 35 different fruits and vegetables. Today, they offer over 2,000 items, ranging from frozen juices to ceramic cookware to compact fluorescent lightbulbs. Bee's Knees has bought out or merged with all four of its original competitors, and has more than 6,000 fanatically loyal regular customers in the Portland area, each of whom spends an average of $54 per week.*

*Part of their success involved good timing. They got into business just as organic products were going from a small but profitable niche market to a consumer craze. And they also catered to two of the most important growth markets: people who were under serious time pressures, and people who wanted to eat healthier food.*

*But what really made them prosper was their business model, which combined the low overhead of a Web-based business with an absolute focus on cultivating face-to-face customer relationships. That's the aspect of their business that competitors have been unable to match!*

### Registering Your Domain Name

The address for your Website is known as a **domain name**. When you type a domain name into the address window of an Internet browser, the browser loads the site and displays it on the screen.

A domain name can be up to 67 characters long, including the suffix (e.g., ".com" or ".net"). The only allowable characters are letters, numbers, hyphens, and periods; it may not contain spaces.

As of this writing, the Internet Corporation for Assigned Names and Numbers (ICANN), the nonprofit body that oversees addressing conventions on the Internet, has proposed sweeping changes to the domain name system.

The controversial new scheme would allow hundreds of generic domains like .eco, .nyc, and .food. It would also accept characters in Arabic, Chinese, and other currently unusable scripts. For more details, visit **www.icann.org**.

Before you register your domain name, think very carefully about the name you want. You may have to live with it for a long time, so you should choose a name that is meaningful, descriptive, easy to remember, and unique. The longer you have a domain name, the higher your ratings from search and listing services will be.

Once you've created a list of possible domain names, you're ready to register the one you like best. Many ISPs will register a domain name for you, or will allow you to register your domain name yourself through their Website.

As a branding and marketing tactic, it's a good idea to use your domain name as part of your e-mail address. For example, the domain name "www.glassworks.com" could yield the e-mail address sara@glassworks.com. Your site host can help you with this.

It's a good idea to use your domain name as part of your e-mail address

Last, be alert to possible double meanings of your domain name, and use hyphens where necessary to avoid them. A site called Experts Exchange learned this lesson the hard way, when they realized that there was more than one way of reading **www.expertsexchange.com**. Today, their domain name is **www.experts-exchange.com**.

### Researching Sites Online

Spending time online is the most important thing you can do while planning your Website. Which online stores are easy to use, and why? Which aren't, and why not? Which Websites are visually appealing? Which ones load the fastest?

The best Websites use clean design, with simple graphics that load quickly. Using elaborate frames, multiple browser windows, or streaming media can crash browsers and frustrate your visitors. Frustrated visitors rarely return for a second look!

As you're deciding on the design elements and functionality you want for your site, you should consider the following questions:

- Who are your target customers, and why would they visit your site? Are they the same people you're trying to reach offline, or are you reaching out to a new audience?
- What level of technology, skills, and knowledge do your target customers have? Will they have to buy new equipment or learn new things to use your site?
- What colors, fonts, and design elements are most appropriate for your business? Will your site be austere or colorful? Playful or straightforward? What's most appropriate for your customer base?
- How much time and money can you afford to spend on your site? Remember to consider maintenance and upgrades.
- How quickly do you need to get your site up and running? Should you sacrifice some of the complex or expensive features you want for the time being, in order to get a Web presence right away?
- How often will you need to change the information on your site?

Consider your future plans, and design a site your business can grow into

Bear in mind that while an off-the-shelf site may get you up and running quickly, you may have to redo it completely when your business grows. For this reason, it's wise to consider your future plans, and design something your business can grow into.

### How Will the Site Fit the Rest of Your Business?

Your Website must be integrated with every other aspect of your business. Consider these questions:

- **Hosting.** Will you host the site on your own server, or will you pay another firm to do it? Unless you run a tech-based business with very specific needs, you will probably prefer to outsource your site hosting. But either way, you need to estimate your monthly traffic, bandwidth needs, backup and recovery systems, and the level of expertise required to maintain, troubleshoot, and upgrade the site.
- **Branding.** How will the site communicate your brand to the public? Colors, graphics, and logos are important, but what about back-end functionality and overall ease of use? Or a commitment to the ethical use of consumer data?
- **Promotions.** How will you attract customers and convince them to buy? What incentives will you offer? How can you use the Web to add value to the transaction?

- **Merchandising.** How will you display your products? What information will you offer? How can technology help you? How will you handle customer questions?
- **Shopping and checkout.** If customers are going to be browsing the site and selecting multiple items, they'll need a shopping cart. Should they have the capability to create a personal shopping or gift list, or customize the site in some other way? Will there be cross-marketing based on previous purchases?
- **Payment processing.** What forms of payment will you accept? How will you calculate taxes and shipping costs? Also, consider security. Customers want to feel secure, of course, but they also get frustrated when given too many hoops to jump through. How will you strike a balance between security and convenience?
- **Inventory and order fulfillment.** Will you accept orders in real time, or compile them at the end of the business day? Will you offer expedited service? If so, will you charge a premium? How will you notify customers that items are out of stock, and what options will you give them (e.g., back order, refund, credit)?
- **Customer service.** How will you notify customers when you ship an order? Will customers be able to track shipments online, or will they have to call or e-mail and ask you to do it for them? How will you provide technical support? Will it be available online (e.g., a downloadable manual in PDF format), via phone and e-mail, or both? What's your return policy, and how will you explain it?
- **Legal considerations.** What kind of legal issues are involved? How will you handle contracts, disclaimers, and warranties? What about privacy issues? Who will manage your compliance efforts, and how will you communicate your policies and standards to customers, employees, and other interested parties?
- **Gathering and analyzing data.** What data will you gather on site usage and statistics? How will you turn them into useful information? What information will you gather about your customers? How will you use it in your marketing efforts? What legal restrictions apply?
- **Customer input.** Will you allow ratings and reviews, or a blog that accepts user comments? If so, what are the terms of use? Can users be anonymous, or will they have to create an account? How will the site be moderated? Will comment length be restricted? What counts as a bannable offense (e.g., spamming, abusive language, off-topic posting)? Who owns the rights to user-generated content?
- **Budget.** Prepare a formal budget for your Website, and remember to include the cost of maintenance and service upgrades. If you do decide to outsource the project, you should learn how to update your site in order to keep text and images current and relevant. Your costs will be much lower—and your turnaround time much faster—if you can update your site yourself.

Prepare a formal budget for your Website, and remember to include the cost of maintenance and service upgrades

*Most e-tailers see the Internet as a means of targeting the widest possible geographical area... the whole world, in many cases! Michael had a different idea. By focusing on his local market, Michael was marrying the convenience of the Web to the friendly feel of a neighborhood grocery store. The fact that the groceries were delivered to people's doors gave Bee's Knee's a human face, which did a lot to overcome people's uneasiness about buying food online.*

*Bee's Knees had several competitors when it started, but these firms were very different. There were organic vegetable firms that would deliver a box of vegetables every week to subscribers, and there were larger chain stores that made deliveries of general grocery products. But no one was doing exactly what Michael wanted to do.*

*Michael had another shrewd tactic. Where many firms would try to drive the competition out of the marketplace, his business plan called for win-win expansion through buying competitors out, or merging with them. That way, he'd get assets, relationships, customer lists, and—in some cases—professional expertise.*

*By April of 2009, Bee's Knees had bought out some of its competitors in the organic food delivery business, and had merged with Harvest Moon, a firm that delivered household goods, cleaners, and bed and bath supplies.*

## Requirements for Building a Website

Make lists of the Website features you must have, the ones you should have, and the ones you'd like to have!

Once you've done enough research to describe the features and functionality you want, you should prioritize them. Make lists of the features you must have, the ones you should have, and the ones you'd like to have.

Next, call up five or six Web designers, make appointments with each of them, and ask for quotes. There's no charge for this first meeting, and you'll be amazed by how much you can learn from it. Carefully evaluate their skills, their design sensibilities, their costs, and your budget. Look at sites they've already developed—their company site, in particular—and ask for customer references.

Once you've got a range of prices from Web design professionals, you can consider these less costly e-commerce options:

- **Buying an off-the-shelf system**. There are many off-the-shelf e-commerce packages available. If you find one that meets your needs, you might be able to save a lot of money. However, remember to allow for growth. You don't want to hobble your Web business at the outset. Buy a program you can grow into!

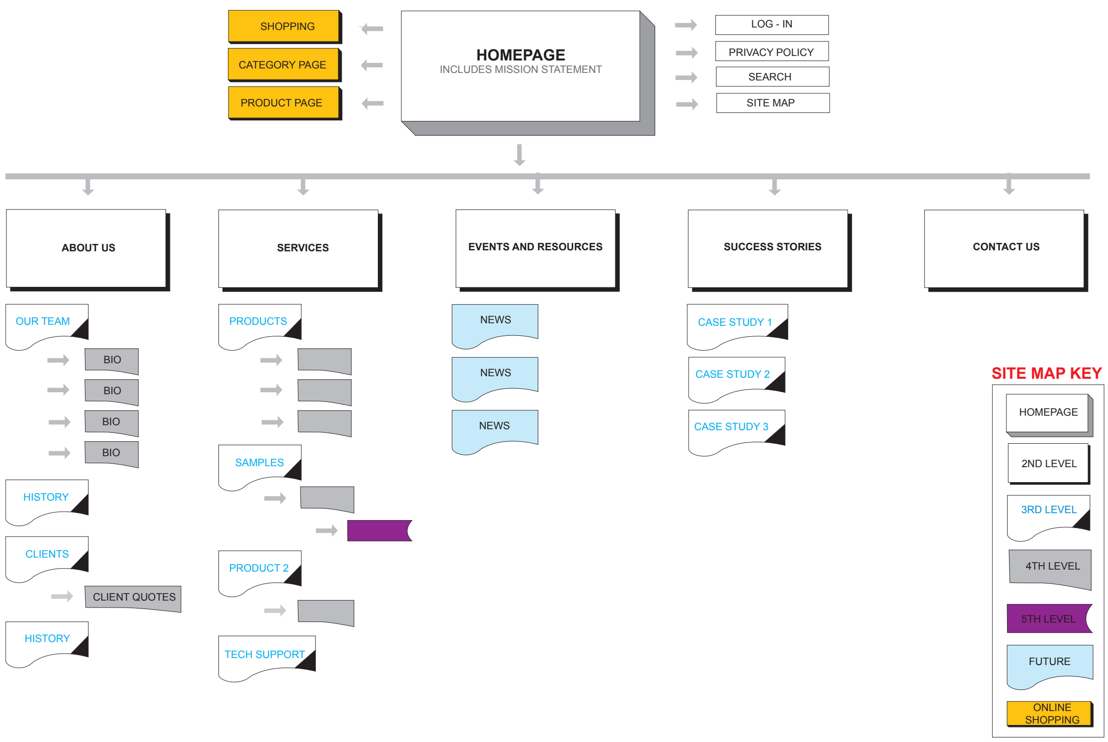
- **Selling through an e-commerce host**. This is an easy and inexpensive way to sell online. You simply register with a host site, choose a template, and upload your product information. Your ISP may even offer an e-commerce package. Of course, you usually pay for greater convenience by giving up a certain amount of functionality and flexibility, and the ability to have a really unique brand identity. Still, these sites can be a great way to put your toe in the water, and many of them offer upgrades when you're ready to grow. FastSpring (www.fastspring.com) is a good example. An even more basic method of hosted selling is to sign up with online markets like eBay Stores (stores.shop.ebay.com) or Etsy (www.etsy.com).
- **Selling through an online retailer or distributor**. There may be an established online store or distributor that would be willing to carry your product. Important points to consider include the site's traffic and reputation, what tools it provides for differentiating your product from competing brands, payment terms, and which business will be responsible for order fulfillment and after-sale service.

## Site Architecture

No matter who's going to build your site, you need to plot out how many pages it will have, how they'll look, and what information they'll offer.

### *Information architecture*

The first step is to draw up a blueprint of your site. It should show your pages in relationship to one another, and the type of content on each of them, like this:



*Page architecture*
Once you've drawn up a chart, you need to decide which elements will appear on each page (e.g., navigation bar, company name and logo), how they relate to each other, and how they'll work with the rest of the site.

*Content creation*
Once you've decided on the organization of the site, and its design elements, you can start working on content. This can include text, images, animation, sound, or whatever else you need to promote your business and communicate your brand.

*Interactivity*
How will users interact with your site? Will they fill out forms, click on checkboxes, or get shipping costs? Will they search your catalog, or access a database? Each of these features requires careful planning, and must be detailed thoroughly. Describe the features, and what happens when the customer uses them.

Describe your site's interactive features, and what happens when the customer uses them

## NxLEVEL® GREEN TIP
ENVIRONMENTAL BUSINESS RESOURCES

It takes a lot of energy to host Websites! This has led many Web hosts to run their servers, data centers, and offices on alternative sources of power, either by paying a utility for renewable power, or by actually generating renewable power themselves. Buying offsets is another common tactic.

Here are some companies that may provide greener hosting and computing power for your site, at competitive prices.

- **Affordable Internet Services Online** (AISO.net) is a 100% solar-powered operation, with its own environmentally friendly data center, and a redundant solar-powered network.
- **Acorn Host** (www.acornhost.com) is "100% powered by green energy." Its primary customer base is small businesses, individuals, and nonprofits.
- **DreamHost** (www.dreamhost.com) purchases Renewable Energy Credits and Emission Reduction Credits in order to reduce the impact of its operations.
- **EcoSky** (www.ecosky.com) uses "an infrastructure that draws power from the sun and wind."

These aren't endorsements, so much as a quick peek at the different strategies green Web hosts are pursuing. In addition to performing due diligence to make sure you're getting the green hosting you're paying for, you'll need to shop around to get the best price, and the features and support you need.

## Basic E-Commerce Capabilities

In this section, we'll take a closer look at three basic stages of online selling: merchandising, making the sale, and getting paid.

### Merchandising

Your e-commerce site is a shop that people all over the world can wander through at any time of the day or night. The trick is to tempt them to do it.

Too many sites assume that the secret to attracting customers lies in displays of high-tech wizardry. In fact, the buying public's interest in such displays is limited. You might love the idea of 3D animation, but it's very expensive to produce, and customers with lower-speed connections may not be able to view it. Others will get bored while waiting for it to load, or simply find it irritating and irrelevant.

What most people want is to be able to find what they're looking for, see some attractive pictures of it, read a detailed description of what it is and why it's worth owning, and browse customer reviews.

Brick-and-mortar retailers are experts in presenting goods, as are catalog sellers. It's not a bad idea to borrow their display ideas. Consider how department stores display merchandise. The physical layout encourages browsing. Lighting and colors inspire a variety of emotions (quiet calm for bedroom items, or sunny cheerfulness for patio furniture). Complementary items may be grouped into "lifestyle" tableaux, to encourage add-on sales.

Far too few Website designers have taken sufficient advantage of the psychological savvy that guides traditional retail display. Obviously, customers can't touch online merchandise, but a zoom feature for photos may be a good substitute. The point here is to think about the psychology of buying, online and off, and how your site can increase the interest of buyers (or, at the very least, avoid chasing them away).

Think about how your site can increase the interest of buyers

Here are a few suggestions:

- Professional, high-resolution photography (with zoom feature, if possible)
- Custom shopping lists and one-click ordering
- Personalized shopping recommendations and gift reminder services
- Helpful tools (e.g., rulers, charts, and calculators)
- Live online chat with a service rep (e.g., through instant messaging or VoIP)
- Smart search capabilities
- Video demonstrations or testimonials
- A no-hassle return policy

*Bee's Knees went through a lot of changes in a short time, and the Website had to keep pace. The IT department constantly overhauled the site to reflect the latest offerings, and the latest customer suggestions.*

*It's not easy to have constant change without alienating customers, but Michael knew he had to achieve exactly that. His philosophy was that if a change required a customer to learn something new, it was too complicated; the only allowable changes were ones that didn't require customer readjustment.*

*One thing they did was bring volunteers in to test out proposed changes. They were timed with stopwatches, and if they got where they were going in the same amount of time, or faster, they knew they were on the right track.*

*The end result was that the back end of the site changed dramatically, while the front end changed for the better in more subtle ways. It was more work and it cost more money, and the programmers weren't always happy about it.*

*But Michael explained it this way: "If I ran a brick-and-mortar store, I wouldn't always be moving doors and windows around, and moving checkout from one end of the store to another. I like exciting change, the kind that draws people in to explore on their own terms. I don't like change that feels like a shell game, where you don't get what you want unless you can guess where it is!"*

### Making the Sale

In this stage, the customer must have the ability to put desired items in a shopping cart, choose from different shipping options, get a price total that includes shipping and tax, and enter a billing address and shipping address.

Here are some features that all e-commerce checkout systems should have:

Customers should be able to access the shopping cart from any page on the site

- Customers should be able to access the shopping cart from any page on the site.
- Customers should be able to change the quantity of items in the cart and delete products. Price totals, including tax and shipping charges, should be recalculated immediately.
- A running total should always be visible, so that customers can avoid exceeding an allotted budget. This total should include all applicable taxes and shipping charges, and should be recalculated when the items in the shopping cart change.
- The cart should have the ability to save an order that wasn't completed. An abandoned cart is often the result of the customer not having a credit card readily available, or some other type of interruption.

- There should be as few checkout pages as possible, and they should load quickly. Studies show that shoppers are more likely to abandon carts the more pages they have to click through, and the longer they take to load. In fact, studies have shown that increasing page speed can boost sales by as much as 20 percent.
- There should be a toll-free telephone number on every page during the checkout process, in case the customer needs to doublecheck information before completing the transaction.
- Your site should highlight security measures, encryption standards, anti-fraud measures, return policies, and any third-party guarantees of security.
- Your customer should have a variety of shipping options, including express service. Display shipping charges and tax early in the checkout process, so that they don't come as a surprise.
- If you accept foreign orders, make sure your shipping charges are accurate, and that your address fields have the capability to accept foreign address information.
- Allow customers to keep their encrypted credit card, shipping, and billing information on file, so they won't have to enter them every time they buy.
- Offer expected delivery time and tracking information. If you use the US Postal Service, offer a trackable service such as delivery confirmation; the extra cost is negligible, and most online buyers will want to track their packages.

Your site should highlight security measures, encryption standards, and return policies,

For most small businesses, a third-party service is the quickest and most cost-effective method of setting up a shopping cart. A good program will include inventory management, accounting, cross-marketing, and customer-management features. Popular brands include Zen Cart (www.zen-cart.com), osCommerce (www.oscommerce.com), and CubeCart (www.cubecart.com). Alternatively, you can choose a hosted, subscription-based shopping cart. In that case, you'll needed to balance the extra expense against the greater availability of service and higher security standards. Do plenty of research to ensure that you get your money's worth!

### Getting Paid

If you're selling online, you should set up a merchant account with your bank so that you can accept credit cards.

If you prefer, you can choose from a number of third-party e-commerce services. The most well known of these services is PayPal (www.paypal.com). If you're a merchant who uses PayPal, your customers can click on a "Pay" button that brings them to a checkout form. PayPal collects the money, and credits it to your account (minus a small fee). You can transfer money in this account to your bank, or access it with an debit/credit card issued by PayPal. Similar services include Google Checkout (checkout.google.com) and ProPay (www.propay.com).

Security means increased e-commerce sales, fewer abandoned shopping carts, and more repeat purchases!

*Security*

E-commerce requires trust, which is why you must offer a secure method of accepting credit cards. Studies show that sites with a recognizable SSL certificate enjoy increased e-commerce sales, fewer abandoned shopping carts, and more repeat purchases.

The standard security method is **secure socket layer (SSL)**, a communications protocol that encrypts customer information. To implement SSL, you'll need an **authentication certificate**. This is a sort of digital ID card that confirms your identity. You can get this from a certificate authority such as Verisign (www.verisign.com). The certificate also encrypts the data. For maximum security, you'll want a 128-bit certificate.

If you're using a third-party provider, be sure to ask what protections they've put in place to reduce the likelihood of fraud and chargebacks.

**Online Payment Tips**

*Assess your processing needs:*

- How many transactions do you expect per month? Is your business seasonal? How will this number change over time?
- Which credit cards do you want to accept? What initial, monthly, and annual fees apply?
- Are there any hidden fees?

*Assess prospective service providers:*

- What is their online reputation?
- What other sites use them?
- How is their customer service? Are they available to answer your questions promptly?
- Do you have to sign up for a specific amount of time, or do they offer a month-to-month contract? Are there penalties for early termination?
- What steps have they taken—online and off—to prevent pharming, phishing, identity theft, and other types of fraud?
- How do they handle chargebacks?

*Calculating taxes*

Sales tax rates vary from state to state, county to county, and city to city. To make matters more confusing, you have to consider states in which you may have a **nexus**. The term "nexus" generally means a permanent location or establishment (e.g., a store, a shipping facility, an office, or a resident sales agent). What constitutes a nexus in e-commerce is a subject of ongoing debate. Consult your accountant or tax attorney for more information.

Once you've ascertained your needs and obligations, you can buy third-party programs that will work with your site to calculate tax. Avalara (www.avalara.com) is a popular provider. As with all taxation issues, have a long talk with your accountant before you make any final decisions.

You should also be aware of the Streamlined Sales Tax Project, which is an attempt by states to create a framework for compelling online sellers to collect sales taxes from buyers in states where they have no physical presence. Advocates argue that competing with tax-free Internet sellers puts local, brick-and-mortar businesses at an unfair disadvantage, and is regressive in the sense that only relatively affluent consumers with the ability and means to buy online receive a sales-tax exemption. Opponents argue that collecting this tax will burden struggling consumers and small-business owners, and hamper the growth of e-commerce.

Not surprisingly, e-commerce giants like eBay and Amazon are passionately opposed to the Streamlined Sales Tax. In mid-2009, Amazon threatened to stop doing business with affiliates who are based in participating states. If you plan to sell online, you'll want to stay informed about this plan.

*Shipping options*

High or illogical shipping costs can scare online shoppers away. In most cases, you should avoid calculating shipping and handling fees as a percentage of the total price of the order. Should the shopper be penalized with exorbitant shipping costs for spending more money at your online store? Of course not. If anything, the shopper should be rewarded!

High or illogical shipping costs can scare online shoppers away!

Free, reduced, or upgraded (i.e., to a faster service) shipping are typical rewards for big online spenders. Expedited shipping is an especially good incentive. The cost of upgrading from UPS ground service to 2-day service is not high, but it can make a huge difference in your customer's perception of your business.

Many e-tailers have decided to offer free shipping as an incentive. For sites with a very high volume of sales, this can be a great way to attract and keep customers. However, somebody has to pay for shipping; if you offer free shipping, you must either accept a lower profit margin on each item you sell; or pass the cost of your policy on to the customer by raising your prices, which makes you less competitive. Also, e-tailers who offer free shipping can face serious consumer disaffection if they ever change this policy.

*Offer a variety of shipping options*

You can reduce abandoned carts and increase revenues by properly handling three pieces of information: the shipper's zip code, the customer's zip code, and the package weight.

With the right software or third-party service, you can use this information to calculate multiple shipping alternatives, such as UPS ground or FedEx next-day air. Standardizing your packing materials will help to avoid weight fluctuations.

Many shippers offer software plug-ins that will work in concert with your site. Visit their sites for more information.

*One of Michael's good ideas was to hold frequent focus groups that offered customers gift certificates in return for advice. These focus groups gradually evolved into a "Board of Customers"; this was a rotating group of customers who helped with company brainstorming sessions in return for a months' worth of discounts at 10 percent below the list price. In addition to providing the firm with many great ideas—and steering them away from some bad ones—these customers became Bee's Knees' ambassadors to the community. They had a strong sense of emotional involvement in Bee's Knees, and wanted to tell other people about it. Michael was getting the best kind of publicity a business can have, and it was costing him next to nothing!*

*Eventually, Bee's Knees had to overhaul its Website completely, in order to take advantage of new customer-management and cross-marketing software capabilities. Michael felt it had reached the point where the site was holding Bee's Knees and its customers back. Also, while it worked beautifully for old customers—most of whom had personalized standing orders that didn't change much from week to week—the new site would have to tempt people to browse.*

*Once again, Bee's Knees ignored the conventional wisdom. Rather than hire outside IT contractors with expertise in these new technologies, Michael decided that his IT staff would learn how to do everything themselves. They already knew the site inside and out, after all, and this way they'd have a new skill that would serve the company well as it continued to grow.*

## Customer Service Online

Customer service is the main factor that determines whether a customer returns to a particular online merchant

Online customers expect the same level of customer service they receive offline—if not more. Studies show that customer service is the main factor that determines whether a customer returns to a particular online merchant. For some companies, the rapid growth of online sales has outpaced investment in customer service, resulting in declining customer satisfaction. To reverse this trend, many businesses try to replicate first-class customer service online.

### Keeping in Touch

One of the biggest complaints customers have with e-commerce is the difficulty of getting in touch with online businesses. They complain that phone numbers can be hard to find on Websites, and if called, may not be answered. Also, customer e-mails often get no response for days on end, or receive an automated response that does not properly answer the customer's question.

To avoid the frustration this lack of contact causes, and to assure customers that your company is legitimate, it's essential to hire and train customer service representatives to answer customer calls and e-mails. Many prospective customers call simply to ensure that the company actually exists. If you have knowledgeable, friendly people answering inquiries, these calls present a perfect opportunity to promote your product.

## Online Marketing Strategies

Almost everyone agrees that online advertising is very different from its traditional counterpart. Many experts feel that online advertising should be interactive, and must offer some sort of reward for the consumer's time and attention. This reward can be as simple as gratified curiosity: one insurance company devised an interactive banner advertisement featuring a very short questionnaire, into which interested users entered their age and annual income to receive an estimate of how much money they'd need to retire. This unusual, compelling ad resulted in a response rate twice the industry average!

Businesses are constantly devising new strategies for online advertising. While most experts agree that standard advertising techniques can be inappropriate for the Web, there's not much agreement about what works and what doesn't. Also, credibility problems arise because many advertisers take advantage of the Internet's tendency to blur the boundaries between objective information and promotional hype.

Just as for any other form of advertising, the regulations of the Federal Trade Commission's Division of Advertising Practices apply: online ads cannot be deceptive, and any objective claims they make must be substantiated. More than almost any other type of commerce, e-commerce depends on consumer trust, so be honest, fair, and deliver on your promises. Creativity and innovation in Internet marketing is almost always valued by online consumers.

### Don't Interrupt!

In his book *Permission Marketing*, Yahoo! Inc. Vice President Seth Godin argues that the online entrepreneur can't rely what he calls "interruption marketing." Instead, Godin advocates giving the customer something in return for his or her time.

This notion of "interruption" is one of the major differences between Internet advertising and traditional advertising. If a consumer wants to avoid advertising interruptions while watching television or listening to the radio, he or she must take an active step like changing the channel, turning the volume down, or leaving the room. By contrast, Internet advertisers usually require that the consumer take an active step (i.e., clicking on a banner or icon) to see the advertisement. In other words, online ads must coax consumers to interrupt their Internet experience willingly.

This is why the idea of **permission marketing** is a sound one. In effect, prospective customers agree to view an advertising message in return for receiving a product, a discount, a coupon, a piece of useful information, or some other reward for their investment of time and attention. You might give away a free duffel bag or mouse pad (imprinted with your logo and URL, of course) to everyone who registers with your site, or to everyone who buys from it. A less costly strategy would be to appeal so strongly to your customers' curiosity or sense of humor that they are drawn to click on your ad. Obviously, there are many possibilities. As an entrepreneur, you know better than anyone how valuable time is, so ask yourself what would compel you to take time out to look at an ad.

Online advertising must offer some sort of reward for the consumer's time and attention

### Customer Engagement Online

As we discussed in Chapter 30 ***Promotion***, customers who show a high level of engagement with your brand are more likely to view and share marketing communications. This is why so many businesses are trying to build brand-based communities online, and encourage conversation and collaboration among customers.

Here are some online marketing techniques that can encourage customer engagement:

- **Create a community.** Provide a forum (e.g., a blog or discussion forum) for your customers to develop their own communities. If you're lucky enough to have a community form on a different site, look for ways to help it grow.
- **Encourage user-generated content.** Customers should be able to post reviews, rate services and site features, answer each other's questions, and suggest improvements. Note that this requires a good moderation policy at the outset; if you keep changing rules in response to problems that arise, users may get frustrated. Don't roll out these features until you're ready! And be sure to prepare yourself mentally for negative comments and constructive criticism.
- **Allow consumers to interact with one another.** For instance, you might make it easy for them to comment, chat, send messages, and post videos or photos.
- **Reward loyalty.** Customers who take the time to promote your business should be rewarded. Although free gifts and discounts are obvious choices, don't overlook little things like symbols of online status. Many sites allow users to earn some sort of symbol—like the colored stars used by eBay—to signify their level of involvement with the online community (e.g., the number of comments they've posted overall, or the number of comments that were rated as "very helpful" by other site visitors).

Customers who take the time to promote your business should be rewarded!

### Blogs

Blogs (short for "weblogs") are online journals that are usually devoted to a particular subject or point of view.

The popularity of blogs provides additional opportunities for branding and marketing. Blog readers comprise a loyal community, and they may be favorably disposed towards advertisers who support their favorite sites. There are blogs devoted to virtually every topic under the sun. If you can find a well-trafficked one that fits your brand identity, you might want to consider advertising on it. For instance, if you make birdfeeders, you might want to advertise on one of the more popular birdwatching blogs.

You can also start a company blog that will keep customers and partners informed about your business, your view of industry trends, interesting articles you read on other blogs, and similar topics. But bear in mind that this requires a serious commitment. It takes time and talent to come up with interesting, original written content on a daily or even weekly basis. While it's true that an interesting, engaging, funny, informative blog can do wonders for your business, it's also true that a dull, pointless, over-opinionated, or poorly written one can hurt it.

You also have to consider how you'll deal with commenters. Handled correctly, your comments section can become a valuable resource for loyal users and prospective customers, but this also takes time and talent. An unmoderated comment section can easily become a snake pit of skeptics, detractors, spammers, and emotionally unstable attention-seekers, while an overmoderated section will chase users away, and may make your company seem insufficiently confident and transparent. How much time can you or an employee realistically devote to striking the proper balance, given all your other responsibilities?

The point is, you shouldn't start a blog simply because everyone else is doing it. Instead, treat it like any other business activity: consider what resources and skills it requires, whether your company has them, and whether blogging is really the most competitive way to use them.

Last, some businesses try to use the comment fields of other people's blogs to post promotional messages and links to their site. This is known as **comment spam**, and it's extremely unpopular. Most bloggers will delete such comments, and many will ban the people who post them.

### Social Networking Sites

Social networking sites are designed to help users get reacquainted with old contacts and make new ones. They facilitate interaction and networking, with a strong focus on creating user-generated content. When used correctly, social networking sites can drive business to your Website, help you to deliver customer service, and create loyalty and trust that will drive sales. They also allow you to communicate with thousands of contacts at once, through various types of instant messaging.

Social networking help users get reacquainted with old contacts and make new ones

The most famous examples are Facebook and MySpace. Both of them are currently adding features designed to make online marketing more effective. For instance, Facebook Pages (www.facebook.com/advertising/?pages) allows businesses to set up profiles that can include all sorts of multimedia features.

Most social networking sites are free or low-cost. However, you have to factor in the time that may be required to get useful results. As with blogs, don't make the mistake of thinking that social networking is some sort of quick and easy way to increase your business's online visibility. In fact, it requires a solid understanding of the technology, the dynamics, and—above all—the etiquette of the communities that rely on it. It's a good idea to frequent such sites for at least a month, as a regular user, before you even think of introducing a promotional message.

The most important thing to understand is that social networking is not advertising. A print, TV, or radio ad is a monologue; social networking is a dialogue. In most cases, you can't simply bombard an online community with your promotional message. Instead, you must participate and contribute in ways that may have little or nothing to do with your business. You need to be part of the conversation, rather than an interruption.

Social networking can be time-consuming (and addictive!), so you should seriously consider what your capabilities are before you get too deeply involved.

Also, remember that different social networking sites have different demographics. As of this writing, Facebook and MySpace are heavily frequented by teens and young adults, while LinkedIn tends to favor older professionals. Research your target sites carefully before proceeding.

Give people a reason to opt in to your messages, and to keep coming back

Don't assume that because this type of messaging is virtually free there's no downside to exploiting it; that's the logic that has made spammers some of the most hated people on earth. Instead, remember the demands of the attention economy: you need to give people a reason to opt in to your messages, and to keep coming back.

Again, social networking is viable to the extent that businesses follow established etiquette, respect other people's time and attention constraints, and avoid overwhelming them with information they don't need.

*Twitter*

Twitter (twitter.com) is a free social networking service that allows users to share information through short posts known as **tweets**, which can be sent from computers, cellphones, and PDAs. You can use it to stay in touch with employees, suppliers, reps, customers, and anyone else who is willing to follow your tweets.

One of the best uses of Twitter is to answer customer questions quickly. You've probably seen supermarkets that have bulletin boards where they post the store's response to consumer questions and suggestions. Twitter streamlines this process, and makes the information available at all hours. A Twitter feed can also alert customers to sale items and promotions, contests, and special events.

It also has great potential as a market research tool. For instance, you might ask a "question of the week" in order to get data you need. Don't simply send promotional messages and ask questions, though. Where possible, you should provide useful information, helpful links, and anything else that you have good reason to believe your customers will value.

You could also use Twitter to keep interested journalists abreast of breaking news about your company, as an alternative to sending a traditional press release. If you take this approach, be sure to write your messages carefully, and watch out for spelling and grammatical errors.

### Paid Advertising

There are three basic ways of purchasing advertising online:

*Pay per click (PPC)*

Under this scheme, advertisers place an link on a host site for free, and pay the host only when users click on it. Typically, the advertisements are displayed when the user does a keyword search that relates to the advertiser's product. The column of sponsored ads that appears in response to a Google search is the classic example.

The advertiser's **cost per click (CPC)** can be a flat rate, or it can be the result of an auction process in which advertisers bid for the ad position with the highest visibility. The CPC for search engines is almost always set by a bidding process. Content sites (e.g., blogs and news sites) are more likely to charge a fixed rate. Note, though, that this rate may vary according to the page on which the link is located, based on its amount of traffic or how specifically it relates to your business.

*Cost per impression (CPI)*

This is similar to radio and TV advertising, in that advertisers must pay to expose their message to a specific audience. An "impression" occurs every time an advertisement loads onto the user's screen. CPI costs are usually calculated per thousand impressions.

*Pay per action (PPA)*

Here, the advertiser pays when the user completes a given action, which might range from filling out a questionnaire, to requesting a brochure, to actually buying the product. The benefit of this method over PPC, obviously, is that you're paying for a specific positive result, as opposed to a statistical outcome that may or may not have been initiated by a prospective customer.

### Online Yellow Pages

Consumers are increasingly looking up businesses online, instead of browsing the local Yellow Pages. This trend is likely to continue, partially because online Yellow Pages can provide additional features like driving directions, photos, coupons, and customer reviews, and also because there are environmental advantages to scaling back the printing of traditional Yellow Pages.

Consumers are increasingly looking up businesses online, instead of browsing the local Yellow Pages

For these reasons, it's essential to list your business on these sites even if you don't have a Web presence. Yahoo Local (local.yahoo.com) and Superpages (advertising.superpages.com) are good places to start; both sites will allow you to create a new listing for your business, free of charge.

Other sites charge for listings, and almost all of them charge for advertisements. Be cautious when assessing the claims of such sites, and the fee structure. While lesser-known sites may offer a better price, they may not have enough traffic or consumer trust to generate sales for your business. At the least, you should look up other local businesses online—competitors, in particular—and see what they're doing.

### Direct E-mails

In general, direct e-mailing is very unpopular with online consumers. Most unsolicited e-mails (or **spam**) offer miracle cures, dubious financial opportunities, or pornography, and this has resulted in a certain amount of guilt by association for legitimate marketers.

It's also true that a busy person who has to answer 50 or 100 e-mails is likely to respond with hostility to an unsolicited e-mail. Experts currently estimate that 80 to 95 percent of e-mail messages are spam.

It's no surprise. From the spammers' standpoint, the cost of sending e-mails is so low that even a tiny success rate (e.g., 1 sale per 100,000 e-mails) can be lucrative. For this reason, some experts are suggesting that mass mailers should have to pay fees depending on how many e-mails they send.

Does this mean you should never send out mass e-mail messages? Not necessarily. If you serve a small niche market, such as model train enthusiasts or collectors of movie ephemera, an e-mailing list of persons currently involved with model train or film newsgroups, discussion groups, chat rooms, or listservs could be invaluable.

Your best bet is to offer regular updates on your company, or a subscription to an online newsletter—information that is resented as unsolicited junk mail is valued when it comes in response to a request. For this reason, your Website should have a link that customers can click on to opt in to your mailing list. This enables you to reach thousands of current and prospective customers at a fraction of the cost of traditional direct mailing, while abiding by the terms of the CAN-SPAM Act.

### Offline Site Promotion

All of your packaging, letterhead, and other business materials should have your URL prominently printed on them. Company vehicles are another good place to post your URL. Word of mouth is a powerful tool, too; tell your customers and friends that your Website just went up, and explain what service or incentive it offers. If you're only marketing in your local area, you might also consider handing out little printed announcements of your Web launch, or other guerrilla marketing techniques.

Many businesses promote their sites with novelty items like keychains, pens, and so forth. This can be an effective strategy, but only if it matches your brand identity. For instance, if you're billing yourself as an environmentally aware business, you probably won't want to shower your customers with frivolous, disposable plastic trinkets.

Every interaction with the public is an opportunity to build and reinforce your brand

Instead, you should offer something recyclable or sustainable, like biodegradable golf tees or a solar-powered LED flashlight. By the same token, if your business takes pride in its American-made goods, you won't want to source your promo items from another country.

Remember: Every interaction with the public is an opportunity to build and reinforce your brand.

## Market Research

When customers and visitors move through your site, their actions are recorded in **log files**. The data gathered in these files can tell you invaluable things about where your customers come from, what browsers they use, what led them to your site, how long they stayed, what they did, and so forth.

Collecting marketing data is very easy online, which has led to many lucrative uses—and abuses—of these data. As described in Chapter 15 *Government Regulations and Taxes*, there are laws that apply to what kind of information you can collect, how you can use it, and whether you can share it with a third party. Talk to your lawyer about these issues.

## Search Engine Optimization

The higher a site ranks in a search engine's results list, the more visitors it usually receives. Therefore, techniques for increasing **page rank** are in great demand.

The higher a site ranks in a search engine's results list, the more visitors it usually receives

The following design features can increase your site's chances of being placed among the top 20 sites by search engines.

- A domain name that describes your products or business.
- A descriptive title for each page of your site (e.g., "Jane Hindson's Stained-Glass Workshop in Bloomington, Indiana").
- Descriptive keywords in your site headlines, body copy and links (do not repeat keywords more than 4 or 5 times on a page). Try to use your most important keywords in text links to other pages. You may want to check out a free program called Good Keywords (www.goodkeywords.com), which can help you optimize your keywords.
- A good **site map** will help search engines find content throughout your pages. Many shopping cart providers offer site map coding that can optimize this page for search engines.
- **Metatags** are HTML tags used in Web pages to provide background information such as the name of the page author, the program used to create the page, and page keywords and description. Many search engines don't read them, but you should have them for the ones that do.
- Alternative text tags give Web authors the opportunity to offer a text description of the images on your site. Adding your primary keywords to your alternative text tags will boost your site's position in search engines.
- Update your keywords based on your search results and those of your competitors. There's no law against modeling your keywords on those of your competition!

Due diligence is a must when choosing search engine optimization firms

You can also hire **search engine optimization (SEO)** firms to improve your page rank, or to teach you or your employees optimization techniques. While this can be a useful service, due diligence is necessary to make sure that the SEO won't use dishonest, manipulative, or illegal tactics.

When looking for an SEO firm, focus on companies that have experience in your industry with businesses of your size. Find out what benchmarks they use to measure success, and what sort of timeframe is involved.

Last but not least, be sure to get several competitive bids, and always ask for references and check them!

## NxLEVEL® TECH TIP

BUSINESS RESOURCES AND THE WEB

For further information on the present and future of e-commerce, we recommend the following easy-to-access sites.

**Pew Internet and American Life Project** (www.pewinternet.org) is an ongoing research project that tracks new and emerging trends in online technology and activities, their effects on American life and culture, and public attitudes towards these trends and effects. This is an invaluable site for anyone who wants to stay informed about online trends.

**E-Commerce Times** (www.ecommercetimes.com) contains a wealth of up-to-the-minute information on buying and selling trends, as well as in-depth features on emerging technologies and legislation. They also have a section devoted to issues affecting small businesses. A good site to read daily!

**eMarketer** (www.emarketer.com) provides statistics and information about every e-commerce topic imaginable, from Internet advertising and marketing, to current and upcoming market trends, to the secrets of Web design. The "eStats" database is especially helpful for the initial planning stages of your business; it has online statistics for ad revenues, Internet usage patterns, market size/growth, and demographics. Complete reports on current Internet usage are available for a fee.

**ZDNet** (www.zdnet.com) offers tantalizing glimpses of emerging computer technologies, and the business opportunities they're likely to create. Their review section is an invaluable resource for assessing new software packages and other products.

*Bee's Knees' new site is a big hit with users. Its system of "virtual aisles" allows them to stroll through the store the way a traditional shopper might, while its improved customization functions allow experienced shoppers to set up their own mini-stores.*

*There are improved specialty sections too. You can have the site display only ingredients used in a certain type of cuisine (e.g., Thai or Mexican), and you can also enter dietary restrictions that will limit what your store displays.*

*For instance, if you're allergic to peanuts, your store will exclude any product that has even trace amounts of peanuts in its ingredient list. Don't want dairy? Nothing containing milk or butter will appear in your store.*

*This increased emphasis on presenting background information is something that keeps users browsing even when they're not in the mood to shop. Want more information about the farm that grows Bee's Knees' radishes? Clink on the farm's link, and take a virtual tour!*

*All in all, Bee's Knees is a fascinating example of what can happen when traditional customer service and new technology converge in a growing market!*

### Web Directories

**Web directories** are indexes to Websites, listed in alphabetical order by category, region, or subject. They're a little different from search engines, in that their listing of sites is compiled by people, not software.

Web directories are indexes to Websites, listed in alphabetical order by category, region, or subject

The most effective directories list sites by subject or category. Because you want as many people as possible to see your site listing, it's very important to choose the category carefully.

Take some time to acquaint yourself with each directory service and how it works before you submit your site. This will help you choose the best category for your site, and could very well mean the difference between 10 and 1,000 visitors to your site per day.

Here are a few of the Web directories you may want to consider:

- **Open Directory Project** (dmoz.org). This is the largest of the Web directories. It's a completely free directory based on Open Source principles, and is probably the single best place to submit your listing. Pages listed with the Open Directory Project are automatically listed in the Google Web Directory (directory.google.com), which combines the Open Directory pages with Google's search technology.

- **Yahoo! Directory** (dir.yahoo.com). This is another important directory, but it's not free. As of this writing, the cost for consideration is $299. This fee is nonrefundable, and does not guarantee a listing. If your site is listed, Yahoo! will charge an additional annual fee of $299 to keep it current.

- **Best of the Web Directory** (botw.org). This is a commercial site that offers listings for sites that meet its technical and quality standards. Like the Yahoo! Directory, BOTW charges a nonrefundable fee for consideration; you can pay a one-time fee of $250, or an annually recurring fee of $100. Its sister site BOTW Local offers localized business information for millions of US businesses, and also accepts ratings and reviews from consumers. A premium listing is available for a monthly fee.

## Conclusion

No matter how small your business is, and no matter what product you offer, you can improve its sales and visibility by going online. Even if you're not yet ready to set up a fancy e-commerce site that accepts credit cards, a well-designed, informative Web page can attract customers you'd never reach otherwise, as well as suppliers, distributors, investors, employees...even buyout offers!

Certain experts believe that most businesses will be unable to succeed and grow without expanding into e-commerce. Whether or not this is true, there's no doubt that staying offline in coming years will make it increasingly difficult to compete. Since you're committed to growing your business, why not start right now to make the most of this powerful tool?

# PART VIII
# MANAGING YOUR MONEY

## Chapter 35
## OVERVIEW OF FINANCIAL STATEMENTS

*About This Chapter:*
- *Basic accounting concepts*
- *The income statement*
- *The balance sheet*
- *Statement of owner's equity*
- *Statement of cash flows*
- *Financial statement analysis*

### Introduction
Accounting is the process of measuring and recording financial information. Financial statements are the means of communicating this information. Users generally fall into two categories:

- **Internal users** include owners and managers, who need to get feedback about decisions they have made, evaluate performance, and identify planning opportunities and needs.
- **External users** include bankers, investors, partners, and governmental agencies, who need to evaluate investment risk, determine credit, or assess taxes.

Financial statements tell the story of what happened to the business over the past year. Comparative statements also include information from previous years. Sometimes, financial statements are prepared as a forecasting tool. These are called **pro forma statements** and result from the budgeting process.

### Basic Accounting Concepts
It's easier to understand financial statements if you understand the basics of accounting.

#### Historical Cost Principle
The **historical cost principle** states that all amounts must be recorded at the exchange price of the transaction at the time it occurred. They are not adjusted for changes in market value.

Financial statements reflect historical cost, not current market value

For example, suppose a business bought land in 1980, at a price of $50,000. In 2009, the land is worth $250,000, but only the historical cost of $50,000 appears in the financial statements, because fair market value estimates are subjective and change frequently.

### Economic Entity Concept

The **economic entity concept** calls for the separation of the business's accounting records from those of all other entities, including owners. Let's say a sole proprietor buys a computer for personal use. Even if business funds are used for the purchase, the computer does not belong in the business's financial statements. If the computer had been purchased for business use, the expense would be included on the financial statement.

### Accrual vs. Cash Accounting

When a business hires an attorney to do legal work, the attorney has revenue and the business has an expense. Suppose the attorney completes the legal work in December and the business pays the bill in January. Should the revenue and expense be recorded in December or January?

The accrual method says to record revenues and expenses when the transaction takes place

Under the **accrual method**, which states that revenues and expenses occur when the action takes place—even if cash changes hands on a different date—the transaction would be recorded in December. Under the **cash method**, which states that revenues and expenses occur when cash changes hands, the transaction would be recorded in January.

The accounting profession recommends the use of the accrual method, but most individuals and some small businesses use the cash method, which is usually easier to understand.

### Full Disclosure Principle

This principle mandates full disclosure of events and circumstances that affect the user of the financial statements. This is done in the statements themselves, or in attached footnotes. As a result of recent lawsuits, the amount of disclosure required has been increasing.

*Louisa Egan was a shrewd and knowledgeable businesswoman who operated a busy travel agency in Peekskill, New York. She specialized in customized adventure travel packages, and knew her clients—and the destinations she recommended to them— personally.*

*By the fall of 2006, she felt she'd reached the point of diminishing returns. She decided to close her office space and manage a small pool of her favorite clients from her home office.*

*But within six months, she was bored. She'd simply had enough of the travel business! She began to toss around other business ideas with her daughter, Anne, who had just graduated from business school. Louisa decided she wanted to start a new business that would create and sell a tangible product, and that she could pass on to Anne when she retired.*

*Louisa and her husband had been making jams every summer for the past 23 years. They used organic raspberries, blueberries, strawberries, and peaches from local farmers. When Louisa and Anne brainstormed for business ideas, they kept returning to the idea of Louisa's Jams.*

*Anne researched the market for specialty jams and talked to several organic farmers. She made an estimate of overhead expenses, and the amount of jars they'd have to sell to make a profit. The market for organic foods was growing, and the numbers seemed realistic. She and her mother decided to go for it.*

## The Income Statement

**Revenue** is the money generated by such earning activities as selling a product, charging rent, or receiving interest on a loan. **Expenses** are the cost of resources used in the process of earning revenue, such as insurance, advertising, wages, and payroll taxes.

An **income statement** is a summary of the revenue generated and expenses paid during a given time period. It has a simple formula:

*Revenues – Expenses = Net income*

This general formula can be expanded to provide more detail:

Your Business
Income Statement
For the Year Ended December 31, 2009

| | | | | | |
|---|---|---|---|---|---|
| Sales | | | | $450,000 | 1 |
| Less: Cost of goods sold | | | | (200,000) | 2 |
| Gross Profit | | | | **$250,000** | 3 |
| Less: Operating Expenses | 4 | | | | |
| Wages expense | | $80,000 | | | |
| Payroll tax expense | | 20,000 | | | |
| Insurance expense | | 5,000 | | | |
| Rent expense | | 24,000 | | | |
| Advertising expense | | 3,000 | | | |
| Utilities expense | | 1,400 | | | |
| Depreciation expense | | 1,300 | 5 | 134,700 | |
| Net Operating Profit or Loss | | | | **$115,300** | |
| Other gains and losses: | | | | | |
| Interest revenue | | | | 700 | |
| Interest expense | | | | (1,200) | |
| Net Income Before Taxes | | | | **$114,800** | |
| Less: Income Taxes | | | | 30,000 | 6 |
| Net Income | | | | **$84,800** | 7 |

The income statement is a summary of actions which took place during a given time period

**ITEM 1—Sales.** Revenue for retail, wholesale, and manufacturing is earned mainly through sales. In the service business, it is called ***Fees earned*** or ***Services revenue***. Notice that there is a separate category, called ***Other gains and losses***, which includes earning activities other than your primary operations.

**ITEM 2—Cost of Goods Sold.** The major expense for retailers, wholesalers, and manufacturers is **cost of goods sold**. This sounds simple enough, but there are many variations to consider. For example, assume that you buy some inventory items for $5.70 each, and later buy some more for $5.90 each. When you make a sale, how will you calculate cost of goods sold? Should it be $5.70 or $5.90?

If you can identify the specific products sold, you can answer the question easily. If not, you must use one of three assumptions: 1) the first in are the first out (FIFO); 2) the last in are the first out (LIFO); or 3) an average of the two.

Manufacturers have three parts to cost of goods sold: direct materials, direct labor, and overhead

Manufacturers must consider three different costs in their cost of goods sold:

- **Direct materials** are materials that become an integral part of the product. For a furniture manufacturer, this would include wood and hardware.
- **Direct labor** is the cost of labor spent creating the product. In the case of the furniture manufacturer, it would be the cost of the workers who build the furniture.
- **Overhead** comprises all manufacturing costs not already included in direct materials or direct labor.

**ITEM 3—Gross Profit.** This is the amount remaining after covering the cost of goods sold. When you subtract all expenses from the gross profit, the result is net income (or loss).

**ITEM 4—Operating Expenses.** All expenses (other than cost of goods sold) incurred in your major line of business (e.g., wages, rent, advertising, payroll taxes, utilities, and depreciation). You can group these expenses into subcategories if you wish. For small businesses, operating expenses normally include all expenses except cost of goods sold, interest, and income tax. These expenses are separated because they are significant for financial analysis.

**ITEM 5—Depreciation Expense.** In common usage, depreciation represents the decrease in value of an asset. Accountants use depreciation to spread the cost of equipment, buildings, and tools over the life of the asset. The cost of these items is an expense of doing business, just like wages or rent. But the equipment has a longer useful life, so it should not be shown as a one-time expense.

Let's say your business bought a piece of equipment for $25,000 and you expect to use it for 25 years. Is this an expense of doing business? Yes, but we record the expense over the item's 25-year useful life. There are several methods of calculating depreciation, but most small businesses use one of two methods allowed under federal income tax laws: the **straight-line method**, or the **Modified Accelerated Cost Recovery System (MACRS)**.

The straight-line method is simple. To calculate it, one simply divides the cost of a piece of equipment by its estimated useful life. In the example above, depreciation expense is $25,000/25 years, or $1,000 per year.

**ITEM 6—Income Taxes.** Income taxes are an expense of doing business, but whether or not you may include them on your income statement depends upon the legal structure of your business.

Income taxes are not considered an expense for sole proprietorships or partnerships, because the taxes are levied on the owners rather than on the business. Income taxes are levied on corporations, so they appear on the corporation's income statement.

**ITEM 7—Net Income.** We have worked our way to the bottom line. Again, for the income statement, that means:

***Revenues – Expenses = Net income***

Remember: As revenues go up, so does net income. As expenses go up, net income goes down. Therefore, selling as much as you can while keeping expenses as low as possible is fundamental to success.

Sell as much as you can while keeping expenses as low as possible

*Anne negotiated a long-term lease of an old bottling and commercial kitchen facility just outside town. A warehouse space was attached to the back of the building. The facility needed a lot of work, so Anne negotiated with the owner to get the first four months free in exchange for restoring it.*

*Anne calculated that Louisa's Jams could produce 10,000 jars of jam during its months of production. The busiest time would be the summer, when local farmers harvested blueberries and strawberries.*

*It would be a seasonal business, since it would only operate its production facility during the summer and fall. In winter, the business would only need warehouse space to hold inventory and a small office space to manage sales, finance, and marketing operations.*

*Anne figured they could rent out their excess kitchen capacity during the down months. Revenue from these subleases would cover the maintenance and overhead costs for the large facility. In fact, depending on how well she managed the facility, the subleases could end up providing Louisa's Jams with some serious income.*

*She asked around, and came up with three local businesses that were interested. Eventually, she decided to sublease to a small catering company called Peekskill Caterers.*

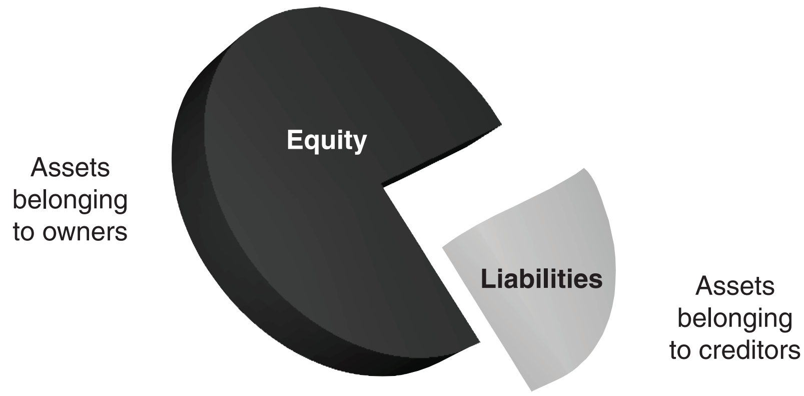
## The Balance Sheet

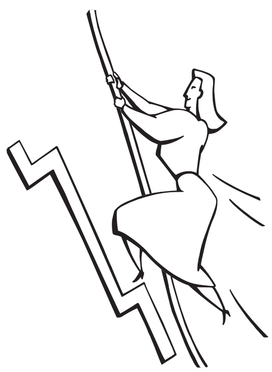
The balance sheet shows the business's financial situation on a given day only. The formula for the balance sheet is:

*Liabilities + Owner's equity = Assets*

**Assets** are economic resources owned by the business, purchased with funds supplied by creditors or owners. **Liabilities** are amounts owed by the business to creditors. **Owner's equity** refers to amounts owed by the business to the owners.

The balance sheet presents the total of what the business owns, and divides up the assets:



Equity represents the amount the business owes to the owners for their investment, plus profit

Normally, owner's equity is described as the amount left over after liabilities are subtracted from assets. Though accurate, this is perhaps not the most helpful way to think about equity. Recall the discussion of the economic entity concept: If the business is a separate economic entity from the owners, then the owners are just like all other creditors. Funds loaned to the business by creditors must be repaid someday, and creditors generally expect to earn interest on their loans.

In the same way, owners hope to get back the amount they put into the business, plus some profit. Thus, equity represents the amount the business owes to the owners for their investment, plus profit.

**ITEM 1—Current Assets.** These are resources that the business owns and expects to convert into cash or use up within one year of the balance sheet date. Segregating assets provides information about the short-term ability of the business to make payments and stay in business. In our example, your business owns assets that it expects to convert into $237,000 cash in the next year. That is to say, in addition to the $35,000 of existing cash, accounts receivable will be collected, inventory will be sold, and other assets will be converted into cash for a total of $237,000.

**ITEM 2—Property, Plant, and Equipment.** Includes assets expected to last more than one year. Remember, though, that these assets are listed at historical cost. Thus, in our example, $250,000 is the cost of the buildings when they were acquired, not their market value today.

Your Business
Balance Sheet
As of December 31, 2009

| | | |
|---|---|---|
| **ASSETS:** | | |
| Current Assets: ❶ | | |
| Cash | $ 35,000 | |
| Accounts receivable | 70,000 | |
| Inventory | 120,000 | |
| Other | 12,000 | $ 237,000 |
| Property, Plant & Equipment: ❷ | | |
| Land | $ 80,000 | |
| Buildings | 250,000 | |
| Equipment | 175,000 | |
| Less: Accumulated Depreciation | (105,000) ❸ | 400,000 |
| Intangible Assets: ❹ | | |
| Patents | $10,000 | |
| Goodwill | 60,000 ❺ | 70,000 |
| *TOTAL ASSETS* | | **$ 707,000** |
| **LIABILITIES:** | | |
| Current Liabilities: ❻ | | |
| Accounts payable | $ 45,000 | |
| Wages payable | 32,000 | |
| Other | 6,000 | $ 83,000 |
| Long-term Liabilities: ❼ | | |
| Notes payable | | $ 245,000 |
| *TOTAL LIABILITIES* | | **$ 328,000** |
| **OWNER'S EQUITY:** | | $ 379,000 |
| *TOTAL LIABILITIES AND EQUITY* | | **$ 707,000** ❽ |

The balance sheet presents the total of what the business owns and who has a claim to those resources

**ITEM 3—Depreciation.** This has already been discussed as a means of spreading the cost of long-term assets over time. How much cost has been expensed in the past is the function of the accumulated depreciation amount listed on the balance sheet. In the example, accumulated depreciation is recorded as $105,000. Therefore, out of the total cost of buildings and equipment of $425,000, there remains $320,000 of depreciation expense. (Note: Land is not depreciated, because the useful life of the land is unlimited.)

**ITEM 4—Intangible Assets.** Intangible assets have no physical presence. You can touch the piece of paper that legally represents a patent, but you can't touch the patent itself, because it is merely a legal concept. The most common intangible assets are patents, copyrights, franchises, trademarks, organization costs, and goodwill (see item 5).

Intangible assets are recorded at historical cost

How important is the "swoosh" logo to Nike, or the Golden Arches to McDonald's? Very important indeed! And yet these assets might not be large amounts in the financial statements. Intangible assets are recorded at historical cost. The only cost to Nike of the "swoosh" was a fee to the firm that designed it. Furthermore, intangible asset costs are expensed in a manner similar to depreciation, called **amortization**. The amount on the balance sheet is the original cost, less accumulated amortization. It may not be a very big number, but it can represent something very important to the company.

This creates problems for small businesses trying to obtain financing. What if the most valuable asset the business owns is a patent? The patent appears on the balance sheet as the cost of obtaining it (e.g., attorney and filing fees). However, research and development costs are not included. Thus, your most valuable asset appears on your balance sheet at a fraction of its worth to the business.

**ITEM 5—Goodwill.** This is another intangible asset. Suppose you buy a company with a reputation for great customer service. Chances are, you'll pay more because of that reputation. The excess payment represents an estimated dollar value for goodwill.

**ITEM 6—Current Liabilities.** These are debts to be paid within the next year.

**ITEM 7—Long-term Liabilities.** These are debts due more than one year from the balance sheet date. They often include notes payable to the bank and investors.

**ITEM 8—Owner's Equity**. For a sole proprietorship, the owner's share of the business is listed as one amount, usually called **capital**. A partnership follows the same format, except that a capital amount is listed for each partner.

The owner's equity for a corporation is divided. The amount invested by the stockholders is **capital stock**. Profits owed to the owners are **retained earnings**.

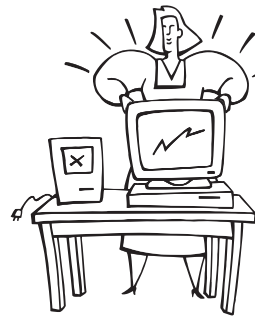
*After their first year of operation, Louisa and Anne realized they'd underestimated the amount of money they needed to operate their business. For one thing, the cost of upgrading their facility and maintaining the old equipment was considerably more than they had expected.*

*Anne sat down and calculated that if the Louisa's Jams invested in new, more efficient bottling equipment, it would save on the cost of continually repairing the old, run-down equipment (that she thought had been such a bargain) and would ultimately result in a larger and more reliable production capacity.*

*The cost of the new equipment was over $50,000. That meant that it was time for Louisa's Jams to look for external financing. But first, they needed to clean up their financial statements, fine-tune their business plan, and create what Anne called "a financing proposal the bank can't refuse!"*

## Statement of Owner's Equity

The **statement of owner's equity** can be viewed as a bridge between the income statement and the balance sheet. The income statement details the income-producing activities of the business over a specified time period, and delineates net income.



Since net income is for the benefit of the owners, the statement of owner's equity adds it to the amount already owed to the owners. The adjusted owner's equity amount is then listed on the balance sheet.

The format differs somewhat depending on ownership structure. For sole proprietorships, the statement will appear as below.

The Sole Proprietorship
Statement of Owner's Equity
For the Year Ended December 31, 2009

| | |
|---|---|
| Beginning capital | $70,000 |
| New investment by owner | 10,000 |
| Net income | 50,000 |
| Withdrawals | (40,000) |
| Ending capital | **$90,000** |

Partnerships use the same format, but with a capital account listed separately for each partner. A corporation should use the format below:

The Company, Inc.
Statement of Retained Earnings
For the Year Ended December 31, 2009

| | |
|---|---|
| Beginning retained earnings | $100,000 |
| Net income | 250,000 |
| Less: dividends | (150,000) |
| Ending retained earnings | **$200,000** |

## Statement of Cash Flows

When businesses use the accrual method of accounting, they gain very useful information about their past, present, and future finances. As noted, the accounting profession prefers the accrual method. However, it's nice to have a simpler explanation of how the business acquired and spent cash.

The statement of cash flows presents the amounts, sources, and uses of cash inflows and outflows

This is the purpose of the **statement of cash flows**: it presents the amounts, sources, and uses of cash inflows and outflows. No new data are required to create this statement; the information comes from the other financial statements.

This may sound straightforward, but preparing a statement of cash flows is often a very difficult task, because amounts recorded using the accrual method must be converted to what they would have been if the cash method had been used. Most small businesses have their accountants prepare this statement.

Your Business
Statement of Cash Flows
For the Year Ended December 31, 2009

| | | |
|---|---|---|
| Cash flows from operations: ❶ | | |
| Net income | $90,000 | |
| Depreciation expense | 50,000 | |
| Increase in accounts receivable | ( 80,000) | |
| Increase in inventory | ( 40,000) | |
| Decrease in accounts payable | ( 10,000) | |
| Cash provided by operations | $ 10,000 | |
| Cash flows from investing activities: ❷ | | |
| Purchase of new equipment | $ ( 55,000) | |
| Sale of old equipment | 40,000 | |
| Cash used for investing activities | $( 15,000) | |
| Cash flows from financing activities: ❸ | | |
| Proceeds from new borrowings | $ 135,000 | |
| Principal payments on borrowings | ( 85,000) | |
| Payment of dividends | ( 30,000) | |
| Cash provided by financing activities | $ 20,000 | |
| Net increase in cash | $ 15,000 | ❹ |
| Cash balance 12/31/08 | 20,000 | |
| Cash balance 12/31/09 | **$ 35,000** | |

**ITEM 1—Cash Flows from Operations.** The statement of cash flows is divided into three categories. The first category details cash inflows and outflows from operations.

There are two ways to present this information; we have shown the indirect method above. Your accountant may choose to use the direct method, but the result is the same either way: it shows what net income would have been under the cash basis of accounting.

The indirect method can be very helpful in understanding the difference between net income and cash flow. Ever thought, "I have a large net income but no cash! How can that be?"

Let's review the example: The business had $90,000 of net income. (This number is taken directly from the bottom of the income statement.) We must adjust this amount so that it accurately reflects the amount of cash held by the business today.

First, net income includes depreciation expense, which is a process of cost allocation and has nothing to do with cash. (The cash was spent years ago, when the business bought the equipment.) Since depreciation does not cause additional cash to be spent, we can add it back to net income.

Next, we'll look at three crucial operating accounts.

- Accounts receivable from customers have increased over last year's level, meaning that many of our sales have not yet materialized into cash.
- Inventory is higher than it was the previous year, so we must have used some of our cash to build up our inventory.
- Accounts payable have decreased, so we must have used cash to pay off more debts than normal.

The statement of cash flows has helped us see that we have lots of net income, but not much cash on hand, thanks to slow collections, increased inventory, and fewer outstanding bills.

**ITEM 2—Cash Flows from Investing.** For small businesses, these inflows and outflows relate primarily to buying and selling property and equipment.

**ITEM 3—Cash Flows from Financing.** The final section lists cash flows from financing activities, including borrowing, paying off debts, issuing stock, and paying dividends.

**ITEM 4—Net Increase in Cash.** The statement concludes with the net change to cash during the year, which should equal the difference between the cash balance at the beginning and end of the period.

*Louisa was new to the process of gathering the sort of data needed to update financial statements. When she operated her travel agency, she'd left all the number crunching to her accountant.*

*But now, working with her daughter, she was fascinated. She was curious to find the answers to some nagging questions, like:*

- *Which jams were most profitable? And what type of products would be most profitable to offer in the future?*
- *How much debt could her business afford to carry?*
- *How attractive was her business to prospective investors?*
- *Had the business broken even yet?*
- *Was Anne doing a good job of managing cash?*
- *What portion of the earnings came from renting out excess kitchen capacity?*

*Updating the business's financial statements gave her the answers to these questions. It was also a powerful reminder of why Louisa's Jams was profitable, and helped prepare the business to seek additional capital.*

## Financial Statement Analysis

It doesn't do any good to get information if you don't use it!

It doesn't do any good to get information if you don't use it! In this section, we'll discuss how to use financial statements to:

- **Forecast trends.** Financial statements are historical documents, and historical data can be used to identify and predict trends.
- **Make comparisons.** To put your business in the proper perspective, you need to compare your information with that of other businesses, with your industry as a whole, with previous years, and with your expectations.
- **Answer questions.** If net income is low this year, why is it low? If the answer is, "Because sales have dropped," why have they dropped? Don't fall into the trap of concentrating on effects. Keep digging until you find causes!
- **Present your story.** Discuss your analysis with your banker and CPA. Not only can they offer advice, but they'll be impressed with your efforts.

Financial analysis is very useful, but it does have limitations. First, if you compare your financial results to those of other businesses, remember that using different accounting methods can cause results to vary. Don't waste time comparing apples and oranges. Second, comparing your business to one many times its size might not be relevant.

It isn't easy to get financial information about other small businesses. Some trade associations publish averages and make them available to members. There are also general sources, which you can find in your public library, or obtain from your banker or CPA. The most well-known publications include:

- *Annual Statement Studies*, published by Robert Morris Associates
- *Key Business Ratios*, published by Dun & Bradstreet
- *Almanac of Business and Industrial Financial Ratios*, published by Prentice-Hall

If you decide to compare your business with published industry data, keep in mind that these are averages from which there can be wide deviation.

Now, let's look at four types of analysis: vertical analysis, horizontal analysis, ratio analysis, and cost-volume-profit analysis.

If you decide to compare your business with published industry data, keep in mind that these are averages

### Vertical Analysis

In this method, each item in the financial statement is expressed as a percentage of a selected base amount. Net sales are used as the base amount on the income statement, and total assets are used on the balance sheet. Consider this example:

| **Your Business<br>Income Statement<br>For the Year 2009** | | |
|---|---|---|
| Net Sales | $350,000 | 100% |
| Cost of Goods Sold | ($130,000) | 52% |
| Gross Profit | 120,000 | 48% |
| Operating Expenses | 100,000 | 40% |
| **Net Income** | **$20,000** | **8%** |

| **Your Business<br>Balance Sheet<br>12/31/09** | | |
|---|---|---|
| **Assets** | | |
| Current Assets | $400,000 | 100% |
| Property, Plant & Equipment | 260,000 | 65% |
| Intangible Assets | 40,000 | 10% |
| | | |
| **Liabilities** | $260,000 | 65% |
| Current Liabilities | 80,000 | 20% |
| Long-term Liabilities | $180,000 | 45% |
| | | |
| **Owner's Equity** | $140,000 | 35% |
| Total Liabilities and Equity | $400,000 | 100% |

The percentages show the relative size of each component. You can then view these percentages in relation to previous years. If operating expenses for our sample business are typically 31 percent of net sales, then you know that some investigation of expenses is warranted. If current assets are usually 35 percent of total assets, what has changed?

Vertical analysis is helpful when comparing your business to a business of a different size, or to industry averages

Vertical analysis is also helpful when comparing your business to a business of a different size, or to industry averages. Instead of comparing the numbers, compare the relationship of the numbers. Is your gross profit of 48 percent average for your industry? How do long-term liabilities comprising 45 percent of total assets compare to your competitors?

### Horizontal Analysis

Horizontal analysis uses percentages over time, rather than down the financial statement. Choose a base year, and express amounts for all other years as percentages of the base amount. Suppose we choose 2006 as the base year. Consider the following sales figures:

| Year | 2009 | 2008 | 2007 | 2006 |
|---|---|---|---|---|
| Sales | $186,000<br>155% | $180,000<br>150% | $126,000<br>105% | $120,000<br>100% |

As you can see, sales tended to increase by five percentage points per year, except in 2008. Investigating the reason for the large jump in 2008 might give you information that will help you plan current marketing strategies, or you could follow the historical trend and budget 2010 sales at 160 percent of the base, or $192,000.

*Anne decided to do a cost/volume analysis to answer her mother's questions about how the business was generating its profits, and how close she was to recouping her initial investment.*

*Louisa's fixed and variable costs included the following items:*

| *Fixed costs* | *Variable costs* |
|---|---|
| *Lease payments* | *Hourly wages* |
| *Salaries* | *Jars, labels, lids* |
| *Equipment maintenance / depreciation* | *Berries* |
| *Insurance* | *Sugar* |
| *Marketing and advertising* | *Pectin* |

*Anne calculated that for every $4 jar of jam they sold, variable costs were $0.55 and fixed costs were $1.45. This meant that each jar generated $2 of profit. If the business continued at its current sales levels, it would repay its initial investment by the end of the year. Louisa was very happy to hear this.*

*By looking at the balance sheet, Anne calculated that the business's debt/equity ratio was a healthy 25 percent. This meant that for every dollar asset held by the business, only $0.25 was* *borrowed! Many businesses would feel that this was too little debt, and that by borrowing more money to grow operations, the business could generate a better return.*

*Anne and Louisa felt that the business could afford to carry more debt, and that the new bottling equipment would help to meet and increase market demand, which would make the business stronger and more profitable.*

## Ratio Analysis

A **ratio** is the comparison of one amount to another. Standard ratios can be grouped into three categories: liquidity ratios, capital structure ratios, and profitability ratios. We'll deal with each of them in turn.

### *Liquidity ratios*

Liquidity ratios are a measure of a business's short-term ability to pay current (and unexpected) debts. Bankers analyze these ratios before approving short-term business loans.

Liquidity ratios are a measure of a business's short-term ability to pay current (and unexpected) debts

$$\textbf{Working capital} = \textit{Current assets} - \textit{current liabilities}$$

$$\textbf{Current ratio} = \frac{\textit{Current assets}}{\textit{Current liabilities}}$$

$$\textbf{Quick ratio} = \frac{\textit{Cash + Marketable securities + Receivables}}{\textit{Current liabilities}}$$

Working capital is the money you need to pay your bills until inventory is sold and receivables are collected. The current ratio is another expression of working capital, but because it is expressed as a ratio, it represents the relationship of current assets to current liabilities, rather than an absolute amount. After all, working capital of $40,000 may be plenty for one business, and very low for another.

Since needs differ from business to business, there are no established minimums or maximums for the current ratio. However, there may be a rule of thumb for your industry. For each business, there is a level at which the ratio is too low and there is a serious risk that current debts cannot be paid. If it's too high, it may mean that the business is keeping too much excess cash, not collecting receivables, or storing too much inventory.

The quick ratio is a refinement of the current ratio. It removes inventory from the calculation because inventory is the least liquid of the current assets.

$$\textbf{Gross profit} = \frac{\textit{Net income}}{\textit{Net sales}}$$

**Inventory turnover** = $\frac{\textit{Cost of goods sold}}{\textit{Average inventory}}$

**Receivables turnover** = $\frac{\textit{Net credit sales}}{\textit{Average net receivables}}$

Earlier, we defined gross profit as net sales minus cost of goods sold. Here, we express gross profit as a percentage of net sales. This percentage is very important for making marketing decisions, determining cash needs, and assessing profitability.

High-volume discount stores like Wal-Mart keep their gross profit percentages down and try to make up the revenue by increasing their sales volume. This strategy seldom works for small businesses, so it's important to keep an eye on this ratio. If your gross profit percentage declines, it means either that sale prices are dropping, cost of goods is increasing, or the mix of what you are selling has changed.

The inventory turnover ratio shows the average number of times inventory is sold during the year. A grocery store would have a much higher ratio than a manufacturer of hand-crafted boats, because people buy groceries more often than they buy boats. Many small businesses get into trouble when their inventory sits and sits; a decreasing inventory turnover ratio will alert you to this problem. If inventory is turning over rapidly, it may mean that customer demand is barely being met, and it's time to expand the business.

Your credit policies affect your **receivables turnover ratio**. Granting credit to slow-paying customers makes the ratio decline. This might explain why your business is always short of cash. A high ratio may mean your credit terms are too rigid.

*Capital structure ratios*

Capital structure ratios measure the percentage of assets funded by borrowing

If you consult published industry sources, you'll find several ratios that measure capital structure. Here are the most common:

**Debt to total assets** = $\frac{\textit{Total debt}}{\textit{Total assets}}$

**Debt to equity** = $\frac{\textit{Total debt}}{\textit{Total equity}}$

These ratios measure the percentage of assets funded by borrowing. The remaining amount represents funding by the owners. For example, if your business's debt to total assets ratio is 65 percent, it follows that 35 percent of the total assets were purchased with your money. These ratios determine the relative riskiness of your capital structure. Carrying large amounts of debt increases the risk of insolvency (inability to meet long-term financial obligations), and necessitates current payments for interest and principal.

A debt to equity ratio of ten to one indicates greater risk than a ratio of three to one. Too little debt may indicate a conservative business that is missing golden opportunities.

***Profitability ratios***

These ratios relate earnings to available resources. You might think of these as answering the question, "How well did I do, given what I had to work with?"

Profitability ratios relate earnings to available resources

**Return on sales** = $\dfrac{\textit{Net income}}{\textit{Net sales}}$

**Return on assets** = $\dfrac{\textit{Net income}}{\textit{Total assets}}$

**Earnings per share** = $\dfrac{\textit{Net income}}{\textit{Average \# of common shares outstanding}}$

Earnings per share applies only to corporations, and must be reported on the income statement. This ratio helps an individual shareholder understand what the corporate net income means; it does not mean that a dividend will be paid immediately in this amount. For some businesses, return on equity is a more appropriate ratio.

*As Anne and Louisa updated the business's statement of cash flows for the past year's operations, they found the following:*

- *25 percent of the business's revenue came from leasing out its excess capacity.*
- *For any given month, the business had an average cash balance of $50,000. This was more than it needed on hand.*
- *The business earned 75 percent of its operating revenues in September and October, when its largest customers paid for orders.*

*Anne and Louisa concluded that they should buy the new equipment in November, when the business had its largest cash reserves. They also lowered their target amount of money to borrow, deciding that they could afford to reinvest a larger portion of profits in the business. In essence, they had underestimated the business's ability to pay for its own expansion.*

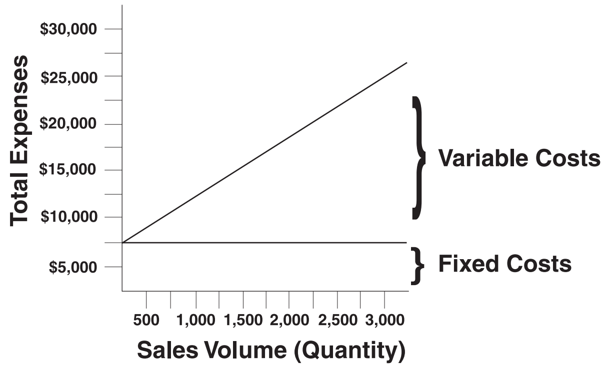
*They also realized that they were earning a lot of cash from their sublease. If they could more aggressively manage that area of the business, they calculated they could increase overall revenues by 10 percent. In the future, Louisa's Jams would lease out excess warehouse space and bottling capacity. They also considered offering their tenants a fuller service facility, including commercial food production planning and budgeting assistance.*

Cost-Volume-Profit Analysis shows how expenses change when sales volume changes

### Cost-Volume-Profit Analysis

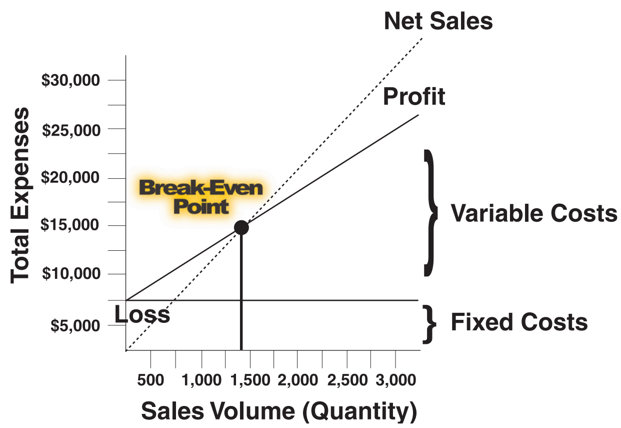
This is a very useful tool for entrepreneurs who want to see how expenses change when sales volume changes.

To perform this analysis, divide expenses into **variable costs** (which change with sales volume), and **fixed costs** (which stay the same despite changes in sales volume).




Most small businesses' expenses are fixed, with the exception of cost of goods sold. Suppose a retail shoe store is open 60 hours per week, and its owners have determined that one worker is needed during every operating hour. The cost of paying for 60 hours of work is fixed, no matter which employee receives the pay. The monthly rent is also fixed. Other major expenses, such as utilities and advertising, might change from month to month, but probably don't vary much if the owners are working within a budget. Thus, the only variable expense is the cost of the shoes that are sold.

Now, if we add to our graph a line depicting total sales, we can see the break-even point: the point at which total sales dollars and total expenses are equal.




We can calculate the break-even point using the following formula:

**Break-even point** = *Total fixed expenses* / *Contribution margin per unit*

The contribution margin is the sales price per unit minus the variable expenses per unit.

The contribution margin is the sales price per unit minus the variable expenses per unit

**Contribution margin** = *Sales price per unit – Variable expense per unit*

It is the portion of the total sales price per unit that goes towards paying off fixed costs. We can adjust the formula to add a desired net income.

$$\textbf{Break-even point} = \frac{\textit{Total fixed expenses + Desired net income}}{\textit{Contribution margin per unit}}$$

Assume the following for the shoe store:

| | | |
|---|---|---|
| Average sales price per unit | \$ 30 | |
| Variable cost per unit | \$ 10 | |
| Total fixed costs per month | \$ 3,000 | |
| Contribution margin | \$ 20 | (\$30-\$10) |

The break-even point for the store is 150 units, calculated as follows:

$$\frac{\textit{Total fixed expenses}}{\textit{Contribution margin}} = \frac{\$3{,}000}{\$20} = 150 \text{ units}$$

If the owners hope to make \$2,000 net income per month, they must sell 250 pairs of shoes.

$$\frac{\textit{Total fixed expenses + Net income}}{\textit{Contribution margin}} = \frac{\$3{,}000 + \$2{,}000}{\$20} = 250 \text{ units}$$

Now let's change things around and see what happens. What if total fixed expenses increase by 20 percent? In that case, 280 pairs of shoes must be sold to maintain the desired \$2,000 in net income.

$$\frac{\textit{Total fixed expenses + Net income}}{\textit{Contribution margin}} = \frac{\$3{,}600 + \$2{,}000}{\$20} = 280 \text{ units}$$

What if the cost of shoes goes up, or we have to lower our sales price, so that the contribution margin decreases \$4 per unit? Now, we must sell about 313 pairs to meet our goal.

$$\frac{\textit{Total fixed expenses + Net income}}{\textit{Contribution margin}} = \frac{\$3{,}000 + \$2{,}000}{\$16} = 312.5 \text{ units}$$

However, note that most businesses sell a wide variety of products, so using an average contribution margin per unit won't help you calculate needed volumes by product. Also, identifying which costs are variable and which are fixed is not always easy.

The use of ratio analysis is critical for managing a successful business

The use of ratio analysis is critical for managing a successful business. Each of these ratios provides you with a window into the inner workings of your company; learn to use them to your advantage. There is a further discussion of ratios in Chapter 44 *Financial Management*.

## NxLEVEL® TECH TIP

BUSINESS RESOURCES AND THE WEB

Here are some sites that can help you find answers to your accounting and tax questions.

- **Premier Payroll Tax Research Library** (www.payroll-taxes.com) compiles links to direct sources for help with labor, unemployment and other tax laws. The site includes the PayrollTalk.com Forum, which "has thousands of contributing members, sharing thoughts on payroll issues, laws and experiences."
- **Small Business and Self-Employed Tax Center** (www.irs.gov/businesses/small). This is the IRS's portal site for small businesses. It includes online learning tools and downloadable forms.
- **SCORE Tools and Templates** (www.score.org/template_gallery.html) offers downloadable templates for break-even analysis, cash flow statements, sales forecasts, and so forth.

*Louisa's Jams presented a financing proposal to four local banks. It stated that the company wanted to borrow $30,000 to pay for new bottling equipment, and that based on its projected sales (growing at 20 percent a year), it could repay the principal with interest in five years.*

*The business was approved for a $30,000 loan one month later. The time Louisa and Anne had put into planning their business and creating and using their financial statements paid off! They had a firm grasp on their business's profitability and cash flows, and were excited to be able to bring Louisa's Jams to an ever-growing audience.*

*They were fast becoming the most famous mother/daughter business team on the East Coast!*

### Limitations of Financial Statements

Although financial statements are the accepted means of communicating financial information about a business, there are limits to their usefulness.

- **Historical cost principle.** Accountants chose this method to make accounting information more reliable, but it also can make the information irrelevant. Who cares how much something cost 50 years ago? Isn't it more important to know how much it's worth today? You won't find that amount in the financial statements.
- **Off-statement transactions.** Despite attempts to make financial statements comprehensive, many transactions are not reflected in financial reporting. This can result from the complexity of the transaction, barter transactions that are not recorded in the books, or the correct application of accounting principles that allow certain transactions to be "off-statement."
- **Use of estimates.** Accounting is not always an exact science. Accountants often estimate income taxes due, bad debt losses, and many other figures. (Of course, accountants must always strive for fair reporting of financial information.)
- **Garbage in, garbage out.** Financial statements are compiled from the company's daily records. If the recordkeeping is shoddy, the financial statements will be too.

## Conclusion

Gathering and analyzing financial information is vital to running a healthy business. Successful entrepreneurs depend upon this information to make decisions. In Chapter 36 *Keeping Books and Records*, the accounting process will be discussed in greater detail, as will organization and recordkeeping.

# Chapter 36
# KEEPING BOOKS AND RECORDS

*About This Chapter:*
- *Accounting basics*
- *Types of accounting systems*
- *The modules of an accounting system*
- *Tax considerations*
- *Recordkeeping requirements*
- *Working with bookkeepers and accountants*

## Introduction

Donald Peterson seemed like a nice guy and a good bookkeeper, but he is now serving a 105-month prison sentence for embezzling millions of dollars from small businesses.

At first, he wrote company checks to himself under a different name. Later, he took on a partner and gave him blank documents to create forgeries. If an employer got wise, Peterson moved to another business and assumed a new identity. He hid his thefts by handing his employer false financial statements. Incredibly, he said that few owners asked to see the bank statements, and none looked at the canceled checks.

Unfortunately, stories like this one are very common. In many cases, the business owner could've prevented theft by understanding and monitoring his or her accounting system.

You must understand your accounting system and review its results

You probably didn't start a small business so you could stay up nights keeping books. Although someone has to do it, it doesn't have to be you; there are many good bookkeepers and accountants out there! But as Donald Peterson's story shows, it is very important that you understand your accounting system and carefully review its results.

This chapter is not intended to make you an accounting expert or solve all your accounting problems. The goal is to help you understand what accounting systems do, how they do it, and your role in managing them. The best systems are those developed and operated under the watchful eye of the owner. You needn't do the work yourself, but you must understand the system and be able to interpret the output. The more involved you are, the better your system will function!

## Accounting Basics

Why is accounting so important? First, there are legal requirements for keeping books and records. The government demands that you maintain records to support the amounts entered on your tax return. Second, bankers and lenders require that records be kept. Last, accounting is a means of gathering the information you need to run your business.

### Internal Controls

A good accounting system includes **internal controls**. These are policies and procedures that safeguard business assets, promote the objectives of the business, assure reliability of the financial statements, and facilitate compliance with laws and regulations. Internal controls vary by business, but here are some basics:

- **Authorization.** Make sure that all business transactions are authorized by the appropriate person. You must clearly state to vendors, banks, and other business partners what authority you have delegated, under what circumstances, and to which employee.
- **Segregation of duties.** This is often difficult for small businesses with few employees. However, good control comes from having authorization, recordkeeping, and custody activities performed by different people.
- **Physical controls.** This includes such things as padlocked doors, safes, and identification cards for personnel. Blank checks and other documents should be pre-numbered, and locked away when not in use. Cash should be deposited daily.
- **Tickler systems.** A tickler system helps you keep track of current bills and orders. This can be a red folder for current orders, or a computer program that produces a daily report of due bills.
- **Audit trail.** A trail of evidence links amounts in the books with source documents. We will discuss examples later in the chapter.
- **Monitoring and review.** You should regularly assess whether your internal controls are effective. Are they really being used? If so, do they accomplish everything they're supposed to? A yearly review by a CPA is also a good idea.

You should regularly assess whether your internal controls are effective

*Sally Garcia was a certified aerobics instructor and personal trainer. She worked as an independent contractor at several of Miami's most popular gyms.*

*After getting divorced, she took three months off to travel through Europe with friends. During that time, she thought a lot about what her next step would be. Business had been good, but she had a nagging feeling that she was capable of doing something more interesting and fulfilling, like starting her own gym.*

*Sally had talked with enough clients to know that most of them felt the fitness clubs in her area were too loud and impersonal. They longed for a smaller, more personal club, and told Sally that they would be willing to pay up to 50 percent more in membership fees for such a luxury.*

*By the time she was back in the United States, she'd decided that she was ready for a bigger challenge. She decided to make her move.*

## Accrual vs. Cash Accounting

In the last chapter, we briefly discussed the difference between the cash and accrual methods of accounting. Under the **accrual method**, revenue and expense are reported when the activity occurs, regardless of whether any cash has been exchanged. The **cash method** calls for reporting revenue when cash is received, and expense when cash is paid.

Accountants prefer the accrual method, because it gives more information and is more accurate when matching revenue with expenses. But many small businesses prefer the cash method, because it's so much easier.

It's also common for small businesses to use the cash method for some transactions and the accrual method for others, depending on what type of information the owners need. For example, if you were very concerned about how much your business owes to creditors, you could use the cash method except when it comes to accounts payable.

Some businesses fall under federal income tax rules that require use of the accrual method. Bank loan requirements may also call for the accrual method. If you're not sure whether to use the cash or accrual method, seek professional advice.

## Debits and Credits

Here's the most basic accounting equation: ***Liabilities + Owner's equity = Assets***.

Suppose your assets, liabilities, and owner's equity each have their own sheet of paper. Take each of these pages and draw a vertical line down the middle, dividing it in half.

| Assets | |
|---|---|
| + | - |

| Liabilities | |
|---|---|
| - | + |

| Owner's Equity | |
|---|---|
| - | + |

Now, you can record increases to each account on one half of the paper, and decreases on the other. Notice that the plus and minus are reversed on the two sides of the balance sheet. This way, when you record transactions, your left sides will equal your right sides.

Suppose your business buys a new computer for $2,000 on account. Your assets have increased, so $2,000 goes on the left side of your *Computer* page. Your liabilities have increased because you owe $2,000, so this amount goes on the right side of your *Accounts Payable* page. You have recorded $2,000 on a left side and $2,000 on a right side. After every transaction, you can check to see if your "lefts" equal your "rights." If not, you have made an error.

The debit and credit scheme tells if you have kept your books balanced after each transaction

Instead of talking about lefts and rights, accountants call them **debits** and **credits**. Debit means the left side of the accounting sheet, and credit means the right side.

This system won't protect you against every type of error. If you record a debit to *Computer* for $2,000 and a credit to *Accounts Payable* for $200, the error will show up when you try to balance the books. But if you record a debit to *Computer* for $200 and a credit to *Accounts Payable* for $200, the error will not be caught automatically. The only errors the system reveals are those that leave the books out of balance.

Debits and credits can get very confusing! Fortunately, you can set up a computerized accounting system that will calculate debits and credits automatically.

### Calendar vs. Fiscal Year

You must also select an accounting year for the business. It's most common to use a **calendar year**. An accounting year that ends on a date other that December 31 is usually referred to as a **fiscal year**. Some businesses choose a fiscal year because of business seasonality, or to gain income tax advantages. Discuss this issue with your accountant.

*Sally opened her health club, Lunar Gym, in August of 2008. The business was a logical outgrowth of her passion for fitness.*

*Sally knew nothing about accounting, so she relied on her general manager to take care of all business-related tasks, including keeping the gym's books.*

*She priced her gym memberships 20 percent higher than her competitors. She offered full club memberships, as well as class-only punch cards. When she felt she needed to increase her membership numbers, she would place an ad in the local paper and offer a discounted membership rate. In this way, Sally managed all of the club's marketing efforts.*

*She knew that her management style was casual, at best. But the business seemed to be profitable. The rent was getting paid, her clients seemed happy, and she had the best instructors and the fullest aerobics classes in town.*

*Then, one day in 2009, her bank called to say it would not cover any more bounced checks.*

## Types of Accounting Systems

Your accounting system helps you keep track of financial information. You collect the data, record them, classify and summarize them, and report them in the form of financial statements. You need an organized method of doing this to avoid reporting incorrect or misleading information.

### The Paperwork

Backing up your accounting data is essential

The chart on the following pages lists some of the most common accounting forms. You may not need all of these forms for your business, or you may need additional paperwork; every recordkeeping system is unique. Some of this information may be in digital form, but the same rules apply. And of course, backing up these data is essential.

| Document | Use | Information Included |
|---|---|---|
| **Invoice** | Seller's request for payment | Seller's name and address<br>Invoice date<br>Buyer's name and address<br>Description/qty of goods sold<br>Dollar amount per item and in total<br>Credit terms<br>Method of shipment<br>Payment due date |
| **Purchase Order** | Buyer's request for goods | Buyer's name and address<br>Date<br>Seller's name and address<br>Description/qty of goods desired<br>Expected price of goods<br>Special shipping instructions |
| **Receiving Report** | Indicates goods have been received | Date<br>Description/qty of goods received<br>Seller's name and address<br>Condition of goods received<br>Name of person who received goods |
| **Checks** | Authorize payment out of a bank account<br><br>Serve as evidence that a bill has been paid | Date<br>Check number<br>Business name and address<br>Payee's name<br>Dollar amount<br>Description of check purpose<br>Authorized signature |
| **Cash Register Tape** | Gives daily sales totals | Date<br>Description of item sold<br>Per-unit price of items sold<br>Total sales amount<br>Method of amount of payment<br>Change required |
| **Time Cards or Tickets** | Determine wages owed to employees | Employee name<br>Time period<br>Pay rate<br>Hours worked, by day<br>Total hours worked<br>Supervisor approval |
| **Payroll Authorizations** | Document employee status and pay information | Employee name and address<br>Date of hire<br>Pay rate<br>Job title<br>Authorized work hours<br>Benefits information<br>Method of payment<br>Who hired the employee |

## Journals and Ledgers

The debit and credit scheme tells if you have kept your books balanced after each transaction. If you wish to use this method, you need a place to record debits and credits, and summarize them for the year.

Business transactions are very repetitive. Sales happen daily, bills get paid every month, payroll is weekly or bi-weekly. This repetition means that the bookkeeper must enter the same debits and credits over and over. You can make the process simpler by having a special journal for each type of transaction. Here are the most common:

| Journal Name | Purpose |
|---|---|
| Sales Journal | Record all sales on account |
| Purchases Journal | Record all purchases of merchandise on account |
| Cash Receipts Journal | Record all cash received |
| Cash Disbursements Journal | Record all cash paid out |

All systems, manual or computerized, use **journals** and **ledgers**. Generally, the journal is used to accumulate transactions. A ledger keeps track of each account. Sales, cash disbursements, and other transactions are recorded daily in the journals. Each month, the journals are totaled and posted in the ledger.

You will also need a **General Journal** for recording transactions that don't belong in one of the special journals.

Here are examples of these special journals. You can customize them to fit your needs.

| **Sales Journal** | | | p2 |
|---|---|---|---|
| **Date** | **Customer** | **Invoice No.** | **Amount** |
| 1/11/09 | Jayco, Inc. | 05-35 | $1,200 |
| 1/12/09 | Davis Glass | 05-36 | 2,800 |

The **Sales Journal** lists all sales on account. Cash sales are listed in the **Cash Receipts Journal**. Notice the trail that is created when you put the invoice number in the **Sales Journal**. If you wish to find out more information about that sale, you know which invoice to examine.

| **Purchases Journal** | | | | | p5 |
|---|---|---|---|---|---|
| **Date** | **Supplier Name** | **Invoice No.** | **Accounts Payable** | **Purchases** | **Supplies** |
| 1/9/09 | Ajax Corp. | A10345 | 725 | 725 | |
| 1/9/09 | OfficePlace | 237 | 122 | | 122 |

The **Purchases Journal** records purchases of inventory and supplies on account. Cash purchases are recorded in the **Cash Disbursements Journal**. Some businesses record inventory purchases in the Inventory account rather than the Purchases account.

| Cash Receipts Journal | | | | | | p2 |
|---|---|---|---|---|---|---|
| Date | Cash | Sales | Accounts Receivable | Customer | Other | Description |
| 1/4/09 | 1,100 | | 1,100 | Ajax Company | | |
| 1/5/09 | 125 | 125 | | | | |
| 1/16/09 | 55 | | | | 55 | Cash Rebate |

Cash receipts are recorded in the **Cash Receipts Journal**. You can set up columns to represent the typical sources of cash for your business. Our example includes a column for cash sales, receipts from credit customers, and a catch-all for miscellaneous receipts.

| Cash Disbursements Journal | | | | | | p3 |
|---|---|---|---|---|---|---|
| Date | Check No. | Cash | Accounts Payable | Customer | Other | Description |
| 1/7/09 | 101 | 437 | 437 | Baker Supply | | |
| 1/8/09 | 102 | 500 | | | 500 | Rent Expense |

The Cash Disbursements Journal is similar to a check register, but provides more detail. Again, you can include a column for any frequently used account.

The Cash Disbursements Journal is similar to a check register, but provides more detail

| Cash Disbursements Journal | | | | p21 |
|---|---|---|---|---|
| Date | Account Description | Ref. | Debit | Credit |
| 1/7/09 | Equipment | 120 | 3,000 | |
| | Notes Payable | 214 | | 3,000 |

The General Journal is used to record debits and credits for transactions that don't belong in one of the special journals. These transactions are entered in the order in which they occur. Many small businesses leave this task to their outside accountants.

The journals tell the bookkeeper what to do to the accounts. Recall that each account is like a piece of paper divided in half vertically. If all these accounts are put together in one book, it is called the **General Ledger**. The account for Cash might look like this:

| Cash | | | | | Account No. 101 |
|---|---|---|---|---|---|
| Date | Ref. | Debit | Date | Ref. | Credit |
| 1/4/05 | CR2 | 1,100 | 1/7/05 | CD7 | 437 |

Notice the account number 101, and the account title of Cash. As directed by entries in the Cash Receipts and Cash Disbursements Journals, $1,100 is added to the debit (left) side and $437 to the credit (right) side of the Cash account. The "CR2" reference shows the source of this debit, and refers us to page 2 of the Cash Receipts Journal.

Does it seem like the same number has been written in two places? It has! Again, this creates a useful paper trail. Although the journals and the General Ledger contain the same numbers, they are organized differently, allowing us to find information readily. If you wish to see how a particular transaction was recorded, you should consult the journal and find the transaction by date. To see what happened to a single account during the period, you turn to that account page in the General Ledger.

*Lunar Gym had a big problem.*

*Sally realized that her general manager spent most of her time managing the front desk. She was unqualified to be keeping books, and had little interest in the financial operations of the business.*

*After digging around a bit, and questioning her manager, Sally found that the manager had been keeping only the most basic of records, and that the club had been bouncing checks regularly for the past six months!*

*She looked back over her last year of operation and wondered if she was actually making any money. If so, where was it? Could she afford the upgrades to the club's facilities she'd been planning? Would she be able to get financing, or was her credit ruined?*

*Clearly, she needed to sort things out and take a good hard look at her business's finances.*

### Computerized Accounting Systems

In their simplest form, computerized accounting systems do the mechanical tasks of adding and subtracting, while the bookkeeper does most of the brainwork. More complex systems are capable of providing management with information that would be much too difficult to accumulate by hand. Most businesses need something in between.

Most accounting software belongs to one of the following groups.

The more complex your business, the more difficult it may be to customize a spreadsheet program

- **Spreadsheets.** These programs are widely available and relatively inexpensive. Popular packages include Microsoft Excel, Abykus, Lotus 1-2-3, and Quattro Pro. Spreadsheet programs are like large worksheets with rows and columns that you can set up to look just like the journals and ledger accounts described above. The more complex your business, the more difficult it may be to customize a spreadsheet program. However, many small businesses choose to use spreadsheet programs because their accounting needs are not extensive and the programs are affordable.

- **Point-of-sale terminals.** The scanners that grocery and department stores use at checkout are sophisticated computerized accounting systems. Data about merchandise are programmed into the computer, and every transaction automatically updates inventory records. This tells management what is moving fast or slow, and what needs to be ordered. The program also automatically updates the accounting system by recording sales and cash received. These systems are expensive, but they can save money by helping to eliminate errors at the checkout stand.
- **General packages.** Several companies sell computerized accounting packages that can be adapted to most businesses. Prices vary greatly with the sophistication of the system. Leading sellers are Quicken, QuickBooks, and Peachtree.
- **Web-based accounting.** Many companies offer access to high-powered accounting software for a monthly fee. This can greatly reduce upfront and administrative costs, and give smaller companies access to the same accounting capabilities enjoyed by much larger competitors. Online accounting programs also give you and your employees instant access whenever and wherever you need it. Popular subscription-based options include QuickBooks Online and ePeachtree. You may also want to check out freeware programs like NolaPro (www.nolapro.com).
- **Industry-specific.** Many companies and trade associations offer computerized accounting systems designed to fit the needs of businesses in a particular industry. These systems often include project or inventory control modules. There are specialized systems for restaurants, retailers, wholesale nurseries, construction companies, and many other businesses.

Continue recording information manually until you overcome the initial problems with your new system

Which computerized accounting system is right for your business depends on the cost of installing, learning, and maintaining the system. Remember to define "cost" very broadly; take dollars, time, and frustration into account! There are likely to be misunderstandings, incorrect results, and baffling error messages at first. You should continue recording information manually until you overcome the initial problems with your new system.

If you decide to use a computerized accounting system, think about the following points:

- What are the hardware requirements?
- How easily can the system be modified to suit my needs?
- Does this company have support personnel to help me if I have problems?
- What happens if my needs expand? Can I add additional modules to this system?
- How user-friendly is the system?
- What types of training are available?
- Does the system produce the types of reports and documents I want?
- Who will work with this system? Do I need to hire someone?
- Check online for accounting system ratings and customer reviews
- Are other local business owners using this software?

## NxLEVEL® TECH TIP
BUSINESS RESOURCES AND THE WEB

Your accounting data are extremely important to your business, so they need to be backed up carefully and stored somewhere safe. Many businesses use local backups, but what if the same disaster that affects your office affects your backup drive?

Because of these concerns, many Websites offer online storage for your data. These services are generally inexpensive, and it's no exaggeration to say that they can save your business in the event of a catastrophe. Here are a few of the best. Note that most of these firms offer home and business versions; the home versions may not be adequate for your needs.

- **SOS Online Backup** (www.sosonlinebackup.com) will back up your data daily. It also keeps an unlimited version history that lets you roll back to any point in time.
- **Mozy Pro** (mozy.com/pro) is a low-cost service that allows you to manage multiple backup schedules from a single computer. Military-grade data encryption is available to protect your privacy. It can also restore file versions up to 30 days in the past.
- **Intronis** (www.intronis.com) is another highly rated service with military-grade encryption.

Of course, much of your accounting data may be in the form of paper receipts, which must also be backed up. There are several products that can quickly scan receipts for digital access and storage. The NeatCompany (www.neatco.com) is a good place to start.

### Write-It-Once Accounting Systems
Certain manual accounting systems allow you to write one amount on a special carbonized form and update several books at once. For example, before writing a check to a supplier, you would place forms representing the cash and payable accounts under the check. When you write the check, it automatically transfers the amount as a reduction to those accounts, eliminating errors that occur when amounts must be written in more than one place.

### Check Registers
The simplest form of accounting system, which is often sufficient for the needs of a small business, is a check register. These differ from your personal check register in that many columns are provided to record the source of cash receipts, or the reason a check was written. Monthly totals allow you to prepare a simple income statement, but it can be difficult to prepare a balance sheet from this information. You may need some help from your accountant.

*One of the first pieces of equipment Sally had purchased before opening her health club was a computer check-in system called an "Aerobitron." The system had cost her almost $7,000, and was supposed to record members' visits, membership dues and other receivables, accounts payable, and other vital business information.*

*Unfortunately, Lunar Gym's front desk staff had rarely entered information into the system. Most worked at the check-in desk as a result of barter arrangements, and had not been trained on the system. Often, Sally would pass the front desk and realize that the Aerobitron hadn't even been turned on!*

*Had Sally taken the time to be thoroughly trained on the system (or to train her front desk manager), the Aerobitron would have been a valuable tool for Lunar Gym. It had many customizable options, and her monthly service contract included staff training and customer support. She had failed to use either.*

*Sally was realizing she'd made some serious mistakes. How many others would she discover? And how would she know where to look for them? She needed help from an expert.*

## The Modules of an Accounting System

Whether computerized or not, accounting systems are often divided into several modules. By "module," we mean a part of the accounting system that requires special paperwork and accounting tasks. Larger firms might have a whole department for each of these parts. Active smaller businesses may have a different bookkeeper assigned to each module.

### General Ledger

Details from all other account modules are fed into the General Ledger; you might consider it the control module. Every account receives a unique account number, which gets listed in a document called the Chart of Accounts. You can assign these numbers however you like, but accountants use a standard scheme. It is best to use systematic account numbers like this:

Details from all other account modules are fed into the General Ledger

| Type of Account | Begin Account # with: |
|---|---|
| Assets | 1 |
| Liabilities | 2 |
| Owner's Equity | 3 |
| Revenues | 4 |
| Expenses | 5 |

Account numbers can help you create special reports. For example, let's assume Wages Expense has been given the account number 520. By extending the account number to indicate location and department, we can create reports by location or by department. You might record information for Wages Expense in account 520-05-12.

| | |
|---|---|
| 520 | Indicates Wages Expense |
| 05 | This expense is from the Albany store |
| 12 | These wages are for employees in the auto repair department |

### Inventory

Inventory accounting can be very difficult and is beyond the scope of this book. The total amount recorded for inventory is the multiplication of two numbers: the quantity of goods times the cost per unit. Ideally, your inventory is turning over quickly, but this does make the accounting process more difficult. There are several methods used to determine the quantity and the cost of goods sold. This is a good subject to discuss with your accountant.

### Accounts Receivable

Controlling accounts receivable is crucial to maintaining an adequate cash position

One accounting tool that gives valuable information about credit customers is the Accounts Receivable Subsidiary Ledger. Controlling accounts receivable is crucial to maintaining an adequate cash position, and maintaining an adequate cash position is crucial to staying in business.

Remember that each account is like a single sheet of paper on which information from the journal is recorded. The Accounts Receivable account includes debits for all sales made on account, and credits for all payments received. However, it is not separated by customer. That information would be very helpful for identifying slow-paying customers and determining if future credit sales should be made. The Accounts Receivable Subsidiary Ledger keeps the credit sales and payment information by customer.

### Accounts Payable

The Accounts Payable Subsidiary Ledger helps keep track of amounts owed to vendors. The total of all balances in this ledger should equal the balance in the Accounts Payable controlling account in the General Ledger.

### Property, Plant, and Equipment

A thorough list of all long-lived assets is required. These records allow calculation of depreciation expense, and help record subsequent disposal of assets. A subsidiary ledger, tied to the account balances in the General Ledger, is often kept for these assets. The subsidiary ledger should include date purchased, name of supplier, a description of the item, check number, and amount. Separate ledgers are often kept by type of asset (e.g., equipment, vehicles, building, furniture). An item should be removed from the ledger only if it is physically removed from the business (i.e., junked, sold, traded in, or destroyed).

### Payroll

Payroll accounting is complicated by all the federal, state, and local rules you must follow. Trying to find out what information to keep, and how and when to report it, can be a headache. You should consider hiring a bookkeeping service for payroll accounting, even if the rest of your accounting modules are handled internally. Many companies offer these services; you can have them perform all the payroll functions (updating employee records, writing payroll checks, preparing payroll tax reports) or you can do some of the work yourself and let them handle the more complicated tasks.

Accounting for payroll is complicated by federal, state, and local rules

Typically, the components of a payroll system include a Payroll Register, which summarizes the payroll for the period (including employee name, hours worked, pay rate, total gross pay, deductions, and net pay), and an Employee Earnings Record, which keeps the payroll information listed above for each employee. They also collect sales tax from customers and payroll taxes from employees, both of which must be forwarded to the government.

*Sally was very worried. Previously, she had assumed that her financial records, however sparse, were at least accurate. She thought they might come in handy someday when she sought additional financing to improve her facility. She was in the process of realizing (perhaps too late!) that financial records are essential for day-to-day management.*

*What Lunar Gym really needed was someone whose sole responsibility would be to keep the books, manage finances, and safeguard the business's assets. This person would steer Sally's operations by providing professional financial guidance on what she could afford and how she could maximize her financial returns.*

*Her first move was to hire Cindy Evangelista, a CPA and freelance financial planner, to help get the books in order. Cindy happened to be a member of the gym, so Sally negotiated a barter exchange for her time: Cindy would receive a lifetime club membership and would be kept on retainer for a monthly fee of $150.*

*Now, with Cindy's help, she was ready to find out how things really stood with Lunar Gym.*

## Tax Considerations

Businesses pay sales taxes, property taxes, income taxes, payroll taxes, excise taxes, and taxes disguised as licenses and fees. It can be pretty overwhelming to sort through all the tax requirements. It is also far too much information to present in this book, so this is another area where you will need help. However, we can provide some general knowledge about income taxes and payroll taxes.

## Income Taxes

How a business is taxed depends on its form of ownership

How a business is taxed depends upon its form of ownership. As we discussed in Chapter 14 *Legal Structure of the Business*, your business can operate as a sole proprietorship, a partnership, or a corporation. There are also some variations of these forms, such as limited partnerships, S corporations, and Limited Liability Corporations (LLCs). Here's how federal income taxes apply to these organizations:

- **Sole proprietorship.** Business income or loss is included in the personal income tax return of the sole proprietor; the business does not pay income tax. The sole proprietor includes a Schedule C in his or her personal return, which is due April 15. The sole proprietor may also be required to pay quarterly estimated income taxes and self-employment taxes.
- **Partnership.** Business income or loss is included in the income tax returns of each of the partners; the business does not pay income tax. (This applies both to limited or general partnerships.) The partners list partnership income or loss on Schedule E with their personal returns. The partnership must file Form 1065 by April 15. Partners may need to pay quarterly estimated income taxes and self-employment taxes.
- **S corporation.** These work very much like a partnership for income tax purposes. Business income or loss "flows through" to the individual tax returns of the corporate owners. Form 1120S must be filed by March 15 and the owner may be required to make advanced payment.
- **Corporation.** The business's income is taxed. The shareholders do not pay income tax on profits earned by the corporation, but when shareholders receive a dividend from the corporation, they pay personal income tax on that amount. The corporation files Form 1120 and pays its income tax by March 15. Corporations may be required to pay quarterly estimated income taxes.
- **Limited Liability Corporation.** LLCs are not taxed directly, so they enjoy the pass-through tax benefits of partnerships and S corporations.

Fortunately, income taxes are based on the same general accounting concepts used to prepare your financial statements. Unfortunately, some of the specific rules are different, so you cannot simply take your business income statement and forward it to the Internal Revenue Service. The differences between your income statement and your tax return fall into one of three categories:

1. Amounts on your income statement that are not allowed on your tax return.
2. Amounts on your tax return that are not included on your income statement.
3. Amounts included on your income statement and tax return, but in different years.

Very few small businesses prepare their own income tax returns. A discussion of the professionals who can help you with this chore appears later in this chapter.

### Payroll Taxes

Payroll taxes are imposed on the employee and the employer.

| Paid by Employee | Paid by Employer |
|---|---|
| Federal Income Taxes | State and Federal Unemployment |
| State Income Taxes | Social Security (FICA) |
| Social Security (FICA) | |

Many states impose accident insurance or workers' compensation taxes on the employer. There may also be county or city taxes, as well as taxes supporting public transportation, emergency response, water treatment, education, and other public necessities.

Our income tax and social security systems are on a "pay as you go" basis. Companies and individuals do not wait until income-tax returns are due to send in the tax owed. Instead, the government collects the money throughout the year.

For employees, this is done by employers. The employer must withhold the taxes from the employee's paycheck and forward the amount to the government. This duty must be taken very seriously, as the government will prosecute violators. Do not consider money withheld from employees as available to meet other business debts. Penalties for failure to make timely tax payments are high!

Do not use money withheld from employee paychecks to meet other business debts!

The employer has several forms to prepare in regard to payroll:

| Form # | Name | Description |
|---|---|---|
| 941 | Employer's Quarterly Federal Tax Return | Reports federal income and Social Security taxes withheld from employees, and Social Security taxes imposed on the employer. **These forms are due after the end of the quarter.** |
| 940 | Employer's Annual Federal Unemployment Tax Return | Used to report federal unemployment tax for the year. |
| 8109 | Federal Tax Deposit Coupons | Used to make deposits of withheld income and both employee and employer shares of Social Security taxes. May also include deposits for federal unemployment insurance. |
| W-2 | Wage and Tax Statement | Given to each employee to detail earnings and amounts withheld. **These must be sent to employees no later than January 31st. A copy is also forwarded to the government.** |
| 1099 | Wage Statement | Given to contract employees |

State and local governments may require additional forms.

The timing of deposits for payroll taxes is based on the amount due. Requirements are subject to change, so get the current information from the IRS or your accountant.

**An Accounting Checklist**

The following schedule of accounting chores is adapted from a very helpful checklist published by the Small Business Administration.

*Things to monitor daily:*

1. Cash on hand
2. Your bank balance
3. Sales and cash receipts
4. Errors or problems that occurred in collection
5. All monies paid by cash and check

*Things to monitor weekly:*

1. Accounts receivable (especially slow-paying accounts)
2. Accounts payable (including early-payment discounts)
3. Payroll
4. Taxes and reports due to government agencies

*Things to monitor monthly:*

1. All journal entries are classified by type and posted to the General Ledger
2. Make sure that income statements are available within 15 days of the end of the month
3. Make sure a balance sheet indicates the balance of business assets and the total current liability
4. Make sure your bank account is reconciled
5. Make sure your petty cash account is balanced
6. Review federal tax requirements and make necessary payments
7. Review accounts receivable, and deal with slow and bad accounts
8. Manage inventory to check on dead stock and order new stock

## Recordkeeping Requirements

Records are very important for documenting the financial history of a business when it is being sold

What records you keep, and how long you do so, depends on your motives. Generally, we keep records either to meet laws and regulations, or so we have data to review when trying to make business decisions. You will need some past records during your business-planning process and when you analyze trends. The records are also very important for documenting the financial history of a business when it is being sold. Income-tax regulations require that records be kept during the three-year period that your tax return is subject to IRS audit. Sometimes, records from seven years past may also be needed.

There isn't a standard list of records and retention times that everyone follows, but here is one idea. Your accountant can help you modify this list to fit your needs.

| Type of Record | Retention Period |
|---|---|
| Bank Statements | 7 years |
| Business Licenses | Until Expired |
| Cash Register Tapes | 3 years |
| Check Registers | Keep Permanently |
| Canceled Checks | 3 years |
| Financial Statements | Keep Permanently |
| General Ledger | Keep Permanently |
| General Journal | Keep Permanently |
| Inventory Records | 7 years |
| Invoices (Accounts Payable, A/P) | 3 years |
| Invoices (Accounts Receivable, A/R) | 3 years |
| Property, Plant & Equipment Records | Keep Permanently |
| Purchase Orders | 3 years |
| Receiving Reports | 3 years |
| Tax Returns | Keep Permanently |
| Time Cards or Tickets | 3 years |
| Travel Expense Records | 7 years |

*The next day was not a good one for Sally. She and Cindy met early in the morning to review Lunar Gym's records. She was relieved that she would soon get to the bottom of her difficulties. She had confidence in Cindy, whom she knew was bright and honest. But Sally was afraid of the other problems waiting for her. How bad was the situation?*

*It was very bad. Sally's front desk manager had been throwing away bills, incorrectly recording expenses and revenues, and failing to collect membership dues. They pored through all the files and receipts they could find. Most were crammed into two large folders in the bottom of the front desk. How could Sally have been oblivious to such a disaster happening right under her nose?*

*One of their most disturbing discoveries was that Lunar Gym had more than $10,000 in outstanding accounts payable. For each day she didn't pay, she was accumulating late fees. Her desk manager had prepared an accounts payable ledger, but most of the bills were not recorded in it. Sally dug a little deeper and found a pouch full of checks for membership dues that had never been deposited. No wonder she was bouncing checks!*

*Sally felt completely responsible for not having taken a larger role in the day-to-day operations of her business. She resolved that things would change that very day.*

## Working With Bookkeepers and Accountants

As a small-business owner, you probably don't want to handle all the bookkeeping tasks yourself. Of course, you should follow the general procedures and consider the issues applicable to hiring any employee, but there are some special considerations when hiring a bookkeeper.

1. **Write a job description.** State which modules in your accounting system, and which specific functions in those modules, are the responsibility of the new bookkeeper. Some bookkeeping positions are "full charge," which means the person works with every accounting module. How many days per week will you need help?
2. **Make sure applicants have the right type of experience.** You don't need to hire the most experienced applicant, but you should judge whether the applicant will be able to handle his or her level of responsibility. Do you have other bookkeepers on staff who will supervise and train the new employee, or will this bookkeeper be in charge? Do you need someone to come in and start from scratch, or are your systems in good working order?
3. **Check applicant's accounting knowledge.** Tests or interview questions work best. Your CPA can help you design questions appropriate for the job description.
4. **Consider the requirements of your current computerized accounting program.** Is it important that the new bookkeeper be familiar with that program? Or do you want someone who can help select a computerized accounting program and design your internal controls?
5. **Check references.** Be sure previous employers were happy with the person's performance. You can also talk to them about what tasks the employee did, and compare them to the job description you've written. It can be difficult to discover a dishonest bookkeeper in advance, but you won't know anything if you don't ask questions.

Always check references when hiring a bookkeeper or accountant!

### Using an Accountant

Very few small businesses can get by without some professional accounting help. There are many services to choose from.

- **Bookkeeping.** You can hire a bookkeeping service to do any or all of the tasks required in your system, including accounts receivable, accounts payable, and payroll.
- **System design.** You may need help designing an accounting system and internal controls.
- **Income taxes.** You will almost certainly need help planning for and preparing your income tax returns.

- **Write-up.** You may be able to maintain the books yourself, but you'll probably need help putting together the financial statements and other reports. Some firms will help you design your accounting system based on the software they use. You give the firm your accounting information in the form of input sheets (which are usually digital files), and their personnel enter it into the computer.
- **Auditing.** As your business grows, you may need an independent audit. Also, an audit may be required by loan agreements, or when a business is offered for sale.
- **Temporary services.** Perhaps all you need is some help getting through the year-end closing of your books, or preparing your annual budget. Or maybe you have a busy season, and need extra help with accounts receivable or inventory. If so, consider using one of the temporary service agencies in your area.

*Who can do this work?*
**Certified public accountants (CPAs)** are the only accounting professionals who can perform an independent audit. They are skilled, well-trained accountants who offer auditing, income tax planning and preparation, estate planning, financial planning, and write-up services. Although their rates may seem high, they can often save you money by refining your accounting system or helping you reduce income taxes.

Very few small businesses can get by without professional accounting help

Some states have professional accountants who are not CPAs. These may include public accountants and licensed tax consultants. These individuals have also passed rigorous examinations and been licensed by the state. They may not perform an independent audit, and while most are glad to help you with tax return preparation, not all offer income tax planning services. As their name implies, licensed tax consultants specialize in income tax return preparation. Public accountants can be very helpful in designing your accounting system, performing weekly or monthly bookkeeping chores, or doing payroll.

There are also many bookkeeping firms with well-trained staff ready to perform bookkeeping functions for you.

*The next afternoon, Cindy reported more problems. She had discovered a total of $5,000 in uncashed checks for membership dues. She was worried that the business had underreported its profits and might have a sizable tax bill for the next quarter.*

*However, Sally and Cindy made some quick calculations, and were pleasantly surprised by what they found. If they collected all the gym's outstanding accounts receivable, deposited all of the "lost" membership dues, and negotiated for more time with their largest creditors, the gym could pay its taxes and begin to operate in the black by year's end.*

*They both agreed that the next step was finding a qualified, motivated, and trustworthy front desk manager to replace the existing manager...and quickly!*

***How to work with your accountant***

Most accountants charge by the hour, so be diligent about giving them organized, complete financial information. Bringing your accountant a shoebox full of loose receipts will cost you extra! Perhaps you have decided that your time is valuable enough that you are willing to pay the accountant to organize your records. That's fine, as long as you remember that you must still monitor the system to see that it's functioning correctly, and review the financial statements carefully.

An accountant with experience in your industry will understand the accounting issues businesses like yours face, but will still need to know particulars about your goals and financial situation. You must be very candid with your accountant, so find someone you can trust. Professional accountants keep strict confidence regarding client information.

Your accounting system should address management information first, and tax requirements second

If you hire an accountant to help design your accounting system, be very clear about the information you need. Some accountants focus on income tax requirements, and will design a system that responds primarily to those laws. Your accounting system should address management information first, and tax requirements second.

*In their final analysis, Sally and Cindy realized that Lunar Gym was undercharging for its club memberships. Not only could her market bear a higher price, but she was not currently generating enough revenue to reach her target profit level.*

*They also decided that the club shouldn't expand until it was getting the most out of the space it had. This meant utilizing unused space to generate extra revenue for the club. For instance, using the childcare room for massage therapy during off-peak hours would even out the club's revenue stream throughout the day, and offer clients more services.*

*Within a month, Sally had hired a new manager, who was responsible for maintaining club membership records, paying the bills, depositing membership dues, and working closely with Cindy to input data for the business's general ledger and financial statements. Before starting full-time at Lunar Gym, the manager attended a two-day training seminar on the Aerobitron and a two-week refresher course on bookkeeping. Three weeks later, all of the front desk staff were trained and using the Aerobitron. Lunar Gym was back on its feet!*

## Conclusion

Accounting is complicated, time-consuming, and detailed, but it's also extremely important for your business. It provides the information you need to run your business, and it's the basis for the tax information you must file with the government.

No one expects you to turn you into an accountant overnight, but as a business owner you must be involved in and knowledgeable about your accounting process.

# Chapter 37
# BUDGETING

*About This Chapter:*
- *The uses of budgeting*
- *What makes a good budgeting system?*
- *Types of budgets*
- *Preparing an annual budget*
- *Learning from budgets*

## Introduction
Budgeting means turning the strategic and operating decisions you described in your business plan into numbers.

Budgets guide purchasing, scheduling, marketing, personnel, and financing activities. Note that the operative word here is "guide," rather than "control." The budgeting process involves educated guesswork, not absolute accuracy. When deviations occur, the results are evaluated, more planning is done, forecasts are adjusted, and action is taken.

Budgets are an integral part of your business plan and financing proposals. A banker is not likely to approve a loan without reviewing and understanding your budgets.

Budgets also help you get to know your business inside and out. While preparing budgets, you must look at every aspect of your business. The more knowledgeable you are about your business, the better equipped you'll be to avoid problems and deal with unexpected calamities.

The budgeting process can also reveal opportunities to reduce costs, improve products, and increase efficiency. It draws attention away from the daily routine of doing the work, and focuses your attention on how the work is actually done.

Last, budgets are useful for communicating plans and goals to your employees, bankers, and investors, and coordinating the various parts of your business.

The budgeting process can also reveal opportunities to reduce costs, improve products, and increase efficiency

## The Uses of Budgeting
The most basic purpose of budgeting is to ensure that your business has enough money to fund day-to-day operations, pay its bills, and reach its goals. A good budget prevents your business from spending more than it earns, obviously, but it also prevents you from sitting on cash that you could be using to grow, and helps you choose the best time to expand into a new market, hire new employees, or upgrade your office equipment.

### Planning

One of the most important purposes of budgeting is to allocate resources wisely, based on an informed estimate of revenue and expenses. It also allows the organization to add and remove products and services from its plan for the future period. In larger organizations, the budgeting process may be completed by individual business units and compiled to form a master budget for the organization.

### Identifying Variances

It's often said that financial statement analysis doesn't give answers, it creates questions. The same is true when comparing budgeted costs to actual costs. Suppose your budgeted labor costs were $140,000, and you spent $152,000. That would leave you with a variance of $12,000, and an obvious question: "Why did labor costs go over budget?"

Perhaps a special order came in, and you had to add workers to get it out on time. Or maybe labor costs were higher because you introduced a new machine or process. Whatever the explanation, this knowledge helps the planning process and keeps the business on track. Above all, it helps you to ask the right questions about your business operations.

### Communicating Goals

Budgets can be a great way of making employees aware of your business goals

Budgets can be a great way of making employees aware of your business goals, and establishing responsibility for those goals. They can also help to meet the needs and address the concerns of investors and bankers.

### Encouraging Good Behavior

When budgeting, remember that budgets can cause certain behaviors. Suppose you promised your salespeople a bonus if sales exceed the budgeted amount. If you set the budget too low, your sales staff will believe that they can easily meet the target and will thus have little incentive to work hard. If the target is too high, they may think it's impossible to meet and give up without trying. Either way, you've caused behavior opposite to that which you desired.

### Responsibility Accounting

Comparing budgeted and actual results can help you to assess the performance of departments or employees. This is called **responsibility accounting**. Try to associate business activities and costs with the individual controlling those costs. That way, you can generate budget reports by function or by person, and use them to evaluate performance.

As we mentioned earlier, variances between budgeted and actual amounts can identify unproductive behavior and help employees make corrections. But be sure to explore variances thoroughly before you fix blame. It's very important to do performance evaluations in a positive manner. Punishment might motivate your employees for a little while, but the possibility of a reward is better in the long run.

*Peekskill Caterers was founded in 2008 by Sarah Erhenberg and her business partner, Jason Spears. They leased a commercial space from another local business, Louisa's Jams, which operated in a large kitchen with lots of extra workspace and an attached warehouse. They paid a monthly fee for rent, and for use of the cooking equipment. They also had access to the accounting expertise of Louisa's daughter, Anne.*

*The only restriction on Peekskill Caterers was that they had to relinquish use of the facilities in August, which was the peak production month for Louisa's Jams. That was fine with Sarah and Jason, both of whom enjoyed taking a full month off each summer.*

*Sarah and Jason were enthusiastic about catering, and were dedicated to making Peekskill Caterers the best catering service in the Hudson River Valley area.*

*Their specialty was serving what they called "Epicurean adventures," meals prepared in a variety of ethnic styles, using organic and sustainably harvested ingredients. Their best-selling dishes were Pan-Asian feasts, combining plates of curries, barbecued satays, vegetable tempura, and steamed dumplings. They prepared these dishes with a unique flair, incorporating their favorite influences from French and Cajun cuisine.*

**The Benefits of Budgeting**

- Improves corporate culture by teaching flexibility and compromise
- Helps translate company strategies into action
- Encourages better performance by aligning incentives
- Monthly updates allow realignment to changing conditions
- Provides a template for rearranging resources to pursue new profit opportunities
- Explains and documents business failure, adjustment, and success

## What Makes a Good Budgeting System?

### Employee Involvement

A participatory process increases acceptance. The person performing a task is in the best position to evaluate that task and help set budgeted amounts. Budgets that come from the top, with no input from employees, are likely to meet resistance and be inaccurate.

A participatory budgeting process increases employee acceptance

### Consistent Use

It's very frustrating to put lots of time and energy into the budgeting process, only to see the completed budgets sit on a shelf and gather dust. When that happens, it's very difficult to get participation in the future. Also, if the critical evaluation portion of the budget cycle doesn't occur, valuable information is lost.

Design your budgets to reflect your accounting system

### Documenting Assumptions

Budgeting involves making assumptions about the future. Write these assumptions down; you will need them when evaluating variances, and to explain your budgets to your banker and other outside parties. You may think you will remember your assumptions, but several busy months later, it won't be that easy.

### Ease of Use

Many computerized accounting systems can produce reports comparing budgeted to actual figures. Using these systems lets you concentrate on content rather than form. You should design your budgets to reflect your accounting system, or make changes to your accounting system if it will result in better information. Remember to let your planning process—not your accounting system—guide what you do. Still, your budgeting shouldn't be too dependent on past assumptions. Realistic data, based on actual practice, is the goal.

### Integration With Your Business

A budget should fit the needs of your business. Are you short on personnel? Prepare a work schedule with an accompanying budget. Is it difficult to get a particular component for your finished product? Time to do a purchasing budget. Whatever is vital to efficient, effective operation of the business should be included in the budget process.

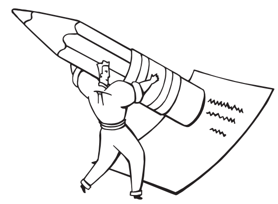
### Budgeting Tips

- **To err is human.** A budget is your best estimate of what you think will happen. Expect to get things wrong. When you do, learn from your mistake and readjust your budgets. Everyone makes mistakes, but the smart entrepreneur adjusts and moves forward.
- **It's a learning experience.** The harder you work at budgeting, the more accomplished you will become, and the more useful it will be.
- **Learn to adapt.** Good budgeters soon learn the art of compromise, and the benefits of remaining flexible. Also, interdepartmental squabbles occur at budget creation and review, providing an excellent opportunity to develop teamwork and conflict resolution skills.
- **Cash flow is crucial.** If you can't pay your bills you can't stay in business. Making conservative estimates, by overstating expenses and understating revenues, is always a good idea.
- **Life is uncertain.** Prepare for the unexpected by trimming expenses, working daily at revenue growth, and setting aside a cash cushion for emergencies.
- **Budgeting is a tool, not a shackle.** If something worthwhile comes along, don't fret about exceeding your numbers now and then. This is especially true for something you know will produce profits.
- **Use it, don't lose it.** It takes work to prepare budgets, so get the most out of them. Budget monthly, and your business will run more smoothly.

*Sarah and Jason were absolutely swamped with catering jobs in the winter of 2008, but for some reason they hadn't generated any profits. In fact, when they looked over their income statement and cash flow records with Anne, they found that they had lost $700 in November and nearly $1,000 in December. What was going wrong? They'd had much more business in December than November…why did more business translate into bigger losses? Anne suggested that they review their pricing and budgeting procedures.*

*It turned out that when Peekskill Caterers bid for a job, they'd estimate the number of hours of the actual job and the number of hours needed for prep time. Usually, Sarah simply added a few extra hours to arrive at a total number of billable hours. Then she'd calculate the total cost of the food, and combine the amounts to create a flat fee for the job.*

*Peekskill Caterers bought most of their high-quality ingredients from local farmers and butchers, and often negotiated bulk rates. But if they needed special cuts of meat or seafood, they had to order in advance and pay more. And sometimes, they'd end up rushing to the local gourmet food store to get supplies they'd forgotten or run out of. Sarah rarely incorporated these costs into her estimates. Unfortunately, costs like these had a tendency to come up more often when business was good. The busier Peekskill Caterers got, the more likely forethought and organization were to go out the window.*



*Anne asked the partners how they incorporated overhead into their bids.*

*"Overhead? Oh, you mean like rent and stuff?"*

*"Yeah. How do you allocate those costs in your bids?"*

*"Well, we figure that just comes out of our hourly fee. We don't make any special provisions to cover things like that. It seems too complicated and messy."*

*Anne rubbed her forehead and poured herself another cup of tea. "We're in for a long morning," she thought.*

## Types of Budgets

### Master Budget

The master budget comprises all the budgets prepared by various departments in the business. We often break these down into two groups:

- **Operating budget**. This includes sales, production, cost of goods sold, and operating expenses.
- **Financial budget**. This includes cash budgets, capital budgets, and projected financial statements.

The cash budget enables you do something about cash shortages before they occur

### Cash Budget
This is the most vital budget for most small businesses. It shows expected cash inflows and outflows, and is often called **cash flow projections**. It enables you to anticipate cash shortages and do something about them before they occur. It will also help you put your cash surpluses to work.

### Capital Budget
Capital budgets refer to acquisition of land, buildings, and equipment. Estimating future revenues and expenses can help determine whether or not the acquisition is a good idea.

### Continuous Budget
At the end of each month, a new month is added so that a budget for the next 12 months is created.

## Preparing an Annual Budget
Pat, owner of Pat's Machine Shop, wishes to develop a cash flow projection for his business. He starts with a first-quarter sales forecast. This is a critical component of the cash flow projection, because all other budgets are driven by forecasted sales.

*Pat's Machine Shop: First Quarter Sales Forecast*

| Months | Jan | Feb | Mar | Total |
|---|---|---|---|---|
| **Product 1** | | | | |
| Units sold | 30 | 40 | 50 | 120 |
| Price per unit | $300 | $300 | $300 | $300 |
| Total sales | $9,000 | $12,000 | $15,000 | $36,000 |
| **Product 2** | | | | |
| Units sold | 70 | 70 | 80 | 220 |
| Price per unit | $500 | $500 | $500 | $500 |
| Total sales | $35,000 | $35,000 | $40,000 | $110,000 |
| **Product 3** | | | | |
| Units sold | 2 | 2 | 2 | 6 |
| Price per unit | $3,000 | $3,000 | $3,000 | $3,000 |
| Total sales | $6,000 | $6,000 | $6,000 | $18,000 |
| **Total-All Product Sales** | $50,000 | $53,000 | $61,000 | $164,000 |

### Sales Forecast

The sales forecast tells Pat how many units he must make, and what he has to purchase to make them. This dictates how many workers he will hire, and what his labor costs and other expenses will be. Once Pat knows these things, he can forecast his cash inflows and outflows.

Pat knows better than to inflate sales estimates just to make his business look good. On the other hand, he also knows that overly conservative sales forecasts can cause problems, too. They might lead him to order insufficient inventory, or hire too few workers.

If Pat's sales forecast leads to a negative cash position, he might wish to start over and see if he was too conservative. Changing the sales units would affect all his other budgets, and perhaps lead to a positive cash balance. That said, he mustn't simply determine the cash balance he wants, and juggle the sales forecasts until he gets that amount.

Pat sells on a cash basis, meaning that he accepts cash or checks only. If this were not the case, Pat would have to factor in the discount rate he paid to the bank on his credit card sales. Then, he would add the actual cash he received each month from collections of his accounts receivable, instead of the sales amount.

Pat's sales forecast uses a very simple format. Yours is likely to be more detailed. In your business plan, you already determined a pricing strategy. Now, you need to add quantity. Often, history is used as a base and projections are made from there. Gathering sales history may be a simple matter of reviewing your records, but this can be complicated if you want to look at data by product or product line. Many small businesses do not keep this information, but if you think it would be useful, you can change your recordkeeping system to give you this information.

An alternative method is to multiply total sales by your product mix ratio. For example, suppose you estimate that 65 percent of your sales normally come from your first product line, 20 percent from a second line, and 15 percent from a third. These percentages provide a rough estimate of sales history by product. You should use percentages of sales dollars to do this. You can also use an industry average; we discussed sources of these averages previously.

When forecasting sales, pay particular attention to past trends in the industry and your business. You may relate a past trend to what was happening in your marketplace and learn something valuable for the future. If you find a trend that you don't expect to be repeated, you shouldn't use it.

Knowing your product's position in its life cycle is very helpful when forecasting sales. If your product is seasonal, that should also be reflected in your forecasts. If your introducing a totally new product, you'll have to make educated guesses, based on a similar product introduced by a competitor, or the same product introduced in a different market.

Knowing your product's position in its life cycle is very helpful when forecasting sales

*Anne soon realized that Peekskill Caterers had no formal budgeting process at all. They had lots of business, though. With proper budgeting and pricing, they could easily be profitable.*

*Anne gathered the following information about Peekskill Caterers:*

- *Their business seasonal business. They generated 65 percent of their total revenue during the peak holiday season between November and December. Most of the remainder was earned in June and July, when marriages were common and many people entertained at their summer houses in the Hudson Valley.*
- *When catering for ten or more people, they hired a helper at $15 per hour.*
- *25 percent of their food costs came from last-minute trips to the gourmet shop.*
- *For the past three seasons, they had underestimated projected sales by at least 40 percent. This explained their last-minute shopping for supplies, and their feeling of never having enough time to plan for personnel needs or supplies.*
- *Over the same period of time, they had overestimated their projected sales for the slow winter months by at least 30 percent. They failed to account for the higher cost of produce during these months, or for the higher utility costs for heating their space.*

*In total, Anne found that Peekskill Caterers had been underestimating their costs by as much as 15 percent!*

Cost of goods sold reflects the costs to the business of the products it is selling

### Cost of Goods Sold Budget

Recall that cost of goods sold reflects the costs to the business of the products it is selling. Service businesses do not have this expense. Retailers and wholesalers should check manufacturer and distributor catalogs or recent invoices for cost information, then make a few refinements.

The per-unit cost used to forecast cost of goods sold should be reduced by expected cash or quantity discounts, and increased by freight charges. In other words, use the net amount you expect to pay.

Manufacturers usually prepare a production budget, which shows how they expect to produce the projected sales units. Manufacturers incur three costs for the units they produce: **direct materials**, **direct labor**, and **overhead**.

There are many ways to incorporate these costs into the cost of goods sold budget. You may wish to add more detail to your schedule.

In the example on the next page, the projections are in the simplest form: Pat's Machine Shop has included only direct materials in its cost of goods sold budget. Labor and overhead costs have been forecast separately and included in the operating expenses budget.

*Pat's Machine Shop: Cost of Goods Sold Budget*

| Months | Jan | Feb | Mar | Total |
|---|---|---|---|---|
| **Product 1** | | | | |
| Units sold | **30** | **40** | **50** | **120** |
| Price per unit | **$45** | **$45** | **$45** | **$45** |
| Total cost | **$1,350** | **$1,800** | **$2,250** | **$5,400** |
| **Product 2** | | | | |
| Units sold | **70** | **70** | **80** | **220** |
| Price per unit | **$150** | **$150** | **$150** | **$150** |
| Total cost | **$10,500** | **$10,500** | **$12,000** | **$33,000** |
| **Product 3** | | | | |
| Units sold | **2** | **2** | **2** | **6** |
| Price per unit | **$300** | **$300** | **$300** | **$300** |
| Total cost | **$600** | **$600** | **$600** | **$1,800** |
| **Total-All Product Costs** | **$12,450** | **$12,900** | **$14,850** | **$40,200** |

This simple presentation doesn't follow the accounting technique known as "full absorption costing," which calls for all three manufacturing costs to be included in the cost per unit. But Pat is using these budgets internally, so the simpler version works for his purposes.

Manufacturers normally have three types of inventory: **raw materials**, **work-in-process**, and **finished goods**. Pat has chosen to ignore this, because his jobs are relatively short and the amount of work-in-process is never very large.

If his costs were tied up in work-in-process for a long time, this would affect his cash flow projections, and his cost of goods sold budget would reflect this.

Note that Pat assumes his expenses will be on a cash basis, which means he will not receive credit from his suppliers.

### Operating Expenses Budget

Pat's next step is to budget his operating expenses. Again, Pat assumes his expenses will be on a cash basis, and that he will not have any accounts payable or other accrual expenses.

You can have as much detail as you wish in your own operating expenses budget. Pat has divided his costs into labor and non-labor, but you can use any categories that make sense for your business.

*Pat's Machine Shop: Operating Expenses Budget*

| | Jan | Feb | Mar | Total |
|---|---|---|---|---|
| **Labor** | | | | |
| Salaries and Wages | $30,000 | $30,000 | $30,000 | $90,000 |
| Payroll Taxes and Benefits | $8,695 | $8,695 | $8,695 | $26,085 |
| **Total Labor Expense** | **$38,695** | **$38,695** | **$38,695** | **$116,085** |
| **Non-Labor** | | | | |
| Occupancy Expenses | $3,355 | $3,480 | $3,355 | $10,190 |
| Outside Services | $650 | $650 | $650 | $1,950 |
| Insurance | $200 | | | $200 |
| Advertising | $300 | $1,050 | $300 | $1,650 |
| Miscellaneous | $100 | $100 | $100 | $300 |
| **Total Non-Labor** | **$4,605** | **$5,280** | **$4,405** | **$14,290** |

Be sure to distinguish between fixed and variable expenses when preparing operating expense forecasts

It's often helpful to have additional schedules supporting the amounts listed in this budget. For example, Pat might have a schedule giving the details of occupancy costs.

Be sure to distinguish between fixed and variable expenses when preparing operating expense forecasts. **Fixed costs** remain the same no matter what you forecast for sales, while **variable costs** change with sales volume.

### Cash Flow Projections

When combined, the sales forecast, cost of goods sold budget, and operating expenses budget lead to the cash flow projections.

*Pat's Machine Shop: First Quarter Cash Flow Projection*

| Months | Jan | Feb | Mar | Total |
|---|---|---|---|---|
| Total Product/Service Sales | $50,000 | $53,000 | $61,000 | $164,000 |
| Total Product/Service CGS | 12,450 | 12,900 | 14,850 | 40,200 |
| Total Labor Expense | 38,695 | 38,695 | 38,695 | 116,085 |
| Total Non-Labor Expense | 4,605 | 5,280 | 4,405 | 14,290 |
| **Net Cash Flow** | **-$5,750** | **-$3,875** | **3,050** | **-6,575** |

This first-quarter cash flow projection gives Pat valuable information. He knows that his initial cash position must be at least $6,575 if he is to survive his anticipated first-quarter cash shortfall.

Pat would complete his annual budget by projecting quarters 2, 3 and 4, just as he did with quarter 1. By combining all four quarters, he would complete an annual budget.

### Projected Income Statement, Balance Sheet, and Statement of Cash Flows

The projected income statement, balance sheet, and statement of cash flows are prepared as previously described, and are not included as examples here.

*A perfect example of Peekskill Catering's difficulties was a Thanksgiving dinner they catered for a party of 12. When Sarah wrote up the invoice for the event, she estimated her costs as follows:*

- *10 hours of work time @ $20 per hour*
- *$250 in food costs*
- *$350 for wine and other beverages*

*When Anne worked with her, reviewing receipts and overhead expenses, they found that her actual costs were:*

- *20 hours of work time (3 hours of research, menu planning, and client management; 10 hours of prep and shopping; 7 hours of cooking and clean-up)*
- *$350 in food costs, including special orders and last-minute runs to the gourmet food store*
- *$350 for wine and beverages*
- *$40 in overhead expenses (including rent, kitchen supplies, utilities, gas, insurance, and taxes), calculated as a percentage of the number of hours spent in the kitchen*

*As you can see, Sarah had undercharged her client significantly! By tracking her expenses rather than approximating them, Sarah recognized what a difference a budgeting system could make. She also realized that with Anne's help, she and Jason could price their services correctly and generate greater profits.*

## Learning from Budgets

Budgets give you feedback about your business operations. You can prepare **performance reports** that compare actual results to budgeted amounts. This will reveal problems that can then be investigated and corrected.

Performance reports compare budgeted amounts to actual results

For many small businesses, performance reports for the business as a whole are sufficient. However, if your business is organized into functional departments (e.g., sales, production, and supply chain management) or according to product line, or if you have more than one location, you should prepare reports for each department. The more detail you have, the more feedback you get. The danger, of course, is that you can get buried in too much detail!

When complex organizations prepare performance reports, they usually start at the bottom of the business and work up. Each report rolls into another report, until you get to the report that shows the business as a whole.

For example, let's assume that Pat has organized his sales staff into regional offices. The salespeople in each region report to a regional director, who reports in turn to the marketing manager at the main office. Pat prepares monthly performance reports by region and in total.

The reports for January included the following:

*Sales Performance Report for January*

| Total Sales | Budget | Actual | Variance Over (Under) |
|---|---|---|---|
| Region 1 | $10,000 | $12,000 | $2,000 |
| Region 2 | $25,000 | $24,000 | ($1,000) |
| Region 3 | $15,000 | $16,500 | $1,500 |
| **Total Sales** | **$50,000** | **$52,500** | **$2,500** |

*Sales Performance Report for January*

| Region 2 | Budget | Actual | Variance Over (Under) |
|---|---|---|---|
| Salesperson 1 | $15,000 | $12,000 | ($3,000) |
| Salesperson 2 | $10,000 | $12,000 | $2,000 |
| **Total Sales** | **$25,000** | **$24,000** | **($1,000)** |

Notice that the report for Region 2 feeds into the report above. The budgeted and actual amounts in the Region 2 report match the figures listed in the report for all sales.

Allocation of costs that are common to all levels of the business can cause difficulties. For example, if Pat prepares performance reports by functional area (sales department, production, administration, etc.), how should he handle the cost of the copy machine or receptionist, or the other things the departments share?

These common costs could be placed in a single performance report, or allocated to various departments. If Pat doesn't allocate them, and excludes the costs from all performance reports, then no one will be looking at those costs to see if they're in line with the budget.

Investigate the cause of variances before jumping to conclusions!

Again, it's important to investigate the cause of variances before jumping to conclusions. It's easy to assume that all expenses over budget are bad, and all savings under budget are good.

However, "bad" and "good" are determined by how well you're meeting your business objectives, the most important of which is profitability.

*Pat's Machine Shop: Performance Report for January*

| Region 2 | January Budget | January Actual | Variance Over (Under) |
|---|---|---|---|
| **COST OF GOODS SOLD** | | | |
| **Product 1** | | | |
| Units Sold | 30 | 42 | |
| Cost per Unit | $45 | $40 | |
| Total Cost | **$1,350** | **$1,680** | **$330** |
| **Product 2** | | | |
| Units Sold | 70 | 65 | |
| Cost per Unit | $150 | $157 | |
| Total Cost | **$10,500** | **$10,205** | **($295)** |
| **Operating Expenses** | | | |
| **Labor** | | | |
| **Salaries & Wages** | **$30,000** | **$32,000** | **$2,000** |

If you were to take the above performance report for Pat's at face value, you might think that something is wrong with Product 1, because January expenses were higher than budgeted.

Going over budget is not always bad, and coming in under budget is not always good!

But notice that this excess occurred because more units were sold than expected. In fact, the company actually managed to decrease its per-unit costs.

This is good, isn't it? Doesn't every business strive to cut costs? Yes, but some costs shouldn't be cut. Suppose the unit cost decreased because the purchasing manager bought cheaper, lower quality goods. If Pat's mission is to produce high-quality, long-lasting products, these purchases do not fit Pat's objectives. But if Pat's goal is to become the discount machine shop in the area, they fit very nicely.

Often, variances are interconnected. For example, Pat's report shows that in January, salaries and wages cost $2,000 more than budgeted. Why did this happen? Perhaps it resulted from the actions taken by the purchasing manager. If inferior materials were used, there may have been difficulties completing the product. Perhaps laborers had to work overtime to fix problems that occurred, and overtime pay wasn't anticipated in the budget.

Pat's sold more units in January than forecasted. This might have resulted from a special order that could only be produced after hours, making overtime pay necessary.

Variances that appear as patterns should always be examined, regardless of size

Which variances should you explore in more detail? This is a difficult question. It usually isn't possible to evaluate every variance. Some businesses investigate all variances above a certain dollar amount, while others look at the relative size of the variance rather than absolute dollar amount. For example, a variance of more than 5 percent from budgeted dollars might be investigated, while a variance of only 0.5 percent might not be. The problem is that some variances are caused by more than one phenomenon, so a small variance might be masking several larger variances that balance each other out. Variances that appear as patterns should always be examined, regardless of size.

We have a tendency to focus our investigations on expenses where the actual amounts are higher than budgeted. But you also can learn a great deal when costs are under the budgeted amount. In some cases, you can even use this information to improve your processes and products.

As you can see, preparing the performance reports is the easy part...figuring out what the reports are telling you is much more challenging.

*After a few meetings with Anne, Sarah and Jason adjusted their sales forecasts for the coming season, taking into account sales for the preceding three seasons. They calculated their total overhead expenses, and budgeted them for each month of the next year's operations. Overhead increased during peak winter months, when they had higher electric and gas costs.*

*They decided to allocate their overhead expenses to catering jobs based on a seven-month year of operations. They had so few jobs during the remaining five months that the business had to be able to generate its total income during peak months.*

*With better sales projections for the coming season, Peekskill Caterers would be able to order the correct amount of supplies ahead of time. They could buy more supplies at lower bulk rates, and make fewer trips to the pricey gourmet food shop. Since a certain amount of last-minute purchases were inevitable, they added an additional percentage to their total supply costs to cover these expenses.*

*Peekskill Caterers also budgeted for hourly kitchen and serving personnel; annual kitchen supply needs like bowls, knives, and aprons; health coverage; gas for their truck; and insurance.*

*The couple finished their meeting with Anne by creating a simple computer spreadsheet template for their budgets. This way, they could easily track overhead costs and supply costs, to make sure they were meeting their projected budgets. They also worked out a project management template, based on their budget, that would aid them in running each catering job more efficiently and professionally.*

*Sarah and Jason left the meeting feeling much more in control of their business. They knew that by following their budgets, they would return Peekskill Caterers to profitability.*

## NxLEVEL® TECH TIP
BUSINESS RESOURCES AND THE WEB

One area in which it's often possible to cut your business's costs is shipping.

Depending on how soon you want a package to be delivered and where it has to go, shipping costs can vary dramatically. By comparing the rates and levels of service offered by different carriers, you can achieve substantial savings every time you ship.

This process just got much easier, because it's now possible to get comparisons of shipping rates online by visiting **www.intershipper.net**, a free service that locates the best rates among carriers such as USPS, UPS, FedEx, RPS, DHL, and Airborne. The quotes are based on how quickly you want the item to be delivered, and how far away the destination address is.

This site also allows you to track packages sent via a variety of carriers at one site, instead of visiting tracking sites for each carrier.

### Flexible Budgets

A flexible budget is actually several budgets in one. It includes a range of activity levels. For example, you might prepare the master budget three times, assuming sales of 50,000, 60,000, and 70,000 units.

Let's say Pat budgeted sales of 2,800 units in March. If actual March sales units totaled 3,200, how would Pat's performance reports look? Obviously, actual sales would exceed budgeted sales.

Wouldn't this also cause many of his actual expenses to be above budget? You would also expect Pat's cost of goods sold to be above the budgeted cost. And perhaps his labor would have a positive variance.

Remember our earlier discussions of fixed and variable expenses? Wouldn't you expect positive variances for all variable expenses? The question then becomes: Is actual cost greater than budgeted cost by the amount you would expect?

Flexible budgets can help answer this question, because they reflect actual sales volume. They recast the original budget, using actual sales volume as a base.

Flexible budgets reflect actual sales volume

Next, we must compare the flexible budget to our actual results, so as to eliminate the overall change in sales volume from the variance analysis. It then becomes apparent what happened to variable expenses, given the sales volume achieved.

Part of the January performance report for Pat's could be redone like this:

| January Performance Report | | | | |
|---|---|---|---|---|
| Region 2 | January Budget | Flexible Budget | January Actual | Variance Over (Under) |
| **COST OF GOODS SOLD** | | | | |
| **Product 1** | | | | |
| Units Sold | 30 | 42 | 42 | |
| Price per Unit | $45 | $45 | $40 | |
| Total Sales | **$1,350** | **$1,890** | **$1,680** | **($210)** |
| **OPERATING EXPENSES** | | | | |
| **Labor** | | | | |
| Salaries & Wages | $30,000 | $30,000 | $32,000 | $2,000 |

For Pat's, as for most businesses, cost of goods sold is a variable expense: it changes with sales volume. Here, the original budget is redone so that budgeted units sold match actual units sold. Actual sales volume is multiplied by budgeted cost per unit. This focuses on cost of goods rather than volume. The original performance report showed a variance of $330 over budget, which is to be expected because sales volume was higher. The flexible budget shows a variance of $210 under budget. This means that given the sales volume, Pat's had a lower cost of goods sold overall.

Notice that the original budgeted amount and the flexible budget for salaries and wages did not change. Pat's pays its employees a salary plus overtime pay. Unless overtime occurs, this expense is fixed; it does not change with changes in sales volume. Thus, assuming no overtime pay, this expense is budgeted at $30,000, no matter what level of sales is anticipated or achieved.

### Performance Measures

Many companies utilize performance measures in addition to their master budgets. These measures focus attention on actions that drive operations. Often, these data are not included in the accounting system, and new procedures must be established to collect them. Machine downtime, customer orders received by day, number of product defects found, and work-in-process time might be tracked over time so that developing trends can be analyzed.

This helps you to evaluate your progress towards your objectives. Although objectives must be measurable, it doesn't always make sense to measure them in terms of dollars and cents. You can use whatever performance measures are meaningful to your business.

## NxLEVEL® GREEN TIP
ENVIRONMENTAL BUSINESS RESOURCES

Improving efficiency and reducing waste can make your money go further. While figuring out how to do this can be a big job for a single entrepreneur, the rise of social networking allows you to benefit from the accumulated experience of entrepreneurs all over the world.

That's the idea behind **Innovation Exchange** (www.edf.org/page.cfm?tagID=29698), which is a project of the Environmental Defense Fund. In addition to detailed information on green technology and business practices, the site features an online community where business owners and experts can exchange strategies on improving efficiency, cutting costs, creating new business models, and transforming their industries through environmental innovation.

The site also compiles an annual Innovation Review, which surveys the year's most compelling new practices and technologies. If you're looking for creative ways to cut costs and root out inefficiencies, this is a great place to start.

## Conclusion

If you've just finished reading this chapter for the first time, you're probably convinced that the budget process is impossibly difficult, confusing, and time-consuming.

It's an understandable reaction. However, the benefits of budgeting infinitely outweigh the difficulty of learning how to do it. Without a budget, you don't have any benchmarks, and no way to see if you are doing better or worse than expected. That's no way to run a business!

Once you've done a couple of budgets, you'll find that the process goes much more easily and quickly. You'll also find that the things you learn from budgeting are absolutely essential to maintaining smooth and profitable day-to-day operations.

# Chapter 38
# CASH FLOW MANAGEMENT

*About This Chapter:*
- *Reasons for holding cash*
- *The cash flow cycle*
- *Managing inventory*
- *Managing accounts receivable*
- *Managing accounts payable*
- *Internal controls for cash*
- *Preparing cash flow projections*

## Introduction
Cash is the lifeblood of business, so you must pay careful attention to your **cash flow**. This is particularly true for small businesses, which tend to operate on a very tight budget—the equivalent of living from paycheck to paycheck. Careful cash management will keep your business from becoming delinquent on its debts, and protect its credit rating.

Cash is the lifeblood of business

It's equally important to manage your cash position carefully when your business is flush with cash. Idle cash doesn't help profitability, but planning for growth presents cash flow management challenges. For instance, you might encounter a cash drain in the beginning as you establish new markets or open new stores.

Whether times are good or bad, careful cash flow management is essential.

## Reasons for Holding Cash
Why do businesses hold cash? In general, there are three reasons:

1. To meet current and upcoming planned expenditures
2. As a precaution against unexpected expenditures or a drop in revenues
3. To meet contract or regulatory requirements, such as compensating balances mandated by a loan agreement

The amount of cash you hold depends on your attitude about risk. How much of a chance are you willing to take that you won't have enough cash to meet your obligations? How much cushioning does it take to make you comfortable? Remember, there's always a trade-off between risk and reward; if you keep an extra $10,000 in your bank account, just in case, you might be missing opportunities to use that cash to earn a profit greater than the interest you're receiving on the cash balance.

Of course, some businesses would love to have an extra $10,000, but their checking account balances never get above $500, and they often make deposits just in time to cover expenses. Obviously, these businesses have a greater risk of cash shortages.

*In 2008, Terry Collins started a pottery business called Glazing Around. She created her own pots, bowls, and vases. She also rented space in her studio to other artists, so that they could work, use her kiln, and retail their art.*

*In the beginning, Terry never thought of herself as a businessperson. She just wanted to make a living by doing what she loved most. She started her business with a small inheritance, and hired a college friend, Amelita Ward, to manage it.*

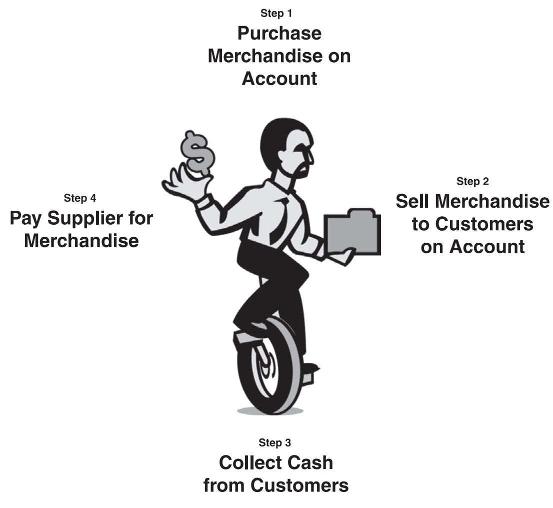
*Terry never created a marketing plan, nor did she ever consult with an accountant. During Glazing Around's first year, the business seemed to be doing fine, so it seemed unnecessary to her.*

*At least that's what she told herself. But in fact, she was uncomfortable with financial issues. She found them dull and distracting—to her, they were exact opposite of art. She was a firm believer in her intuition and her luck, and preferred to leap without looking because it had always worked in the past.*

## The Cash Flow Cycle

Manage your cash flow cycle!

The **cash flow cycle** (also known as the cash-to-cash cycle) represents the length of time that cash is tied up in business operations. If the cycle is shortened, cash will be freed up to begin the cycle again, or to be invested in other projects. The cycle looks like this:



Therefore, how long cash is tied up in business operations is a function of 1) how long your inventory sits before being sold; 2) how long it takes your customers to pay; and 3) how long before your suppliers are paid. Managing cash flow means managing these activities. To shorten the cycle, you can speed up sales, speed up collections from credit customers, or slow down payments to suppliers.

## Managing Inventory

Total inventory cost is a function of two variables: the quantity of goods in inventory, and per-unit cost. You must consider both when managing inventory. You can reduce your investment in inventory by decreasing either the quantity you hold, or its cost. Reducing per-unit cost calls for careful attention to the purchasing function. A manufacturer must also monitor labor and overhead costs.

Businesses hold inventory to meet actual and potential customer orders, to guard against supplier shortages, to corner the market, or because they've taken advantage of quantity discounts offered by suppliers. A bad reason for holding inventory, but a very common one, is that the business has not taken the time to manage it properly.

### Inventory Turnover Ratio

How often does your inventory turn over?

**Ratio analysis** is a means of evaluating how effectively you're managing your cash flow cycle. The **inventory turnover ratio** tells you the average number of times your inventory turns (is sold) during the year.

$$\textbf{Inventory turnover} = \frac{\textit{Cost of goods sold}}{\textit{Average inventory}}$$

We can convert this into days by dividing the inventory turnover ratio into 365 days:

$$\textbf{Average days in inventory} = \frac{\textit{365 days}}{\textit{Inventory turnover ratio}}$$

For example, assume the following for Blodgett Brass Company:

$$\textbf{Inventory turnover} = \frac{\$\ 3{,}900{,}000}{\$\ 300{,}000} = 13 \text{ times per year}$$

$$\textbf{Average days in inventory} = \frac{365}{13} = 28 \text{ days}$$

On average, Blodgett's inventory is in stock for 28 days before it sells. Whether this is high or low depends on the environment in which Blodgett operates. They should consider industry averages, their geographical location, their financial history, and any other special circumstances. However, if they wish to decrease the cash-to-cash cycle, Blodgett may try to turn their inventory more often than every 28 days.

How can they do that? The obvious answer is to increase sales. Another way is to reduce inventory by eliminating obsolete and slow-moving products. Careful evaluation of what sells and what doesn't is vital to this process.

Good buying decisions have a substantial impact on inventory levels

Good buying decisions have a substantial impact on inventory levels. For each item in your inventory, you must consider how many to buy and how much to pay.

There are several mathematical models you can use to help determine the optimum level of inventory to hold, and how much and when to order. One is the **Economic Order Quantity (EOQ)** model, which calculates the optimum quantity of inventory to order, based on the cost of ordering and storing the goods, anticipated sales, and per-unit cost. There are also many computer programs that can help you determine ordering strategies.

Some businesses have turned to **just-in-time delivery (JIT)** systems to reduce inventory levels. These systems attempt to get inventory to your operation just in time to be used or sold. This significantly decreases inventory levels and reduces the cash flow cycle. This may be easier said than done, however. The process requires special cooperation between you and your suppliers, and is very difficult for businesses with wide swings in sales volumes.

Many firms have implemented some of the just-in-time concepts and modified the process to suit their needs. You can find many books and articles about JIT systems.

*Amelita had a different opinion about the importance of accounting. She often urged Terry to take a more active role in business planning and management, but Terry always seemed to have something else going on.*

*After all, Terry had plenty of customers to take care of, her kiln was working at peak capacity, and all the available space for other artists was rented. Since things were going so well, she never saw a need to spend time away from her art. She figured that as long as people were buying her art, the best thing she could do with her time was to make more of it.*

*Although Amelita didn't agree, she was easily steamrolled by Terry's enthusiasm and optimism. Although it bothered her that Terry didn't take more of an interest in her business's financial health, Amelita figured that she could take up the slack.*

*At first, it was pretty easy. But before long, it began to seem as though there weren't enough hours in the day to do the accounting work that needed to be done. While she fixed one problem, two more would come up. And when she asked for Terry's input, she got brushed off. "I'm an artist, not a bookkeeper!" Terry said.*

## Managing Accounts Receivable

Managing **accounts receivable** means balancing the risks and rewards of your financial and marketing goals. For instance, new credit customers may help you meet sales goals, but if they prove to be slow payers, the cash flow cycle may be lengthened and your financial position weakened.

On the other hand, if you don't offer good credit terms, you may lose sales.

### Receivables Turnover Ratio

What is your average collection period?

Ratio analysis can help you evaluate the effectiveness of your credit policies. The **receivables turnover ratio** indicates the average number of times receivables turn (are collected) during the year.

$$\textbf{Receivables turnover} = \frac{\textit{Net credit sales}}{\textit{Average net receivables}}$$

This can be converted into days by dividing the ratio into 365 days:

$$\textbf{Average collection period} = \frac{\textit{365 days}}{\textit{Receivables turnover ratio}}$$

Here's another example for Blodgett Brass Company:

$$\textbf{Receivables turnover} = \frac{\$\ 7{,}200{,}000}{\$\ 650{,}000} = \text{about 11 times per year}$$

$$\textbf{Average collection period} = \frac{365}{11} = \text{approximately 33 days}$$

On the average, Blodgett's customers take 33 days to pay. As with Average Days in Inventory, Blodgett must consider their environment before evaluating whether this ratio is high or low.

If they wish to decrease the cash-to-cash cycle, Blodgett should try to reduce the average collection period for their receivables. To do this, Blodgett should review their criteria for extending credit, the credit terms they offer, and their collection activities.

### Credit

If your business sells to customers on account, you need to monitor who gets credit and how much they get. When considering credit for your customers, it's wise to use the same methods bankers use when evaluating a loan applicant.

With that in mind, let's take a look at the "Six Cs" of credit.

- **Credit history.** Review credit history for new and repeat customers. Don't assume that circumstances remain constant for your customers. Pay close attention to customers who ask for increased credit, or request special terms or extended credit. Many agencies can supply credit histories and ratings.
- **Character.** Evaluate your customer's intention to pay by checking reputation and references.
- **Capacity** refers to your customers' ability to pay the debt. Look at their past and present financial reports, and observe their current operations.
- **Collateral.** Usually, there is no collateral for an accounts receivable transaction. You may be able to retrieve the merchandise, but that is not always possible.
- **Conditions.** Consider general and local economic trends.
- **Capital.** Customers in a solid financial position are less likely to default.

Your credit evaluation probably won't eliminate all bad debts. Even good customers can fall on hard times. All you can do is try to reduce the risk by performing credit evaluations diligently.

Remember that there is a cost to having funds tied up in receivables

*Choosing credit terms*

Your business should have clearly written procedures stating what information you require from credit applicants, and which employees have the authority to grant credit.

The credit terms you offer customers include the credit period and cash discounts. Extending the time before customers must pay lengthens your cash flow cycle, so that your bills may come due before your customers pay.

Remember that there is a cost to having funds tied up in receivables: the money can't work for you until you get it. If you shorten the credit period, your customers might either become delinquent on their accounts or buy elsewhere. Determining the optimum credit period may take some experimentation. It's always wise to review what your competitors are doing. Of course, it depends where your company is in the business cycle. For instance, if you have a totally new product and no competition, and lots of customers, you don't need to extend very much credit.

### Cash Discounts

Many businesses offer cash discounts for early payment of invoices. For example, you might offer your customers terms of "2/10, net 30." This means that customers who pay within 10 days of the invoice date will receive a 2% discount. Otherwise, the normal payment period is 30 days.

Businesses offer cash discounts to attract customers, and to reduce the average collection period. The discount is the price the business pays for these benefits. Two percent may not sound like much, but remember that it is causing customers to pay 20 days sooner than they would without the discount.

## Collections

The part of cash flow management that business owners like least is trying to collect from delinquent customers. There are collection agencies who will do this for you, but they charge a high fee; most businesses resort to this only after other efforts have failed. How much effort you put into collecting receivables is a trade-off between the time and money it costs versus the cash you lose if you fail to collect.

The best strategy is not to let accounts become delinquent in the first place. Careful review before extending credit will help. Also, an effective billing system will ensure that customers receive timely, accurate invoices. If customers know you'll notice if they're delinquent, they'll be more likely to pay on time. Errors on invoices can cause disputes and delays, so you should make every effort to avoid them. Personally contacting late payers can also help to keep them on track.

Try not to let accounts become delinquent!

*One day in May of 2009, Terry had a rude awakening. She went through her mail and actually looked at some of the bills, instead of just passing them on to Amelita. Almost every bill that she opened showed a past due balance! How on earth had that happened?*

*All of this was very alarming to Terry. Obviously, the bills needed to be paid right away, before any more finance charges could pile up!*

*Unfortunately, things were not quite that simple. Terry looked at the bank statement, and found that she didn't have enough money to pay the upcoming month's rent, let alone a half-dozen overdue bills.*

*It was obvious that something had gone very badly wrong, and Terry had a pretty good idea of who was to blame.*

### *Aging accounts receivable*

One effective tool for managing collections is to age your accounts receivable. An **aging report** lists receivables by how long they have been outstanding. Here's an example:

**Blodgett Brass Company**
**Accounts Receivable Aging Report**
**January 30, 2009**

| Customer | Total Due | Under 30 Days | 30-60 Days | 61-90 Days | Over 90 Days |
|---|---|---|---|---|---|
| Acme, Inc. | $1,400 | $1,200 | $200 | | |
| BitCO | $3,570 | $2,070 | $850 | $650 | |
| Cox Corporation | $2,090 | | | | $2,090 |

The aging report allows you to identify slow-paying customers, follow up on collections, and evaluate credit and collection policies.

### Assigning and Factoring Receivables

**Assigning** receivables means using them as collateral for a short-term loan. (This is also known as pledging your receivables.) The lender reviews the collectibility of your receivables and lends you some percentage of the total. You repay the loan, plus interest, as you receive payments from your customers.

**Factoring** receivables means selling them to a financial institution. The factoring agreement may be on a "with recourse" or "without recourse" basis. If factored with recourse, you still have a collection risk, because the financial institution may seek funds from you should collections be less than anticipated. If factored without recourse, the financial institution cannot seek additional funds from you. As you can imagine, the financial institution will be very careful before entering into this type of transaction.

Factoring does not result in a loan and no interest is paid. The factor's fee will be the difference between the accounts receivable sold and the cash the factor gives you. One advantage of factoring is that the factor typically assumes all administrative responsibility for collection. Customers send payments directly to the factor. Some businesses see this as a way to reduce overhead costs by eliminating some accounting tasks.

Assigning and factoring your receivables are both effective ways of speeding up cash inflows. However, these methods can be very expensive. Interest rates charged on short-term loans for which receivables are assigned will usually be several points above the prime rate. And factorers may offer as little as 80 percent of the face value, depending on the quality of the receivables. For this reason, factoring is usually a poor choice for a small businesses, unless its receivables are of very high quality, with little collection risk, and the owner needs cash very quickly.

### Credit Cards

Many retailers shift the credit risk and collection burdens away from themselves by accepting credit cards. National credit cards, such as VISA and MasterCard, offer revolving credit financing to consumers. The retailer, after making the sale to the consumer, turns in the credit card charge slip and receives 95 to 98 percent of the total credit charge. The institution that issued the credit card bears the risk of nonpayment.

If you're going to accept credit cards, shop around for good terms!

To become a credit card merchant, you need to fill out an application and sign an agreement with a bank or other financial institution offering the service. These institutions offer many different services and terms, so check around before signing an agreement. Talk to your banker, other merchants, or your local Small Business Development Center for some ideas. Or, if you have a newly registered business, look in your mailbox. The financial institutions will find you!

## Managing Accounts Payable

The final component of the cash flow cycle is how long it takes to pay your bills. This is the part of the cycle you should try to extend, but only within reason! You don't want to become delinquent on your bills, but you don't need to pay too quickly either.

Using a ratio to monitor this process is more difficult than for inventory or receivables, because your suppliers are likely to offer a wide variety of credit terms. However, you may find it helpful to compute the average time to pay for purchases.

Average time to pay for purchases:

$$365 \text{ days divided by } \frac{\textit{Total purchases}}{\textit{Average accounts payable}}$$

Blodgett Brass has the following ratio:

$$365 \text{ days divided by } \frac{5{,}100{,}000}{490{,}000} = \text{about 35 days}$$

Do your suppliers offer cash discounts for early payment? Should you pay early enough to take the discount? These points were discussed in relation to accounts receivable; everything said there is now true for you, but from the customer's perspective. You have to balance the advantage of taking the discount, versus the disadvantage of giving up the money sooner.

A **tickler system** is very helpful in controlling payments to creditors; it sorts bills according to the date they're due. Ideally, you'll pay bills when they're due (or, if you want a cash discount, just at the end of the discount period).

## Internal Controls for Cash

**Internal controls** help safeguard assets, and ensure the accuracy of financial information. Internal controls are not meant simply to guard against theft and embezzlement. They also reduce the number of honest errors, help locate errors before it is too late to fix them, and help employees operate efficiently.

Internal controls help your business safeguard its assets

The objectives of internal controls for cash include:

1. Ensuring that all cash that should have been received was indeed received, deposited, and recorded properly.
2. Ensuring that all cash disbursements were authorized and properly recorded.
3. Ensuring that cash balances are secure and adequate.

Review checks carefully before you sign them!

### Authorization

Every business transaction must be authorized by someone. For cash, this is usually accomplished by having authorized check signers. Your bank maintains a signature card that must be signed by all persons whom you've authorized to sign checks. Usually, the business owner will be an authorized check signer, but it is important to have additional people on the signature card in case the owner is unavailable.

Many businesses require dual signatures on checks above a certain amount. For example, the business may require two signatures on checks greater than $5,000, and on all checks to owners and employees.

Check signers should carefully review what they sign. Many cases of embezzlement occur because the business owner simply signs anything the accountant puts in front of him or her, without reviewing the information. Checks to be signed should be presented with supporting documents attached. Examine the invoice and compare amounts, payee, and dates before signing the check. If you don't recognize the payee, ask questions or look at your authorized vendor list.

Businesses that issue many checks sometimes use computer-generated signatures or a check-signing machine. In such cases, internal controls must safeguard the use of the computer program or check-signing machine so that no unauthorized persons have access. Having a machine sign the checks for you does not reduce your responsibility to review supporting documents.

*As soon as Amelita arrived, Terry confronted her with the stack of overdue bills. Amelita described this as "a nagging cash flow problem." She explained that payments from some of the customers, and some of the artists, lagged behind the due dates of the bills. As a result, the money usually wasn't available until the bills were past due.*

*Amelita assured Terry that when this had happened in previous months, all the bills had eventually gotten paid, but that it was getting to be quite a balancing act.*

*"You mean this has happened before? Why didn't you say something about it?" demanded Terry.*

*"Actually, I did. More than once. In fact, I tried to tell you just two days ago, but you got a phone call and then ran out the door."*

*"You could have told me when I got back."*

*"I've been trying to tell you about it for six months! But the minute I bring business questions up, you just turn your ears off. It makes my job pointless, and I was thinking of resigning."*

*Terry felt very upset. She was torn between being angry at Amelita, and worried about what she would do without her.*

### Reconciling Bank Accounts

Businesses must reconcile their monthly bank statements with the cash balance on the books. Too often, this internal control is put off until the task becomes so burdensome that it's dismissed forever. If it doesn't get done for several months, mistakes are harder to find and the whole process becomes very frustrating.

Reconciling items is often simply a matter of timing. Deposits in transit are deposits you made that have not yet been posted by the bank. Outstanding checks are those that have not yet been cashed by the payee. You've already deducted these amounts from your cash balance, but they haven't yet been taken out of your account by the bank. Service charges may also be a reconciling item, as the business often doesn't know the amount of the charge until it receives the bank statement.

Your banker can help you develop a bank reconciliation form. In fact, many banks include a form on the back of the monthly bank statement. A particularly useful method is to reconcile both the bank balance and the balance per books to the correct amount of cash. Here is an example of a bank reconciliation in this format:

| **Blodgett Brass Company<br>Bank Reconciliation<br>March 31, 2009** | | | |
|---|---|---|---|
| Balance per bank statement | $3,500 | Balance per books | $2,900 |
| Deposits in transit | 490 | Service charge | (15) |
| Outstanding checks | (1,075) | Error recording check | 30 |
| **Correct cash balance** | **$2,915** | **Correct cash balance** | **$2,915** |

This format is useful because it indicates the correct amount of cash. This is the cash balance that should be included on the balance sheet. In this example, the business must adjust its books for the service charge of $15 and the error of $30.

Bank statements should be mailed directly to the employee responsible for reconciling them. Other personnel, especially those charged with writing checks or keeping the accounting records, should not have access to the statements.

### Segregation of Duties

Segregating duties is a very important internal control for cash. The goal is to have different people performing authorization, recording, and custodial functions. Do not permit one employee to handle a transaction from beginning to end. In particular, the person who handles the cash should *not* be in charge of recording the amounts in the books.

Do not permit one employee to handle a transaction from beginning to end!

Here are some ideas for segregating duties in a business with plenty of people to cover all the tasks. Most small businesses don't have the luxury of going to this extreme, but you can use this model to help you segregate the tasks as much as possible.

| | |
|---|---|
| ***Segregation of duties for cash sales*** | |
| Handles central cash register | Person 1 |
| Closes register and prepares cash report | Person 2 |
| Prepares deposit slip | Person 1 |
| Makes deposit and compares slip to cash report | Person 3 |
| ***Segregation of duties for checks received in the mail*** | |
| Opens mail and makes a list of checks received | Person 4 |
| Prepares deposit slip | Person 5 |
| Updates accounts receivable records | Person 6 |
| Compares the information from Persons 4, 5, and 6 | Person 7 |
| ***Segregation of duties for cash disbursements*** | |
| Prepares checks | Person 8 |
| Signs checks and reviews supporting documents | Person 9 |
| Mails checks | Person 9 or 10 |
| ***Segregation of duties for bank reconciliation*** | |
| Prepares bank reconciliation | Person 11 |
| Reviews bank reconciliation | Person 12 |

### Physical Controls

Cash is easy to lose, so you must take steps to safeguard it. This includes controls for unused checks and cash on hand. Storing cash in a safe is a good idea, but be sure to control access to the safe combination, and how money is placed into and taken out of the safe. There's safety in numbers, so you should have more than one person present when cash from the safe is handled.

An even better physical control for cash is timely deposits. Banks have made it very easy for their customers to deposit cash daily, with special merchant windows and night deposit boxes. Bank deposits should be made by the business owner or a trusted employee (or, even better, by two employees together).

It's very important to safeguard unused checks!

It's important to safeguard unused checks. Leaving the company checkbook in an unlocked desk drawer is absolutely unacceptable! Lock checks in a desk or safe, and allow access only to authorized check signers or the person who prepares the checks. Checks should be pre-numbered, so you can account for every check in the series. Voided checks should be defaced so they can't be used again.

### Controls for Cash Registers

Cash registers can be very valuable internal control devices. Remember, you have good internal control when there is a third party involved in the transaction. When cash registers are used, the customer can see the prices of items being purchased, and review the total sale and change given.

Electronic point-of-sale systems that use scanners can also help to eliminate mistakes or theft, as long as prices are entered correctly in the system.

When there are cash shortages or overages, be sure to identify who had responsibility for the register at the time. Not only is there concern about theft, but such situations may indicate that additional training is necessary, or that your procedures are flawed.

When there are too many hands in the till, reconciling shortages or overages becomes very difficult. The best solution is to have one person assigned to each cash register, with no other employee authorized to use that register, but this is seldom possible. Many companies use employee identification numbers that are logged into the register before use, and make a point of providing a new cash drawer at the beginning of each shift. In any case, it should be made very clear to employees who has authority to operate the cash register and who does not.

In addition, some employers use surprise cash counts to test if internal controls over cash registers are appropriate and whether employees are following those controls.

*Terry was feeling very confused. Everything had always worked out for her in the past! The only thing that had changed was Amelita, so it seemed clear that the problem was with Amelita's work ethic, not Terry's.*

*On the other hand, Amelita was an old and dear friend, and Terry didn't want to lose her friendship her by blaming her for the problems at Glazing Around.*

*In the end, Terry sought advice from her sister Ruth, who had just returned home after the end of spring semester at the state university where she was working on her MBA.*

*Once Ruth had heard Terry's story, she said, "I hate to tell you this, but you've broken every basic rule in starting up a small business."*

*"But I hired Amelita to handle all this stuff! If the accounting is messed up, wouldn't you assume it was the accountant's fault?"*

*Ruth sighed. Terry had a lot to learn, and it was going to take a lot of teaching.*

*A couple of hours later, Ruth and Terry agreed that Ruth would analyze the business from top to bottom, and get it set on the right track—she would do everything from preparing marketing and business plans, to finding a good CPA. In return, Terry would pay Ruth for her time, and let her use the situation with Glazing Around for her thesis.*

## NxLEVEL® TECH TIP

BUSINESS RESOURCES AND THE WEB

**Pulse** is an online cash flow management program designed for small businesses. It allows you to monitor and visualize your data on a daily, weekly, or monthly basis. You can also organize your income and expenses by project. You can try it free for 30 days by visiting **pulseapp.com**.

**MathWiz** is a versatile, easy-to-use financial calculator with spreadsheet-style input for cash flow analysis, amortization, and loan repayment schedules. MathWiz's financial functions include net present value (NPV), future value (FV), internal rate of return (IRR), payment amount, periods, and payback.

The system includes multi-term amortization tables, calendar date calculations, and trigonometry and basic math functions. Other features include roll-back, cut and paste, save, and a "paper tape." You can download a trial version at **www.informatik.com/math.html**.

## Preparing Cash Flow Projections

There are many different types of budgets, including budgets for sales, cost of goods sold, and operating expenses. These budgets serve as the basis for a budgeted income statement, a balance sheet and—most important of all—the cash budget (also known as **cash flow projections**).

The information comes from the other budgets, but is organized so that cash is highlighted. Preparing a cash budget can help you anticipate cash shortages or plan for using excess cash.

Cash flow projections reflect cash coming into and going out of your business

Cash flow projections are often confused with the income statement. Remember that your income statement may reflect the accrual basis of accounting, whereas cash flow projections reflect cash coming in and going out.

It is important to understand the difference between the **statement of cash flows** (an accounting statement) and your cash flow budget.

The statement of cash flows and the cash flow projections are presented in different formats: the statement of cash flows generally shows what happened in the past, while the cash flow projection is concerned with the future.

### Timing of Collections and Payments

Here's an example of cash flow budgeting for Pat's Machine Shop. The format is the same as that found in the workbook that accompanies this text.

| Months | January | February | March | Qtr Subtotal |
|---|---|---|---|---|
| **(A) Beginning Cash Balance** | $25,000 | $12,840 | $2,469 | $25,000 |
| | | | | |
| **Cash Receipts** | | | | |
| Cash Sales | $30,000 | $31,800 | $36,600 | $98,400 |
| Collect Accounts Receivable | | | | |
| Within discount period | $12,740 | $13,504 | $15,543 | $41,787 |
| After discount period | $5,000 | $5,300 | $6,100 | $16,400 |
| Collected in following month | $1,550 | $1,600 | $1,696 | $4,846 |
| Sales of Fixed Assets | | | | |
| Miscellaneous Income | | | | |
| **(B) Total Cash Receipts** | **$49,290** | **$52,204** | **$59,939** | **$161,433** |
| | | | | |
| **Cash Disbursements** | | | | |
| Cash Purchases (Merchandise) | $12,450 | $12,900 | $14,850 | $40,200 |
| Pay Accounts Payable | | | | |
| Labor Expenses | $38,695 | $38,695 | $38,695 | $116,085 |
| Owner Withdrawals | $1,500 | $1,500 | $1,500 | $4,500 |
| Non-Labor Expenses | $4,605 | $5,280 | $4,405 | $14,290 |
| Purchase of Fixed Assets | $250,000 | | | $250,000 |
| Debt Payment - Old | | | | |
| **(C) Total Cash Disbursements** | **$307,250** | **$58,375** | **$59,450** | **$425,075** |
| | | | | |
| **Net Cash Flow (B-C)** | **($257,960)** | **($6,171)** | **$489** | **($263,642)** |
| | | | | |
| **Adjustments to Cash Flow** | | | | |
| (+) New Debt | $200,000 | | | $200,000 |
| (+) New Owner Investment | $50,000 | | | $50,000 |
| (-) New Debt-Interest Payments | ($1,500) | ($1,500) | ($1,500) | ($4,500) |
| (-) New Debt-Principal Payments | ($2,700) | ($2,700) | ($2,700) | ($8,100) |
| (-) New Owner Withdrawals | | | | |
| | | | | |
| **(D) Adjusted Net Cash Flow** | **($12,160)** | **($10,371)** | **($3,711)** | **($26,242)** |
| | | | | |
| **Ending Cash Balance (A + D)** | **$12,840** | **$2,469** | **($1,242)** | **($1,242)** |

In this example, the worksheet for Pat's Machine Shop breaks sales into two parts: sales made for cash, and sales made on account. This reflects the delay between making a sale on account and collecting the cash.

Pat's offers credit customers terms of 2/10, net 30. If customers pay invoice amounts within 10 days, they receive a 2% discount off the invoice amount. Otherwise, the entire amount is due within 30 days. Amounts owed after 30 days are past due. In this case, it is necessary to estimate what percentage of customers will pay in time to earn the discount.

Pat's has estimated that 60 percent of sales are for cash, with the remaining 40 percent on account. The historical collection pattern for sales on account is as follows:

| | |
|---|---|
| Customers paying within 10 days | 65% |
| Customers paying after 10 days but within 30 days | 5% |
| Customers paying after 30 days but before 60 days | 8% |
| Customers not paying at all | 2% |

Historical patterns are often used to forecast cash collections. Any discounts allowed are subtracted from projected sales dollars, as are any bad debts expected. This determines the amount of expected cash collections.

We must also consider potential discounts in relation to accounts payable. Pat's has a place in the budget for cash purchases and purchases on account. However, in this example, all his purchases used cash, and therefore only one line is needed in the cash flow projection. If it's significant, consider the timing of your payments, and any discounts you expect to receive.

### Operating Expenses

In general, your cash flow projections include the same operating expenses shown on your operating expenses budget and your budgeted income statement. Depreciation expense is an exception. We include this on the budgeted income statement because we are trying to allocate the cost of long-lasting assets over time. However, depreciation expense has nothing to do with cash, so it doesn't belong in the cash flow projections.

### Owner Withdrawals

One aspect of cash flow projections that small business often miss is **owner withdrawals** from a sole proprietorship or partnership. If you have other sources of support, it may be an acceptable budget assumption that you will not withdraw cash from the business. However, if the owner needs cash withdrawals to provide personal income, these must be included in the cash flow projections worksheet.

If you don't budget any compensation for yourself, you might not get any!

Many small businesses fail in part because the owner underestimated or did not anticipate personal cash requirements. Budgets have a way of coming true, so if you don't budget any compensation for yourself, you might not get any!

### Borrowing and Cash Balances

The cash flow projections worksheet has a place to record anticipated new borrowing and payments on debt. Notice that in January, Pat's plans to buy some new equipment. The purchase is shown as a cash outflow, and the money borrowed from the bank as an inflow. This format makes it easy to see whether the business will generate enough cash to repay its loans. (Don't forget to budget interest and principal payments.)

Pat's has a negative cash balance projected for the end of March. Armed with this information, he can take steps to prevent the problem. Perhaps he will have to forego his withdrawal, postpone some purchases, or borrow on a line of credit at the bank.

You may need to consider minimum cash balance requirements. Some businesses have a policy of not letting their bank accounts dip below a specified dollar amount. You may have balance requirements established in a loan agreement. Look at the ending cash balance for each month of the cash projections and consider whether minimum cash balances will be maintained. If not, look for ways to bring additional cash into your business.

### Assumptions

Remember that these are just estimates. Simplifying assumptions is acceptable! If your business experiences very few bad debts, you might wish to ignore these in your forecasts. When you make assumptions about your projections, be sure that they are reasonable and document them in writing. This is helpful when explaining your projections to outsiders like your bankers and investors, and allows you to remember why you used a particular number. Later, you should compare your assumptions with what actually happened to see if you must alter your assumptions for future cash budgets.

Be sure that your assumptions are reasonable, and document them in writing!

### Evaluating Alternatives

Cash flow projections are very useful when evaluating alternatives for your business. This is especially true of projections made using a computer spreadsheet program. You might wonder, "What if we were able to increase our sales by 15 percent next year?" Adjust your sales and expenses accordingly and put the new estimates in your cash flow projections worksheet to see the effect on your cash position.

*Ruth had been searching for a good subject for her thesis, and now she knew she had found it: she would write a case study on how to re-engineer a small business and optimize its operations.*

*The next day, Ruth arrived early at Glazing Around. Within minutes of conferring with Terry and Amelita, Ruth realized that Amelita cared about her job, but had become discouraged. It was easy to understand how this had happened: Terry had brushed aside every approach Amelita had made to her about finances, because finances weren't art, and art was what Terry cared about, to the detriment of every other aspect of her business.*

*Without Ruth having to say much, the full realization of things hit Terry hard. She felt guilty. She had let down her artists and her customers. And she had put her friend Amelita in an untenable situation by not involving herself in the day-to-day operation of her business.*

*She immediately apologized to Amelita, and promised that she would start getting involved as of that very day.*

### Managing Excess Cash

Surplus cash is cash that is not required to meet current obligations. Many businesses have a targeted or minimum cash balance that they feel they need to conduct daily operations and as a precaution against the unknown. If you find your cash balance exceeds this minimum, there are several things you should consider before investing those funds:

What should you do with your excess cash?

- Is this a temporary surplus, or is this amount continually available?
- What financial requirements are coming, and when? Income taxes? Employee bonuses? Balloon payments on debt?
- How much of a risk are you willing to take with this money?
- How much time are you willing to devote to managing this cash?

The first two questions address the issue of **liquidity**. Liquidity means the ability to convert an investment back into cash easily. Do you need an investment that allows you to withdraw the funds quickly? Sometimes you can anticipate when you will need the cash. For instance, if you know that you will have a big tax bill to pay in March, you can choose an investment that allows withdrawal at any time, or that expires by March.

*Investment risk*

Every investment has some element of risk, but some have more than others. The amount of risk you wish to take determines what type of investment is right for your excess cash. Risks investors take include:

- **Default risk** is the risk that the issuer will be unable to make interest or principal payments on schedule.
- **Liquidity risk** is the risk that the investment cannot be sold at a reasonable price on short notice.
- **Return risk** is the risk that the market price of the investment will go down.

Of course, there's a drawback to buying investments that have relatively little risk: reward and risk are inversely related, so investments with less risk will yield smaller returns. If you want a greater return, you usually have to accept more risk.

*Common investing strategies*

It's important to consider whether your excess cash is temporary or permanent, because short-term and long-term investing strategies differ. Long-term investments may include expanding your business or buying another one. Other chapters in this book discuss these options, so short-term investments will be discussed here. In all cases, you should consult your banker and investment counselor for advice.

Here are some of the most common investments on the market:

- **Interest-bearing accounts.** Many banks offer money market and other business bank accounts, which pay interest at a rate higher than savings accounts. Although these accounts may not yield the highest return on your investment, they are generally safe, liquid, and very easy to arrange.
- **Certificates of deposit (CDs)** usually pay a slightly higher interest rate than a bank account, but you give up some liquidity. They are sold with a fixed term, and there is a penalty charge for early withdrawal. This investment may be appropriate when you have surplus cash for a known period of time.
- **Government securities.** Treasury bills sold by the United States government have maturities of 91 days, 182 days, or one year. However, there is a ready market for T-bills, so they can be sold with as little as one day remaining to maturity. The safety of this investment means the interest rates are relatively low. The federal government also issues Treasury bonds, which have maturities of three to five years. They are considered more risky than T-bills, and may be less appealing for a short-term investment. Last, many state and local governments issue bonds, which pay interest that is not subject to federal income tax. Municipal bonds carry lower interest rates because of this tax advantage.
- **Commercial paper** comprises unsecured short-term promissory notes issued by large corporations, like Ford Motor Credit Corporation. The maturity is usually 60 days or less, but the minimum investment can be very high. It's not easy to sell commercial paper once you have it, so you should plan to hold it until maturity. Interest rates on commercial paper reflect the fact that the investment is unsecured, and the borrower is not the federal government. Accordingly, interest is higher than that for T-bills.
- **Money market funds.** These funds pool the resources of many investors and purchase short-term securities, such as T-bills, CDs and high-quality commercial paper. A fund allows the investor to diversify holdings without having to buy each investment individually. The fund shares are liquid and easily obtained, often without a commission.
- **Mutual funds.** These operate like the money market funds described above, except that they invest in stocks, bonds, or some combination thereof. Some are very large and invest only in fairly safe securities. You can also find highly specialized funds that invest exclusively in a certain industry or in growing companies. The relative risks and rewards of these funds vary; you will need to do some research before choosing one. Mutual fund share prices are subject to market swings, so you should be careful to choose one that matches the risk you are willing to take.

Due diligence is mandatory when assessing investment opportunities

- **Socially responsible investing.** Some businesses choose investments that will help the environment, or give something back to the community. Although such investing does not necessarily deliver a lower rate of financial return, and in some cases may be safer or more profitable than a traditional investment, some entrepreneurs are willing to accept lower returns because of the emotional satisfaction involved, while others are more focused on the goodwill such investing generates among their customers. Renewable energy is a popular area for investment, as is **appropriate technology** geared to the needs of the developing world (e.g., water purification technology, or solar ovens). Microfinance—which makes start-up capital available at fair interest rates to disadvantaged entrepreneurs in the United States and the developing world—is another popular option, not least because microfinance loans have a very high rate of repayment.

## NxLEVEL® GREEN TIP

ENVIRONMENTAL BUSINESS RESOURCES

If you're interested in green or socially responsible investing, here are some links that will provide more information on your options. As with any other investment opportunity, you should perform due diligence before investing in a green business or mutual fund.

**GreenMoney Journal** (www.greenmoneyjournal.com) has focused on green and socially responsible investing since 1992. They offer a free quarterly e-newsletter.

**Green Collar Economy** (www.greencollareconomy.com) maintains a list of green mutual funds at **www.greencollareconomy.com/Green-Directory/Capital/Green-Mutual-Funds**.

**Social Investment Forum** (www.socialinvest.org) is a US national nonprofit membership association for professionals, firms, and organizations dedicated to advancing the practice and growth of socially responsible investing (SRI), which assesses environmental, social, and corporate governance criteria in addition to standard financial analysis.

**Social Funds** (www.socialfunds.com) features "over 10,000 pages of information on SRI mutual funds, community investments, corporate research, shareowner actions, and daily social investment news."

*By the end of the summer, Glazing Around was in healthier shape. Terry was now making a point of being involved with the business on a day-to-day basis. At first, she had to force herself, simply because she'd promised she would. But before long, she came to enjoy it. She liked knowing how her business was doing; it was a source of pride to her. She also discovered that there is an art to running a business the right way!*

*Ruth's marketing plan had helped to secure a grant from a foundation that was interested in supporting women in arts-based businesses. This gave Glazing Around the operating funds it needed to improve its cash flow, buy more kilns, and add space for more artists in the studio. Meanwhile, the establishment of incentive payment terms for artists and customers optimized revenue generation. Late payers were reduced to less than five percent of accounts receivable.*

*Also, Glazing Around took advantage of similar terms from vendors and suppliers on accounts payable. According to Ruth's new cash flow projections, the business realized a 35% increase in its average liquidity from this change alone.*

*Soon, the business had paid off its creditors. Sales were up and morale was high. It was funny how easy things suddenly seemed! Terry had always believed in shortcuts; she liked saving time and saving money. Now, there were no more shortcuts. She was spending extra money on accounting, and taking extra time to do things the right way. And oddly enough, there seemed to be more money available, and things were moving faster and more smoothly than ever before. As Ruth put it, "You get where you want to go much faster by moving slowly in the right direction, than by speeding in the wrong one!"*

*On the day Ruth left Glazing Around to go back to school, Terry, Amelita, and all of the artists gave her a round of applause. After Ruth left, Terry and Amelita sat down to review accounts receivable before Terry glazed a magnificent new vase. It would look great in a new show that she was putting on after Labor Day!*

## Conclusion

If cash is the lifeblood of business, then consider yourself the doctor. Give your business a check-up by doing cash flow projections, and prescribe ways to make it healthy by managing the cash flow cycle.

The importance of these procedures can't be overemphasized. If you don't pay attention to cash flow, the long-term prognosis for your business is poor!

# Part IX
# Financing Your Business

## Chapter 39
## FINANCING YOUR BUSINESS

*About This Chapter:*
- *Identifying your financial needs*
- *Debt or equity?*
- *Preparing to seek financing*
- *Creating a financing proposal*
- *The Cs of credit*
- *Developing a good banking relationship*

### Introduction
One of the most common reasons given for the high failure rate of small businesses is lack of adequate **capital**. Capital is any asset that a business uses to create value and generate profits, including financial resources, equipment, and even employees.

**Working capital** describes a business's most liquid asset, cash. This is the type of capital that growing businesses usually lack. Obviously, a business can't survive without cash to pay for people, equipment, supplies, and other expenses.

All business owners need to know how to obtain capital. It is rare indeed that a business does not need additional capital to grow!

A business can't survive without cash!

### Identifying Your Financing Needs
Why do you need financing? Are you planning a new venture, just getting started, expanding a successful venture, or managing a business that has matured? This section describes typical reasons why businesses seek financing.

#### Research and Development Money
Small business is the source of many innovative products and services. But to research and realize innovative ideas, an entrepreneur may need **seed capital** or **pre-venture financing**. This type of capital can fund market research, technical research, strategic planning, and product development. Early-stage funding is usually too risky for lending institutions, so it's generally provided by business owners, investors (and, in some cases, by local, state, or federal government, in the form of a loan or grant).

#### Start-Up and New Growth Financing
Start-up costs include professional fees, inventory, equipment, deposits, marketing materials, and working capital. Growth-related costs might include upgrading equipment

to expand capacity, compensation for additional employees, research and development for new products, bulk purchases of supplies or inputs, or additional working capital to support larger orders with longer payment terms.

### Purchasing a Business

Some entrepreneurs elect to buy an existing business or a franchise. In addition to start-up costs, such items as **goodwill** must be financed. Goodwill might include an established brand name or a favorable location. It may also include expertise, or knowledge possessed by the people within the business. An entrepreneur who buys an existing business usually finances only the portion of the purchase price that is linked to tangible assets like equipment, inventory, or buildings. Goodwill is usually financed by the owner under a separate financing contract, or by the purchaser in cash.

### Working Capital

One of the most common reasons small businesses fail is an inability to anticipate working capital requirements. Often, small businesses suffer from a disproportionate level of cash versus fixed assets, so they depend on daily receipts to meet operating expenses. If income from sales slows, creditors may force the business into bankruptcy. If the business grows too fast, and has cash flow problems, it may suffer the same outcome.

Seasonal working capital is used to cover seasonal fluctuations in expenses

- **Seasonal working capital** is used to cover seasonal fluctuations in expenses. Often, the demand for a business's products varies from month to month, and season to season. Ski resorts, which rely on the winter months to generate all their revenue for the year, are a good example. During the summer, ski resorts must overhaul their equipment and groom ski slopes, which means they have many expenses but little revenue. Such businesses often require seasonal financing to supplement working capital.
- **Permanent working capital** is funding that a business requires on a regular basis to cover such expenses as payroll, debt repayment, utilities, marketing campaigns, and rent. It's rare that a business can fund its expansion solely from its own profits. Usually, it must increase its working capital with outside financing of some sort.

Loans for seasonal capital are usually paid back within one year. Permanent capital loans are financed as term loans, and repaid over several terms or years.

Your business may need both. Take a look at your sales records for the past year or more. Are there seasonal fluctuations in revenue? Do you have different levels of expense at different times of the year? Differentiating between permanent and seasonal working capital needs will help you to calculate how much money your business needs.

Choosing flexible forms of assets, like renting property and equipment instead of buying it, allows a small business to keep more of its capital liquid.

### Equipment Acquisition

A business's existing equipment can serve a limited number of customers, so expansion often means buying new equipment. Commercial banks usually provide this type of loan.

### Real Estate Acquisition

Suppose an established restaurant operates in a building it has leased for 15 years. The owner of the building decides to sell, so the restaurant owner buys the building to ensure long-term use of the business site. This is a typical example of real estate acquisition.

*In 2008, at age 18, Michael Quinn became one of the youngest firemen in San Francisco Fire Department history. An ambitious fellow, he soon signed on for additional training, and earned a seat as the Emergency Medical Technician (EMT) on his engine team. Mike was often first at the scene of an accident, evaluating injuries and administering first aid.*

*Mike routinely stabilized injured people for transport to the nearest hospital. In his first year, he stabilized over 150 people for spinal cord and neck injuries, using a temporary neck brace called a C-collar. Mike felt that these collars were poorly designed. They came in only three sizes, and in the hustle and bustle of the accident scene, he and other EMTs often made mistakes in estimating the size of the injured person's neck. Frequently, they had to fit and refit collars until they found the proper size. And each time they removed and refit a collar, the potential for additional injury increased.*

*Mike knew there had to be a better way. And then one day, the idea struck him: What if he used his expertise to design a better C-collar?*

## Debt or Equity?

Businesses can be financed by either debt or equity, each of which has advantages and disadvantages.

### Debt Financing

**Debt** is a direct obligation to pay an asset (usually money) to a creditor who supplied your business with an asset. The creditor expects to be paid interest on the debt. The amount of debt payments depends on the amount borrowed, the length of the loan, and the interest rate.

**Short-term loans** are for less than one year. These are almost always seasonal working capital loans. The most flexible form is called a **line of credit**. It allows the entrepreneur to borrow money as needed, up to an approved limit. This is like having a credit card that expires in a year, but with a much lower interest rate. As funds are repaid, the line of credit is replenished and the funds can be borrowed again.

**Tips for Financing Your Business**

- The more assets your business requires, the more financing it will need. Likewise, the more rapidly sales grow, the greater the asset requirements.
- Always finance your business's growth so that you maintain an appropriate level of cash, cash-equivalent assets, or financial liquidity. You can measure the level of your liquidity using the **current ratio** (current assets divided by current liabilities). Set a target ratio that your business must maintain. A current ratio of 2 means that your business has twice as much current assets (like cash) as current liabilities.
- The amount of equity you have invested limits the total amount of debt your business can carry. Banks and other sources of financing expect any outside financing to be matched by owner's equity.
- Internal and external sources of equity are available to your business. Equity initially comes from the owner's investment in the business. This is known as **external equity** because it does not derive from business operations. **Internal equity** arises from the business's profits being reinvested in the business.

**Intermediate-term loans** are for three to seven years, and are used for permanent expansion of working capital, or to acquire equipment. The loans are generally at a fixed interest rate, and may include a penalty for early repayment.

Long-term loans are for ten or more years, and are usually for real estate transactions or high-value equipment purchases. These loans are generally at a fixed interest rate, although variable rate loans may be available.

Virtually every small-business loan through a bank is a secured loan

Virtually every small-business loan through a bank is a **secured loan**. This means that the business, or the business owner, has pledged assets as **collateral** for the loan in case the business is unable to repay its debt. An **unsecured loan** simply means that no collateral has been pledged. People most often obtain unsecured loans from family or friends.

### Equity Financing

**Equity** involves no obligation on the part of the business to repay money. However, the individual supplying the money becomes an owner or an investor in your business.

If your business is a partnership, then the person or group who has invested in your business becomes either a general or a limited partner, and has rights as negotiated and outlined in your partnership agreement.

If your business is a corporation, the investor becomes a holder of either common or preferred stock in the business, and can exercise the powers of a stockholder as defined in your bylaws. Preferred stockholders receive any dividends (a percentage of profits) paid by the business before common stockholders.

### Pros and Cons of Debt and Equity

Whether you'll seek debt or equity financing, or a mix of the two, depends on a number of variables. Here are a few of the issues you should consider.

How do you decide between debt and equity financing?

*Ownership*

If you use equity to finance your business, you grant the investor a share of future profits, and the ability to exercise some control over business operations. This loss of control is permanent, unless you have negotiated a **buy-out clause** that allows you to buy the shares back from the investor at an agreed-upon price. In the best cases, the right investor can provide the business with additional management expertise.

An owner may lose control under debt financing if the loan agreement contains restrictive covenants, such as limitations on payment of dividends and salaries, or a required minimum level of inventory. This issue here is weighing your need for additional capital against your desire to control the business you started.

*Obligation to repay*

Debt financing places pressure on the business to make scheduled loan payments to repay principal and interest. An expanding company may have difficulty meeting these obligations.

*Tax considerations*

The interest portion of a loan payment is tax deductible, but the principal portion is not. Dividends paid to any owners, including passive investors, are not tax deductible.

*Capital structure*

**Capital structure** is the mix of debt and equity financing that a business uses to fund its base of assets. Equity is a permanent source of funds, while debt is always temporary. Acquiring equity financing also increases the asset portion of your business's balance sheet. It need not be paid back, because it's not a debt.

The higher the percentage of debt financing your business uses, the greater the monthly payments you must make to repay that debt. This increases the risk that your business's cash flow will not be adequate to meet debt payments.

Carefully managed debt can carry many benefits, most notably financial leverage. Leverage exists as a result of the fact that interest payments, or the interest expense of debt financing, is a fixed cost agreed upon at the outset of the debt contract (e.g., a fixed rate term loan, equipment loan, or mortgage). It is held steady over time, while the business's operating income may rise. This means that the business has the borrowed funds at its disposal to invest, producing a greater return than what it must pay on its debt. In this positive scenario, the business benefits.

Unfortunately, if the business operations are not as profitable as forecasted, the business will earn a lower return and have difficulty meeting its fixed debt obligations. The banking crisis that unfolded in late 2008 and early 2009 illustrates this problem.

*Industry*
Every industry defines a given **debt to equity ratio** (D/E) as standard or acceptable. Creditors are reluctant to provide debt financing to businesses with D/E ratios outside this range. Talk to your banker, accountant, or local Small Business Development Center representative to determine the norm for your industry. Both creditors and investors will have their own ideas about how much risk is associated with your business. Risks specific to your business may also include geographic and technological considerations. See Chapter 44 *Financial Management* for more information on this topic.

*Cost of proposal*
Any business that is seeking financing of any kind (including financing from friends and family) must prepare a **financing proposal**. No matter how great your business idea is, and how certain its success, no business speaks for itself. A financing proposal communicates your business's financial position, the quality of its management, and the degree of risk it offers lenders and investors.

You should consider obtaining assistance with the preparation of financial statements and projections, the preparation and review of legal documents, and research for marketing and technical information.

The cost of these services varies a great deal, depending on where you live and the amount of assistance you need. Get help from your lawyer, CPA, SBDC, or business consultant.

When obtaining debt capital, you may not need legal services until it's time to sign the loan agreement. Before searching for prospective investors, meet with your attorney to verify that you are in compliance with state and federal securities regulations.

*Owner preferences*
If you want to retain absolute control over your business, you may have a difficult time working with an investor. On the other hand, if you see advantages to having another voice in management, you may welcome an investor who brings both money and talent to the business.

If you want to retain absolute control over your business, you may have a difficult time working with an investor

Raising equity capital requires good sales and communication skills. You are selling your business's promise of profitability, and selling yourself as a qualified manager of your business.

Before pitching your business, take stock of yourself. How will growth in your business affect your personal goals, your family, your employees, and your current customers? Are you prepared for the responsibilities of a larger business? Remember: Change, both good and bad, is inevitable during periods of high growth.

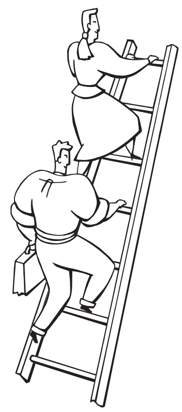
*Lending community and prospective investors*
Can your business really service additional debt? If not, equity financing may be the best alternative. If equity seems like an attractive option, can you offer an attractive rate of return to an investor? You'll need to test the reaction of prospective investors.

*By April of 2009, Mike and a friend, who was an engineering student, had made a sample of what they called the Quinn Collar. The changes they made to the basic design of the emergency C-collar were few, but critical. Instead of coming in three different sizes, the Quinn Collar was adjustable. They also found a source for recycled foam and other materials, to make the collar more environmentally friendly.*

*Mike tested the idea on ten other EMTs he knew in various engine companies throughout the city. He spoke with a friend who was a neck and spinal cord specialist, and incorporated his feedback. Once again, a few minor adjustments were made and everyone felt that the collar was a remarkable breakthrough.*

*Mike's engineer friend was able to make test models of the new collar, but needed more time and expert assistance to create a design for mass production. In the next several months, they borrowed $2,000 from family members to pay attorney fees for patent protection.*

*Next, they enlisted the help of Mike's girlfriend, a recent graduate of business school, to help them write a business plan. They had a bankable idea, but they needed help and money. The three of them decided to form a partnership, and began calculating the amount of capital they would need to launch and grow the business.*



Your NxLeveL® Business Plan is the starting point for seeking financing

## Preparing to Seek Financing

A comprehensive business plan is the starting point for preparing your financing proposal. Preparing a complete business plan enables you to predict your financing needs in advance, instead of approaching your banker each time a need arises. Helping you to prepare these documents is one of the primary purposes of this book.

### Determining How Much You Need

There are two important things to consider when determining how much funding to request. First, the amount you request depends on how your business will use the funds, and the type of collateral you can offer. For instance, the amount available for financing the purchase of a piece of equipment may be determined by a bank rule limiting such loans to 75 percent of the purchase price. The financing of real estate and fixed assets is usually limited by a maximum percentage of the transaction.

Determining the amount needed for permanent working capital or seasonal working capital is more difficult, since it depends on the accuracy of your financial forecasts.

Second, your cash flow projections define the amount of money you need to borrow, particularly for working capital, and demonstrate the monthly payments that the business can afford.

The number of years required to repay a loan depends on the length of financing being sought. A one-year cash flow projection may be sufficient for a seasonal working capital loan, but a five-year loan to expand working capital requires a three- to five-year forecast.

### Identifying Possible Sources of Financing

Once you have calculated how much financing your business needs, you can begin shopping for sources.

Don't approach these sources until you know your exact needs. How much money do you need? When? How quickly will you be able to repay it? Will you need additional money later? Can you leverage future commitments of business (as documented in letters from customers) to increase your business's credibility and likelihood of receiving financing from a bank?

Research lenders before you approach them for a loan!

Acceptance guidelines vary from one financial institution to the next, so try to learn about the person or organization you intend to approach, and find out what specific information they require. Many institutions specialize in business loans, and they are a good place to start your search for financing.

Here are some of the things you should find out about funding sources before you approach them:

- To whom should you submit your proposal?
- What information do they want?
- How do they make decisions about financing?
- What types of business have they previously lent to, or invested in?
- If they don't supply the funds, can they help you find other financing?
- What is the average timeframe for a loan decision?

Here are some additional questions for bankers:

- What other business services do they offer?
- Does the bank make SBA-guaranteed loans?
- Does the bank participate in other government loan programs?
- What is the handling charge on credit card receipts?
- Can they supply your business with a line of credit?

### Unconventional Financing Techniques

- **Microlending.** Microloans were originally intended for women, minorities, and low-income entrepreneurs. But in the wake of the 2008 banking crisis, microlenders increasingly serve borrowers who were turned down elsewhere.
- **Landlord financing.** Negotiate to have your landlord pay for some needed upgrades, add that to the rent and amortize it over the life of your business's lease; or negotiate free rent for a piece of the business.
- **Use other people's credit.** If you can't get sufficient credit, have an acquaintance's business buy the inventory or supplies you need, then pay the total back according to the supplier's terms.
- **Contract financing.** If yours is a service business, negotiate to have customers prepay services through one-year, all-inclusive contracts.
- **Concession sales.** If you are a retailer, sublease part of your retail space to vendors whose products complement your own.
- **Staged financing.** Look for financing in stages, starting with enough to help you get your business up and running so that you can prove its profitability.
- **Buy a business instead of starting one from scratch.** There are many ways to finance the purchase of an existing business. It is not uncommon to be able to negotiate financing from the seller for as much as 80 percent of the purchase price, or to repay the purchase price incrementally from future cash flows. It is also easier to get bank financing for an existing business than for a start-up.
- **Participate in a small-business incubator.** Many state and local governments sponsor incubators by providing below-market rent and low-cost support services to small businesses.

*Mike and his partners laid out their business objective: to market a unique, patented C-collar for the temporary stabilization of victims of neck and spinal cord trauma.*

*They would contract the actual manufacture of the collars to a medical supply manufacturer, and negotiate to have their C-collar distributed by an existing network of medical supply distributors. This would result in a lean operation that leveraged its most valuable asset: the patent on the Quinn Collar. They hoped that if things went well, a larger medical supplies company would buy the rights to the patent, or they could license the patent to many such companies.*

*They began by using common sense, educated guesswork, and industry research to calculate how much financial capital it would take to launch their new venture. They took into account sales projections for their first three years; operating expenses for years one through three; start-up costs for equipment, research, and development; attorney's fees; and marketing.*

*They also took a look at the average asset-to-sales ratio of other small medical supply businesses. With this work complete, they settled on the sum of $150,000 for their first two years of operations, assuming they achieved their target sales level of $200,000 in that period. They decided to pursue a bank loan for $60,000 of the $150,000 they needed.*

*Their calculations for their asset requirements broke down as follows:*

| | |
|---|---|
| *Cash* | *$50,000* |
| *Accounts receivable* | *35,000* |
| *Inventory* | *45,000* |
| ***Total current assets*** | *130,000* |
| *Total fixed assets (computer, office equipment, etc.)* | *20,000* |
| ***Total assets*** | *$150,000* |

## Creating a Financing Proposal

The **financing proposal** is a marketing document prepared in order to obtain capital for your business. It should educate the lender about your business, and make the lending decision easier by showing that you understand the factors that determine your business's success, and have carefully reflected on your objectives and your strategies for achieving them.

Approach your financing proposal as you would any marketing effort

You can increase your chances of obtaining financing if you bear in mind that you are selling the promise of your business. In other words, approach your financing proposal as you would any marketing effort. First, get to know the customer, then tailor your proposal so that it speaks directly to the customer's interests, concerns, and needs. You should also personalize your proposal with the name of the person receiving it, the name of the financing source, and references to the financing programs you're requesting.

Here are the specific contents of a financing proposal.

- **Cover Letter.** This is a one-page letter on business stationery, addressed to the person who will be reviewing your financing proposal. You may wish to thank the person for previous conversations, briefly describe what is in the proposal and provide a rationale as to why you should get the loan, and confirm any future appointment.
- **Summary of Financing Request.** This first page should quickly and clearly summarize the major points of your proposal. Specifically, it should cover the purpose of the financing, the amount and terms requested, the source of funds for repayment, and the collateral offered.
- **Use of Proceeds.** Your financing source will want to know how you'll use the money. This is an opportunity to highlight the amount of capital invested by existing owners, and the use of business funds.

- **Collateral** is an asset that you pledge to the lender as security for a loan. If you are seeking a secured debt, list the assets that you will use as collateral, and their current market values. (Note: These values must be based on sound reasoning.) Collateral for your loan is negotiable, so don't begin by offering every asset you own. (Skip this page if you are seeking equity financing or an unsecured loan.)
- **Investor Return.** This is your opportunity to present to the investors the financial return they can expect on their investment. You should state whether you will have an option to buy out their investment at a future date for a predetermined amount. (Skip this page if you are seeking debt financing.)
- **Business Plan.** Your entire business plan is part of your financing proposal. Also, financing sources will usually ask for supplemental information, such as tax returns for the last three years, personal financial statements for all owners, and any other information that is relevant to the business or loan request.

Your entire business plan is part of your financing proposal!

**Sample Financing Proposal Cover Letter**

Ms. Priscilla Frauenzimmer, Loan Officer
Westside Bank
San Francisco, CA

Dear Ms. Frauenzimmer:

As agreed in our recent conversation, I am presenting on behalf of my firm, Quinn Collar, a loan proposal for your consideration. We have a unique medical product that will help save lives. As explained in the body of this document, we are requesting a loan in the amount of $60,000. We propose the following repayment schedule:

(Insert proposed repayment schedule here)

The loan will be used for the following purposes:

(Insert intended application[s] here)

In support of this request, I have enclosed the following documents and exhibits:

(Insert list of enclosures here)

It is my understanding that a variable interest rate equivalent to X percentage points above the prime rate would apply to the approved loan.

Thank you for your consideration. I eagerly await your reply.

Sincerely,

Michael S. Quinn, Partner
The Quinn Collar
San Francisco, California

What will a credit check reveal about you and your business?

## The Cs of Credit

Do you know what a credit check will reveal about you and your business? If not, have a credit company perform a check, so you'll know what to expect. As a small-business owner, you should expect to have the credit check cover you and your business. You can order a copy of your personal credit history by contacting organizations like TCI Credit Bureau or EQUIFAX. Either will send you a copy of your credit report for a small fee.

Here are six factors that lenders will consider when evaluating your financing proposal.

- **Credit and financial history.** The financial history presented in your financing proposal should include your personal credit history, as well as a summary of your business's financial performance to date. Your business's financial history should include clear financial data tables and text. Include sales, cash flow, profits, and key financial ratios like the Current Ratio, the Inventory Turnover Ratio, and the Receivables Turnover Ratio (see Chapter 44 ***Financial Management*** for more information on these ratios).
- **Character.** The soundness of a small-business loan is often as dependent on the trustworthiness of the owner as on the track record of the business. Your reputation in your area is important, so you should provide excellent local business references. Be sure to ask permission before citing them as a reference.
- **Capacity** refers to your business's ability to repay the loan with cash generated from operations. Your financial projections address this concern, but bankers are also influenced by the past financial history of your business. If your business has been no more than marginally profitable in the past, but your projections are optimistic, you may have difficulties convincing a professional lender that your business will be profitable in the future. Good past performance is the major criterion by which a lender will judge your financing proposal.
- **Collateral.** If your business can't make its loan payments because of poor sales or low profits, the lender will satisfy the debt by taking title to your collateral. Most loans are secured with real estate or paper assets (i.e., stocks and bonds), but in some cases, it may be possible to use expected assets as collateral.
- **Conditions.** How will future economic trends affect your business? What steps have you taken to reduce risk, take advantage of opportunities, and overcome looming obstacles? How are similar businesses faring, and how much competition do you have? You assessed these and other issues in your business plan. Now, you should share these assessments with your banker.
- **Capital.** Are you committed to your business? The lender wants to see a commitment, both in terms of time and money. You are asking the lender to supply debt financing for your business. The banker is watching your debt to equity ratio. How will you or your business provide the equity portion of the project you are seeking to finance?

*After several months of research, Mike and his partners settled on the following projections:*

- *They'd earn $60,000 in sales the first year, and $140,000 in year two.*
- *Net profits would be 15 percent of sales ($9,000 in year one, and $21,000 in year two).*
- *They negotiated with a manufacturing contractor to extend credit on production, resulting in estimated accounts payable of approximately 10 percent of sales.*
- *Each of the three partners would invest $15,000 of his or her own money in the business, in exchange for 5,000 shares of common stock.*
- *They would approach their local bank for a short-term line of credit of $30,000, and a midterm loan of $60,000.*

**The Quinn Collar Projected Balance Sheet**
**(at end of Year One)**

| | | |
|---|---|---|
| **Assets** | | |
| Cash | $50,000 | |
| Accounts Receivable | 35,000 | |
| Inventory | 45,000 | |
| Total Current Assets | 130,000 | |
| Fixed Assets | 20,000 | |
| Total Assets | **150,000** | |
| **Debt** | | |
| Accounts Payable | 6,000 | (10% of $60,000 sales) |
| Credit Line | 30,000 | |
| Total Current Liabilities | 36,000 | |
| Long Term Debt | 60,000 | |
| Total Debt | **96,000** | |
| **Equity** | | |
| Common Stock | 45,000 | ($15,000 x 3 partners) |
| Retained Earnings | 9,000 | (15% of sales) |
| Total Debt and Equity | **$150,000** | |

*Not long after, Mike and his partners met with their banker and made their pitch. To make a long story short, they got what they wanted! In exchange for the loan, Quinn Collar agreed to the bank's two loan requirements: 1) The business's current ratio (current assets divided by current liabilities) must not fall below 1.80; 2) No more than 60 percent of the business's* *financing would come from debt (stated another way, the business's total debt versus total assets should not be greater than 60 percent). If Quinn Collar failed to meet these requirements, they would have to repay the loan immediately.*

*It had taken a while, but it was worth it. With a great idea and plenty of money in the bank, Mike and his partners were ready to revolutionize emergency response, save lives, and get rich!*

## Developing a Good Banking Relationship

The first rule of banking is to choose a banker located near your business. You will be more inclined to visit your banker, and vice versa, if he or she is local. Choose a more distant banker only if local bankers do not understand your business needs. Local banks generally have a commitment to supporting local businesses, and are therefore more receptive to local loan requests.

Here are some more tips for developing a good banking relationship.

### Select a Banker You Trust

You should feel like your banker will listen to your concerns. By the same token, you want a banker who tells you his or her concerns. It's very frustrating have a financing proposal turned down, but receive no explanation!

### Select a Banker Who is Interested in Your Type of Business

Find a banker who either has existing clients in your industry, or expresses interest in learning more about your industry. A good banker can offer you advice, and advocate approval of your financing proposal.

If your banker suggests that you modify your proposal, listen carefully. The suggestion might not work for your needs, but the banker wouldn't make a suggestion if it weren't important to the process.

If your banker suggests that you modify your proposal, listen carefully!

### Present a Complete Financing Proposal

Want to make a good impression on your banker? Make sure your financing proposal is complete the first time! The majority of entrepreneurs approach bankers with incomplete or poorly executed proposals, so this is your chance to shine.

### Tell the Truth

The financing proposal is a marketing document. It presents your business situation in a positive light based on fact. If you try to hide facts about your business, you are probably going to be unsuccessful.

Remember: The banker is looking at the capacity of your business to repay the loan. Show the banker how you will use the proceeds of the loan to improve this capacity. Disclose problems at the beginning and demonstrate how you will overcome them.

### Be Patient

Entrepreneurs think bankers take too long to make decisions, and bankers think entrepreneurs are always in a hurry. Before submitting your proposal, find out how long the process will take, and then provide the information needed by your banker. Finally, realize that the process may take longer than anticipated. The lesson is to start the process well in advance of when you need the financing.

Start the loan application process well in advance of when you need the financing!

### Do All of Your Banking at the Same Bank

Some entrepreneurs are always shopping banks in hopes of saving service fees or getting a better interest rate. It always pays to shop around, but having done so, choose one bank to supply all your services.

### Recommend Business Associates to Your Banker

Once you have developed a good relationship with your banker, demonstrate support by referring other business owners to him or her. Bankers need to make good loans, so they appreciate referrals to good business owners.

### Practice Your Verbal Presentation

You should be fully conversant with all the elements of your written proposal, so that you can verbally present them in a logical and concise manner.

## NxLEVEL® TECH TIP

BUSINESS RESOURCES AND THE WEB

Finding capital for your business can be simplified by looking online.

- **The Foundation Center Online** is the premier clearinghouse for information on raising money from foundations (www.fdncenter.org)
- **Federal Money Retriever** (www.fedmoney.com) is a software database that provides descriptions, eligibility requirements, available funds, and contact information for government loans and grants.
- **Ohio State Virtual Finance Library** (fisher.osu.edu/fin/overview.htm) provides contact information for banks, investment banks, and exchanges, as well as links to a wide variety of online financing information.
- **Go BIG Network** (www.gobignetwork.com) is "the world's biggest community of start-up companies." You can use this site to advertise your funding needs to investors.

## Conclusion

Begin immediately to implement the concepts covered in this chapter. Develop a good relationship with your banker, start working your personal and professional networks, and make sure you have an excellent business plan.

Approach your next search for financing by taking the following steps:

- Determine why you need financing
- Select debt or equity. If debt, determine what type
- Develop a well-researched, concise financing proposal and verbal presentation
- Present a customized version to each prospective source of financing
- Be persistent
- Be professional
- Demonstrate confidence and integrity
- Know your financing target
- Maintain close relationships with financing sources

# Chapter 40
# MONEY SOURCES

*About This Chapter:*
- *Personal funds*
- *Financial institutions*
- *Small business administration loan programs*
- *Other government loan programs*
- *Other sources of money*

## Introduction
Entrepreneurs often think only of banks when they look for financing, but there are plenty of other options. This chapter provides information about the various money sources available to small businesses.

## Personal Funds
National studies show that four out of every five new businesses are launched with the personal funds of the owner. Personal funds include:

Four out of every five new businesses are launched with the personal funds of the owner

- **Savings.** This includes money in a savings account, a money market account, a certificate of deposit, or even a shoebox under the bed.
- **Investments.** Besides stocks and bonds, this includes stamps, coins, jewelry, and precious metals.
- **Life insurance.** Many life insurance policies allow you to borrow against the cash surrender value of the policy.
- **Second mortgage.** You may be able to borrow a percentage of the equity you have in your home. This includes refinancing your house or taking a second mortgage loan.
- **Personal loans.** You may be able to obtain a personal "signature loan" at your bank or credit union.
- **Spouse income.** Determine how much is available on a monthly basis to help finance your business needs. You can invest this monthly amount in your business, or use it as the basis for obtaining a loan.
- **Family and friends.** While not really a source of personal funds, your family and friends may provide capital because of your personal relationship with them.
- **Credit cards.** Credit card financing can be extremely dangerous, and should be considered only as a last resort.

*Ryan Mikus was a high school teacher in Kalamazoo, Michigan for 29 years. When he wasn't correcting tests or coaching soccer, he was indulging in his passion for coppersmithing. He had a studio in the old barn at the back of his property, where he made lamps and candlesticks. He particularly admired the styles of the copper masters active in the Arts and Crafts movement, which was popular during the late 19th and early 20th centuries.*

*When he retired in 2008, he decided to turn his hobby into a business, and market an array of elegant, original handcrafted copper lamps, vases, and candlesticks.*

*After several months of perfecting his designs and production techniques, Ryan was ready. He decided to sell his lamps under his own name, inscribing each one with the words: "Hand-crafted in the studio of Ryan Mikus, Kalamazoo, Michigan."*

*He took his three best lamps to well-known home design stores in Kalamazoo, Holland, and Detroit. He was surprised and inspired by the overwhelmingly positive feedback. "How much for ten like this?" one store buyer asked. "How many can I have by Christmas?" another inquired. Ryan knew it was time to begin building his business.*

*But first, he would need enough capital to buy materials, upgrade his equipment, and buy a new computer. Ryan asked himself, "I wonder if I'll have to borrow money to do all this?"*

## Financial Institutions

Debt financing means that you incur an obligation to pay back money that has been lent to your business

This section examines financial institutions that can provide the **debt financing** needed by small businesses.

Debt financing means that you incur an obligation to pay back money that has been lent to your business. Sources of debt financing often require some form of asset as **collateral**, to ensure that the debt will be repaid.

### Banks

Different banks serve different markets. Small community banks focus on serving local businesses; a large commercial bank with hundreds of branches operates quite differently, and will usually take a very conservative approach to small-business lending.

Savings banks tend to specialize in home mortgages and automobile loans. This doesn't mean you can't approach them for a business loan, but it's not their major business line.

Many commercial banks are interested in business loans. Their loan officers are accustomed to processing business loan applications, and are familiar with other financing options if you don't qualify for a loan from their bank.

It's important to understand that banks usually don't make loans to businesses in the start-up phase; they prefer to make government-guaranteed loans. (Government-guaranteed loan programs are discussed later in this chapter.) Although larger banks have been more willing in recent years to consider small-business loans, smaller community banks are likely to be a better bet for conventional financing.

Small community banks may be your best bet for conventional financing

### Credit Unions

Credit unions are nonprofit, cooperative, tax-exempt financial institutions that are required by law to limit membership to clearly defined segments of the population, such as members of a labor union, a church, an advocacy group, or an occupational field.

Credit unions tend to offer better dividend rates on deposits and lower interest rates on loans than a conventional bank, but they also tend to offer smaller loans. Still, if you (or a family member) are eligible to join a credit union, you may be able to borrow some or all of the capital you need from that source. Loans that will aid in community development and growth, or otherwise benefit its field of membership, tend to be of particular interest to credit unions.

### Consumer Finance Companies

Consumer finance companies make small personal loans (usually a few thousand dollars), primarily to people who would have difficulty obtaining credit elsewhere. CFCs charge higher interest rates and processing fees than banks and credit unions, and are accordingly more flexible about approving financing requests. Some consumer finance companies have been accused of predatory or dishonest lending practices, so it's best to research such companies thoroughly before seeking a loan. Above all, keep an eye out for hidden fees, taxes, insurance payments, and prepayment penalties, all of which can add very significantly to the cost of the loan.

### Commercial Finance Companies

Commercial finance companies are similar to consumer finance companies, except that they tend to focus on business loans that are considered too risky or unique for banks. Examples include GE Capital Credit and The Money Store.

These loans can be helpful if your business has adequate collateral, and has been turned down by a bank. That said, be prepared to pay a high interest rate, offer lots of collateral, and face substantial penalties for early repayment.

As with consumer finance companies, read the fine print very carefully before accepting a loan. Hidden costs can make these loans very expensive.

### Community Development Loan Funds (CDLFs)

These loans are intended to aid with community renewal, by promoting business growth and economic independence in disadvantaged communities.

Organizations that offer these loans are called Community Development Financial Institutions (CDFIs). These groups range from small, local nonprofits to large banks with millions of dollars in assets.

These institutions lend money to businesses that most banks avoid. Currently, about 300 CDLFs provide loans to disadvantaged American communities at below-market rates.

To find out who makes community development loans in your area, call the Opportunity Finance Network at (215) 923-4754, or visit **www.opportunityfinance.net**.

### Leasing

A **lease** is essentially a long-term rental agreement. However, it can be considered a form of financing, because it frees up funds for other needs.

Leasing can free up your funds for other needs

- **Financing** leases are the most common. The lessee maintains the equipment, and may have the right to buy the equipment at the end of the lease.
- **Operating leases** are also called maintenance leases. The lessor is responsible for the maintenance of the equipment.
- **Sale and leaseback** is similar to a financing lease. The owner of a fixed asset sells it to another party, who then leases it back to the original owner.

*Advantages of leasing*

- A lease seldom requires a down payment
- Your business will not have a liability on its balance sheet
- Less debt on your financial statements
- You may be able to make payments over a longer term than with a loan
- Leasing costs are tax-deductible
- You can upgrade high-tech equipment by ending one lease and starting a new one with new equipment

*Disadvantages of leasing*

- A lease almost always costs more than a loan
- You probably won't own the asset at the end of the lease
- The business does not have an asset on its balance sheet
- May be hard to obtain for start-up businesses

**Checklist for Leasing Agreements**

- **Cost of the lease.** How much is each payment? When are payments due? What is the real amount of rental fees or interest? Is there a grace period before you are assessed charges? What is the total amount you will pay over the lifetime of the lease?
- **Extra costs.** Must you pay security deposits? Installation charges? License fees? Taxes? Penalties for early cancellation of the lease?
- **Lease flexibility.** What are the provisions for skipped or late payments?
- **Service.** What maintenance and service will be provided, and by whom? Is there a guarantee for the equipment? Must you pay for servicing? Will you receive a refund for downtime if the equipment fails?
- **Insurance.** What level of insurance coverage is included in the lease? Will you be assessed an insurance fee, or be billed separately by the insurance provider?
- **Equipment upgrades.** What are the provisions for upgrading or replacing equipment during the term of the lease? How much will it cost you?
- **Residual value.** What will the equipment be worth at the end of the lease period? (This directly affects your lease payments.)

*Ryan had been selling a few lamps a month, but didn't have enough revenue to buy the kind of computer set-up he wanted. Accordingly, he had two financing options.*

*If he took out a loan, he'd have a new asset (the computer), as well as a new liability (the loan to pay for the computer) on his balance sheet. He'd have to maintain the computer, and depreciate its value on his balance sheet over time.*

*If he leased the equipment, he wouldn't own it. Thus, it wouldn't appear as an asset on his balance sheet, and neither would the corresponding liability of the loan. Instead, he'd pay a monthly lease payment, which would be recorded on his books as an expense.*

*Ryan enlisted the help of his accountant, Bob Fuegner. After reviewing Ryan's credit, cash flow projections, and equipment needs, Bob recommended leasing. He had several reasons:*

- *Ryan could record the cost of the computer equipment as an expense, thus lowering his net taxable income*
- *The computer supplier would provide service and technical assistance, allowing Ryan to focus on his work*
- *Ryan could upgrade his computer when better technology came on the market*

*So that was settled. But where would Ryan get the rest of the financing he needed?*

## Small Business Administration Loan Programs

Research the availability and terms of SBA loans

The US Small Business Administration (SBA) was created in 1953 to assist small businesses. The SBA guarantees a portion of business loans made by banks and other lenders that conform to its guidelines, which is helpful to small businesses who need long-term credit, but can't afford the terms offered by conventional lenders.

To be eligible for an SBA-backed loan, your business must meet the following basic requirements:

- It must be a for-profit enterprise doing business in the United States or its possessions
- It must meet the SBA's size requirements
- It must be independently owned and operated
- It must not be dominant in its industry
- It must have applied for, and been denied, a conventional loan by a private lender
- You must have a reasonable amount of equity in the business
- You must have exhausted other means of financing, including personal assets

There are additional eligibility restrictions, which vary based on the industry in which you operate. You can visit the SBA online at **www.sba.gov** for more information, or call toll-free at 800-8ASK-SBA.

### SBA 7(a) Loan Guaranty Program

This is the largest and most popular of the SBA loan programs. It was designed to help small businesses obtain long-term financing for such needs as working capital, machinery, equipment, fixtures, leasehold improvements, building acquisition, and construction.

The loan is made by a private lender under the SBA's terms, and the SBA guarantees a percentage of the loan. Many American banks participate in the 7(a) program, as do some non-bank lenders.

The SBA doesn't guarantee 7(a) loans in full. However, the amount they cover has increased as a result of the passage of the American Recovery and Reinvestment Act. As of 2009, the SBA will guarantee up to 90 percent of 7(a) loans (the previous limit was 85 percent). This means that if you were to default on a loan of $100,000, the SBA would reimburse your lender $90,000. (Note that this guarantee is strictly for the lender. As the borrower, you still owe the full amount of the loan!) In addition, the fees associated with 7(a) loans have been eliminated. These changes may be temporary, so check with the SBA for more information.

In order to get a 7(a) loan, you must meet a variety of eligibility factors, including size, type of business, use of proceeds, character, management capability, collateral, owner's equity contribution, and—of course—credit. All owners of 20 percent or more are required to personally guarantee SBA loans.

Applying for Section 7(a) loans can be complicated and time-consuming. Fortunately, your local lending institution or economic development office may be able to help you with this paperwork.

Historically, the SBA has taken weeks or months to respond to 7(a) loan requests. But as of 2009, it has pledged to turn complete applications around in two to four days.

There are several variations of the 7(a) program, which we'll discuss below.

The turnaround time for a LowDoc loan may be 36 hours!

### *LowDoc program*

This "low documentation" version of the 7(a) program makes it easier for small-business owners to obtain SBA guarantees on commercial loans under $150,000.

Since its creation in 1993, nearly 90 percent of LowDoc applicants have obtained financing. As its name implies, the paperwork involved in LowDoc is minimal. The applicant completes the front of a one-page SBA application, and the lender completes the back (supporting financial documentation is still required, of course).

LowDoc applications undergo an expedited approval process, so you may get an answer to your request in as little as 36 hours.

Here are some more details about LowDoc:

- Your business may not employ more than 100 people
- Average annual sales for the preceding three years may not exceed $5 million
- Borrower must pledge available business and personally owned assets (however, the loan will not be declined when inadequate collateral is the only unfavorable factor)
- Personal guaranties of the principals are required

### *CAPLines program*

CAPLines is actually five loan programs in one, all of which help small businesses to meet short-term and cyclical working capital needs. Each CAPLine program has a maximum maturity of five years; some call for a shorter initial maturity.

Holders of at least 20 percent ownership in the business are generally required to guarantee CAPLines loans.

*Ryan Mikus stumbled onto Seed Ventures Capital Club after researching investment clubs on the Internet and speaking with his Chamber of Commerce.*

*It had been started by four retired entrepreneurs who had money to invest, and wanted to help other businesses get started in their community. That sounded good to Ryan!*

*So did the other things he learned about them. They preferred to invest in several moderate-sized projects, rather than a few big projects. Their criteria for investment were:*

- *$20,000 to $100,000 per project*
- *Businesses willing to accept and act on their managerial and strategic advice*
- *Service or manufacturing businesses with a strong management team*
- *Businesses that produce high-quality, "old world" services or products*
- *Businesses that draw on the skills of local talent*

*Seed Ventures was looking for projects that would complement their existing portfolio of investments. They enjoyed facilitating networking among their businesses, and creating a coalition in which the sum is greater than the parts.*

*It sounded perfect...especially the type of high-quality products they wanted to invest in. The question was, how should he approach them? Luckily, Bob had the answers.*

### *Prequalification Program*

This program assists prospective borrowers in applying for and securing loans. It targets low-income borrowers, disabled business owners, new and emerging businesses, veterans, exporters, rural businesses, and specialized industries.

When seeking a guaranteed loan, you work with an intermediary who makes sure that your application and its supporting documentation are in good order. Once the intermediary feels that your application is ready, he or she sends it to the SBA. If the SBA finds the application has merit, it issues a letter declaring its willingness to guarantee your loan.

To find out whether there is a prequalification intermediary operating in your area, contact your local SBA office.

### *MicroLoan Program*

Under the MicroLoan program, start-up or growing businesses may be eligible for loans of up to $50,000. Proceeds cannot be used to pay existing debts or to purchase real estate. The MicroLoan program is available in most states; check with your local SBDC.

### *Certified Development Company (504) Loan Program*

The CDC/504 program offers special terms for businesses pursuing energy efficiency or sustainability projects

A **certified development company (CDC)** is a nonprofit organization that works with the SBA and private sector lenders to provide financing to small businesses. There are about 270 CDCs nationwide, each of which covers a specific geographic area.

The CDC/504 loan program provides growing businesses with long-term, fixed-rate financing for such fixed assets as land, buildings, machinery, and renovations to existing facilities. Special terms are available for businesses that are pursuing certain types of energy efficiency or sustainability projects. It can't be used for working capital, consolidating or repaying debt, or refinancing.

As of 2009, borrower and lender fees for CDC/504 loans have been temporarily suspended by the American Recovery and Reinvestment Act.

Contact your local Small Business Development Center (SBDC) or Chamber of Commerce to find the CDC that serves your area.

*US Community Adjustment and Investment Program (CAIP)*
This loan program was created in 1993, in order to help US communities that suffered significant job losses as a result of the North American Free Trade Agreement (NAFTA). As of this writing, over 230 counties in 29 states are eligible for this loan, as measured by job losses and unemployment rate.

CAIP can be used with both the 7(a) and 504 SBA loan programs. Note that CAIP loans include a job-creation requirement. For 7(a) loans, the borrower must create one job for every $70,000 that the SBA guarantees. For 504 loans, the borrower must create one job for every $50,000 that the SBA guarantees.

CAIP loans include a job-creation requirement

*Pollution control loans*
This 7(a) program offers loan guarantees for the planning, design, or installation of a pollution control facility. This facility must prevent, reduce, abate, or control any form of pollution. Recycling programs are also eligible for these loans. The loan must be used for fixed assets.

### Small Business Investment Company (SBIC)

The SBIC Program is the only venture capital program sponsored by the federal government. The SBA licenses private venture capital firms, and these SBICs have a portion of their financing guaranteed by the SBA. They provide equity capital and long-term debt to small businesses that have significant growth potential. The cost of loans and debt securities is regulated by the SBA.

Small businesses that qualify for SBIC assistance receive equity capital, long-term loans, and management assistance. Although they sometimes offer equity capital, SBICs are not permitted to take permanent control of small businesses.

### Specialized Small Business Investment Company (SSBIC)

SSBICs operate much like SBICs, but have additional financial leverage, which is provided by the SBA in return for agreeing to invest in, or loan to, small businesses with socially or economically disadvantaged owners.

### Small Business Innovation Research (SBIR)

The SBIR program is designed to stimulate technological innovation, and gives small businesses the opportunity make proposals to meet the research and development needs of the federal government. Eleven federal agencies participate in the program, and the SBA publishes solicitation announcements on a quarterly basis. (The SBA monitors and coordinates SBIR, but does not make awards.)

There are three phases to the program.

- In Phase I, a small business can receive up to $100,000 to develop a prototype or otherwise prove its concept.
- In Phase II, a small business that successfully completed Phase I can receive as much as $750,000 to develop the prototype for production.
- There is no government funding for Phase III, where the product is actually placed into production.

### Small Business Technology Transfer (STTR)

This program started in 1992, and is similar to the SBIR program. The small business submitting an application must collaborate with a nonprofit research institution.

*Ryan knew he needed to put a lot of work into his business plan and financial projections before he could make a pitch to Seed Ventures. And that's just what he did.*

*Working closely with Bob, and an advisor at the SBDC in Kalamazoo, he eventually concluded that he'd need $30,000 for the first year of operations. If sales followed as he planned, he would need only $10,000 in year two.*

*Ryan wrote up an executive summary of his business plan, and a cover letter in which he clearly outlined how much funding his business needed. He had professional pictures taken of his best pieces, and enclosed them in a nicely organized binder. He doublechecked his spelling and grammar, had Bob triplecheck his figures, sent the package to Seed Ventures.*

*During the next two weeks, Ryan found it hard to concentrate on his work. It felt like everything was up in the air! What was taking so long? Finally, Bob jokingly pointed out that if Ryan wanted to get any work done at all, he'd have to uncross his fingers.*

*Ryan needn't have worried. His business plan summary was one of nearly 30 that Seed Ventures received that week. It took them a while to get to his, but they were intrigued by what they saw, and they decided to take a closer look. They liked his lucid, straightforward writing style, and they liked his business plan. After a brief consultation, they decided that they wanted to meet with him.*

## Other Government Loan Programs

The loan programs offered by state and local governments vary greatly from state to state. Many counties and cities have established small loan funds; check for such programs in your area. Local governments may operate the program themselves, or through another agency, such as a CDC, that has experience managing loan programs.

## NxLEVEL® TECH TIP
### BUSINESS RESOURCES AND THE WEB

The Internet is full of investors looking for opportunities, and entrepreneurs who need money to get off the ground, so it's no surprise that there are many Websites that try to match investors and entrepreneurs. Here are a few examples:

**Garage.com** (www.garage.com). Garage.com assists entrepreneurs with obtaining financing by providing mentoring and access to a network of high-quality investors. The site offers expert advice, access to research and reference materials, and several forums designed to help you launch and grow your business. There are also links to high-tech and entrepreneurial news stories, a news agent that scans 600 news sources, and a fascinating archive of "Stories From Hell," which comprise accounts of entrepreneurial lessons learned the hard way. You can subscribe to several useful mailing lists at this site.

**Lenders' Interactive Services** (www.lendersinteractive.com). This interactive site asks you for information about your business, then recommends lenders whose interests match your needs. You can even request that those lenders contact you.

When looking for financing, online or off, remember that there are plenty of bogus lenders out there. Visit **www.allbusiness.com/business-finance/business-loans/3535-1.html** for advice on how to identify and avoid loan sharks and scam artists.

### Patriot Express

The SBA's Patriot Express Pilot Loan Initiative targets veterans and members of the military community who wish to establish or expand small businesses.

Eligible military community members include veterans, active-duty service members eligible for the military's Transition Assistance Program, reservists and National Guard members, and spouses of any of the above. Visit **www.sba.gov/patriotexpress/index.html** for more information.

### Rural Economic & Community Development Administration

The USDA's Rural Economic & Community Development Administration (RECDA) offers loan programs for small businesses in rural areas. You can visit **www.rurdev.usda.gov** for up-to-date availability and terms.

*Intermediary Relending Program (IRP)*

The Intermediary Relending Program makes loans to small businesses and other legal entities in cities that have a population of less than 25,000. The loans are made by intermediaries such as CDCs, or other nonprofit organizations. The loan can finance up to 75 percent of a project, with a maximum of $150,000. Loan recipients must document their inability to finance the project through commercial credit or other government programs. This program often appears locally under the name Rural Development Fund.

The Business & Industry Loan Guarantee Program encourages commercial financing of rural businesses

***Business & Industry Loan Guarantee Program***

The Business & Industry Loan Guarantee Program encourages commercial financing of rural businesses. The business owner applies through a commercial financial institution, and together they submit an application to RECDA. Most types of businesses in cities with a population of less than 50,000 are eligible. There is no official minimum loan, but loans typically begin at the SBA 7(a) maximum and can be as high as $10 million.

***Revolving loan funds***

Local and regional revolving loan funds take a subordinated security position to a loan from a private lender. Loans are limited to eligible borrowers in particular counties or cities. Standards and rules vary from region to region.

*After several meetings with Ryan Mikus and a visit to his shop, the members of Seed Ventures Capital Club settled down to decide whether to invest.*

*They had a good feeling about Ryan. They were very impressed with his business plan. They felt his cost and revenue projections on target, and his market potential solid.*

*Their only concern was that Ryan was a sole proprietor. Seed Ventures knew that partnerships had a higher rate of success, and were generally more stable. They decided that they would invest in Ryan's business, but would require that he find a partner who had stronger management and marketing skills than he did. They would help Ryan to identify and recruit this partner.*

*If he agreed, they would invest $30,000 in Ryan's business in the first year, and $10,000 in the second year. They would then reevaluate his operations and profitability and make a judgment about whether to invest additional funds.*

## Other Sources of Money

The previous section discussed sources of debt capital that are frequently used by small businesses. This section discusses sources for equity capital, as well as some less common sources of debt capital.

### Equity Financing

If you decide to seek equity capital, remember that you are selling a portion of the ownership of your business. If your business is presently a sole proprietorship, it will have to become either a partnership or corporation. This is a complex issue, for which you should seek legal counsel.

If your business is a partnership, the provider of equity capital will become a partner. How much of your business the investor will own is negotiable. You should have a written partnership agreement that thoroughly details the rights and obligations of each partner. Most partnerships are general partnerships. Limited partnerships have specific accountability and tax considerations; if you intend to form a limited partnership, you must consult an attorney who is experienced in these issues.

If your business is a corporation, the source of equity capital becomes a stockholder in the corporation. A corporation may issue preferred stock in addition to common stock. Preferred stockholders do not vote at stockholder meetings. It's also possible to issue more than one class of common stock—some of which do not confer voting rights—or to sell the investor warrants or rights for shares of stock in your business.

Limited liability companies (LLCs) are an increasingly popular form of business ownership. If you are interested in obtaining equity capital for an LLC, consult a knowledgeable attorney.

Be aware that obtaining equity capital is a more time-consuming process than obtaining debt capital. Sources of equity capital demand more information and take longer to review it, and you'll need help from attorneys and accountants to complete the process.

Obtaining equity capital is a more time-consuming process than obtaining debt capital

*Venture capitalists*
Venture capitalists make high-risk investments in young, unproven companies with the potential for very high rates of return. They look at companies with the potential for explosive growth, sales in the multi-millions, and an exit strategy that will allow them to profit from their investment.

*Investment clubs*
In some communities, local business people pool their money to make investments in new and established businesses. This allows smaller investors to participate, and larger investors to spread their risk.

There is no official listing of these groups, which vary in size, investment strategies, and targeted industries. Local Chambers of Commerce are a good source of information. You can also look online. Some are easy to locate, while others maintain a low profile.

*Investment bankers*
Investment bankers are in the business of providing equity capital (not loans) to new and young businesses. They do this by selling shares of stock in the business to their customers. They rarely deal in amounts less than $1 million, and are interested only in businesses that offer attractive rates of return. They seek out the same types of businesses as venture capitalists, but are not as willing to take risks.

**Venture Capital Tips**

- **Answers to investment requests usually come within 21 days.** If you don't get an answer within this time, save your energy—focus on other investors and funding sources.
- **Make your calculations simple, clear, and to the point.** Investment analysts continually hear pitches for funding, and they respond better to easy equations and simple math.
- **Demonstrate that you are at risk.** Investors are more likely to consider funding your business if they know that you have a high incentive to succeed.
- **Don't pay yourself too much money.** Make sure your uses of funding are clearly described, and that the important money goes towards essential expenses. No golf club dues, expensive lunches, or exorbitant salaries!
- **Have a plan for getting to market.** Venture capitalists want to see concrete, aggressive plans for generating sales and earning profits. They want to know your exact timetable for entering the market, and how long it will take to become profitable.
- **Show explosive growth.** Venture capitalists look for companies that grow at a phenomenal rate, and show millions of dollars in sales within the first few years.
- **Toot your own horn!** Highlight any awards or media coverage you've gotten, and point to larger, established organizations with whom you have done business or partnered.

*Private investors*

Angels are a good source of debt and equity capital

Every area has some local entrepreneurs who have been very successful. These people, sometimes referred to as "angels," are a good source of both debt and equity capital for local small businesses. Your attorney, accountant, or banker may be able to put you in touch with such individuals.

*Private exchanges*

Downturns in the economy will often produce an avalanche of new ideas. One such stroke of genius is the recent response to the collapse in the venture capital market. The struggling economy had a negative affect on IPOs, which made venture capital harder to come by. Accordingly, **private exchanges** popped up as a solution to this problem. These exchanges allow stakeholders to exchange their shares in start-ups for hard cash. The object is to create a market for exchange in start-up companies, as an avenue for raising additional capital and overcoming a national liquidity crisis. For more details, visit SharesPost.com or SecondMarket.com

*Professionally managed pools*

Large institutions often pool their money into a partnership that invests in small businesses.

*Strategic partnerships*
Large corporations often invest in small businesses that will help the corporation enter new markets and provide a return on investment. It is important to understand that the motive is more than profit; they are looking for small businesses that fit into a strategic mission or long-range plan. For this reason, these relationships are commonly referred to as **strategic partnerships**. There are three common forms for such investments:

Partnering with small businesses can help large firms enter new markets

- **Stock purchase.** The large corporation buys some of your stock and becomes a stockholder in your company.
- **Joint venture.** The corporation and your business form a partnership, and the corporation provides capital.
- **Licensing agreement.** You retain total control of your business, but sell the corporation specified rights to use or sell your products.

*Employee stock ownership plans (ESOPs)*
Employee stock ownership plans are similar to other methods of selling equity in your business. The difference is that you are selling shares of stock to your employees rather than to outside investors. This provides your business with equity capital to use for expansion, and gives your employees a vested interest in the success of your business. This is usually not feasible for a start-up company unless it's well financed from the outset. However, the SBA offers loans for ESOPs under its Qualified Employee Trusts Loan Program. Contact the SBA for information on eligibility and terms.

*Initial public offerings*
The term **initial public offerings** (IPOs) refers to the first time a corporation offers its shares of stock for sale on a publicly traded stock exchange.

The Securities Act of 1933 began the federal government's regulation of publicly traded securities. The act fulfills two objectives:

1) To provide prospective investors with full and fair disclosure of the character of new securities.
2) To prevent fraud and misrepresentation in the sale of securities.

The Securities and Exchange Commission (SEC) is the agency that enforces federal statutes relating to securities. Any agreement that obligates your business to pay another party a portion of your profits or to make interest payments is a security. Thus, the federal government closely regulates the issuance of publicly traded stocks. However, several cost-effective options are available to the entrepreneur seeking equity capital. Consult a securities lawyer before issuing any shares of stock.

*Small Corporate Offering Registration (SCOR)*
SCOR enables small businesses to originate and sell stocks to investors with a minimum of cost and regulation. Most small businesses can raise up to $1 million per year, provided they have equity equal to at least 10 percent of the amount of capital being raised.

Form U-7 is the registration form for corporations that are registering under state securities laws, and are exempt from SEC registration under Rule 504 of Regulation D. The average cost to prepare a SCOR offering is under $25,000. (Note: SCOR offerings may be illegal or restricted in certain states.)

*Intrastate offerings*

An **intrastate offering** is a security offered and sold only to residents of one state. Such an offering is exempt from SEC regulation, but is still subject to the securities laws of the state in which the security is offered. Such state laws are often called **blue sky laws**. In order to qualify for the intrastate offering exemption, your business must be incorporated in the state in which it is making the offering, carry out a significant amount of its business in that state, and make offers and sales only to residents of that state.

There is no fixed limit on the size of the offering, nor on the number of investors who may purchase your stock.

## NxLEVEL® GREEN TIP

ENVIRONMENTAL BUSINESS RESOURCES

Here are some potential sources of funding, or information on funding, for green businesses.

- **Eco Investment Club** (www.ecoinvestmentclub.com) connects green businesses with potential investors. Its mission is "to support the progression of the Green Movement by promoting Sustainable businesses, education, networking, relationship building, and Eco Investing, which ultimately drives the Green Economy."
- **Investors' Circle** (www.investorscircle.net) is "a network of over 200 angel investors, professional venture capitalists, foundations, family offices and others who are using private capital to promote the transition to a sustainable economy." Their "Resources" page offers links to other funding resources for entrepreneurs. They hold a conference and venture fair twice a year.
- **Good Capital** (www.goodcap.net) is "an investment firm that accelerates the flow of capital to innovative ventures and initiatives that harness the power of the market to create sustainable solutions to some of society's most challenging problems."
- **Cleantech Group** (cleantech.com) comprises "8,000 qualified cleantech investors, 9,500 companies and professional services organizations worldwide and a core group of 1,300 elite members with assets exceeding $3 trillion."

In addition, **Green VC** (www.greenvc.org) maintains an exhaustive list of green funding sources at **www.greenvc.org/green-funding-sources.html**.

*Ryan agreed to meet with the members of Seed Ventures as frequently as needed to make sure his business was on target. He also agreed to take on a partner.*

*Soon, Seed Ventures introduced Ryan to Betsy Dykstra, a 31-year-old business development manager for a major lamp company in Holland, Michigan. She also had an MBA from Michigan State. Ryan's business was exactly the kind she had been wanting to work with, and she and Ryan hit it off well.*

*The partnership between Ryan and Seed Ventures also worked well. In the first six months, he met with members of Seed Ventures several times, getting guidance on establishing wider distribution, investing in additional equipment, and evaluating a possible move to a better-equipped workspace.*

*By the end of his first year of operations, the business was breaking even and Ryan's lamps were being sold in fine furniture and gallery stores throughout Michigan, Illinois, Indiana, New York, California, and Colorado.*

## Other Innovative Sources of Financing

### *Peer-to-peer lending*

Peer-to-peer lending connects borrowers and lenders directly, without mediation from a financial institution. Such loans may be secured or unsecured, and usually involve Web-based social networking.

Peer-to-peer lending connects borrowers and lenders directly, without mediation from a financial institution

There are three basic models:

- In the **marketplace** model, sites like Prosper.com connect lenders with borrowers through an auction-like process. The lender who offers the best loan terms wins the business of the borrower.
- In the **crowd financing** model, a small amount of money is gathered from many individual contributors in order to fund a specified project. The funding may be treated as a loan, or it may be something more akin to a donation or sponsorship, with no expectation of repayment. Kickstarter (www.kickstarter.com) is a good example of a crowd financing site.
- In the **community lending** model, a community or group pools its money and loans it to one of its members. The theory is that the preexisting relationship encourages fiscal responsibility and full repayment. GreenNote (www.greennote.com), which arranges student loans through the individual student's social network, is a typical example.

*Loan guarantors*
Small-business owners who cannot support the collateral and capacity requirements of their loan application can overcome this problem by finding a third party with assets that can be used as collateral. This means that the third party assumes the risk of making the loan payments if you default. The cost of such a guarantee varies greatly.

*Loan brokers*
Loan brokers find financing for business owners and other individuals. They often charge a flat fee up front, which you must pay whether you obtain financing or not. Some brokers charge a smaller up-front fee, and then take a percentage of the loan upon approval. You should select a loan broker very carefully. It's a good idea to ask prospective loan brokers for references from businesses they've helped finance.

Ask prospective loan brokers for references from businesses they've helped finance

*Suppliers*
A supplier can be a source of capital in two ways. First, a major supplier may be interested in providing you with equity or debt capital. A strong motivation for the supplier is often a desire to work with a proven wholesaler or retailer in your geographic area. Your success will put money in the pocket of your supplier.

Second, you may be able to negotiate favorable terms for your business if the supplier is motivated by having your business in the area. These terms can include discounts, extended payment periods, cooperative advertising, or any other concession that helps your business conserve its capital.

*Franchising*
It is possible to purchase some franchises with little money down and obtain the start-up financing directly from the franchisor. When a direct loan is not possible, the franchisor might guarantee your loan with a lender that's familiar to the franchisor.

*Owner contract, when buying a business*
When selling a business, most entrepreneurs want the buyer to obtain financing so that they can be "cashed out." This is often not possible and the seller must carry a contract for a portion of the selling price. The term, interest rate, and collateral are all negotiable.

## Conclusion

As you can see, there are many ways to finance a growing business. But before you talk to any prospective source of financing, you must know exactly how much money your business needs, and what its projected revenues and expenses are.

When seeking financing, you need to pay close attention to the fine print: always have your lawyer and accountant review any offers or contracts that come your way! It's impossible to overemphasize how important this is.

With a well-researched business plan and a carefully written funding proposal, you can find just the right source of funds.

Remember: Perseverance, excitement, and confidence in your idea will inspire lenders and investors to become as enthusiastic about the promise of your business as you are!

# PART X
# DEALMAKING

## Chapter 41
## NEGOTIATIONS AND DEALMAKING

*About This Chapter:*
- *Three styles of negotiation*
- *The role of power in negotiations*
- *The process of negotiation*
- *Your negotiating partners*

### Introduction

You may not consider yourself a negotiator, but whether you realize it or not, you negotiate every day. Whenever you debate which movie to go to with friends, or discuss whose turn it is to take the garbage out, or offer your child a reward for getting better grades, you are negotiating.

Studies show that good negotiation skills are an important factor in entrepreneurial success. This is likely to become even more true as time goes on. Businesses are relying more heavily on independent contractors, and working more closely with supply chain partners. As a result, the classic relationship between the boss and his or her employees is becoming less common. Instead of simply ordering an employee to do a job, you may find that you have to negotiate with one or more independent contractors to get things done properly, on time, and for the right price.

Win-win negotiation leads to the best and most lasting agreements

Many people incorrectly see negotiation as a contest of wills that the most aggressive or powerful negotiator always wins. In fact, the best negotiators are cooperative and flexible; they recognize that their own interests depend on creating a win-win outcome that leads to a strong and lasting working relationship.

Like any other skill, win-win negotiation can be learned and practiced. Understanding what good negotiators do, and why they do it, will help you achieve great results.

### Three Styles of Negotiation

If you're like most people, you try to avoid the conflicts that can arise from negotiation. Certainly, negotiating is sometimes a nerve-wracking process in which resolution comes at the expense of one of the parties. The highly competitive nature of business demands that companies negotiate in order to survive, so it's not surprising that negotiations can become difficult when the stakes are high. Negotiations can also be complicated by conflicting personalities, delicate egos, cultural differences, time pressures, and worst of all, a sole focus on personal gain.

But it can be different. Negotiation can produce solutions that neither side could have achieved independently. It can create enduring agreements, enhanced partnerships, and greater benefits for all.

In fact, negotiation can be open, friendly, and even fun!

Good negotiators understand themselves and what they want out of the process, but they also try to find where their own interests and those of their counterparts overlap. They take into account the other side's interests and perspectives, and use their negotiation skills to resolve conflict and create win-win solutions.

As we mentioned above, different people take different approaches to negotiating. Some naturally seem to favor a "hard" approach, while others prefer "soft" negotiations.

Let's take a closer look at what these terms mean.

### Hard Negotiation

Hard negotiators seek a win-lose (or zero-sum) outcome at the expense of the business relationship. They're aggressively competitive, and often resort to threats or bluffing.

There's usually very little trust between the negotiating parties, and minimal interest in maintaining the relationship. Parties engaged in such negotiations pursue their own interests, and have little or no concern for the interests of the other side.

### Soft Negotiation

Soft negotiators seek a positive relationship at any cost. They focus on minimizing differences and points of conflict, and will readily make concessions.

Win-win negotiation is tough on problems and easy on participants

The danger of being a soft negotiator is that you may not be able to protect your interests and assert your rights. Also, if hard negotiators perceive you as someone who can be bullied or exploited, they may become more aggressive; each concession they get will embolden them to try for another.

### Win-Win Negotiation

This approach is neither hard nor soft. Instead, it combines the best of both approaches by being hard on the problem and soft on the participants.

Like kids in a three-legged race, win-win negotiators work together to reach a shared goal. They make every attempt to approach problems cooperatively, and to achieve a mutually positive outcome through open, honest communication.

In short, they attack problems, rather than each other!

| Negotiating Styles and Behaviors | | |
|---|---|---|
| **Hard** | **Win-Win** | **Soft** |
| • Tries to negotiate on home turf | • Tries to negotiate on neutral turf | • Negotiates on other side's turf |
| • Focuses debate on own issues | • Focuses on both party's issues | • Focuses on other party's issues |
| • Ignores other party's demands | • Listens to other party's demands | • Concedes to other party's demands |
| • Low offers and very high demands | • Moderate demands and offers | • Low demands and high offers |
| • Requires other party to make first offer | • Seeks an interchange of offers | • Presents offers on other party's terms |
| • Demands large concessions from other party | • Pursues mutually beneficial settlement | • Makes large concessions at outset of process |
| • Exaggerates own priorities, while ignoring the other side | • Shares reasons for priorities; seeks same from the other party | • Adapts to other party's priorities |
| • Rarely concedes, and only on items of low value or interest | • Encourages meaningful concessions from both sides | • Concedes immediately to the other party's demands |

*Alan Kubler was born and raised in Grand Junction, Colorado. In November of 2008, just after his 26th birthday, he was laid off from his construction job. He needed a new job, and soon, but he wasn't really sure what to do or where to look.*

*He needed to talk to someone, so he looked up his old high-school counselor, Jack Skelton, who had always had a knack of making him feel hopeful about his future.*

*"He always said I was a smart kid, which I liked hearing," Alan recalls. "But he was also kind of pushy. Always telling me to plan for this and work for that. I didn't want to hear that stuff in those days. But I'd grown up a lot since then. This time, I was ready to listen and learn."*

*Jack was more than happy to talk to Alan, and ended up offering to mentor him. After getting a sense of Alan's skills, he advised Alan to get on the computer and start learning everything he could about Grand Junction.*

*"I've lived here my whole life," Alan said. "What more do I need to know about it?"*

*Jack explained that he needed to look at the population, the kind of work people did, the social programs, the types of businesses that were coming to town, college enrollment statistics… everything. More than that, Alan needed to understand how the town fit into the region, the state, and the country. What were the trends? Was the area shrinking, or growing? It wasn't long before Alan realized that he didn't really know very much about Grand Junction at all, and he was eager to learn!*

## The Role of Power in Negotiations

We feel that the win-win approach is the most effective one for negotiators. However, many negotiators never use it, and still make incredible gains. They achieve their goals by dominating the negotiation process through a show of power.

This shows that the balance of power, the context of the negotiations, and the relationship of the participants all determine the outcome of negotiations, regardless of one's approach. Still, threats and aggression usually don't usually produce the ideal settlement. Agreements made under pressure last only while one party feels weaker; when the weaker party gets the opportunity to back out, the agreement falls apart.

### Principles of Power

There are many kinds of power. Authority confers one type of power, and self-respect confers another. You can be powerful by having more money, or by having more intelligence. You can win negotiations through strong-arm tactics, or through honesty.

Aggressive negotiation can be intimidating, but it's often a sign of weakness. Think about it: if you have something really worthwhile to offer people, you usually don't need to be aggressive to get their cooperation. And beyond that, how much power do you really have when you can't hold on to what you've won?

Here are a few basic principles of power:

- Power is always relative and limited, never absolute
- Using power always involves risk
- Power can change hands suddenly and unexpectedly
- Power can be real or perceived
- Power can be exercised without action
- Power is only as strong as it is believed to be
- Power exercised out of fear, greed, or anger is weakness

Power is only as strong as it is believed to be

Think about your own past negotiation experiences. Consider the balance of power between you and your counterpart. Did actual power or perceived power play a larger role in the outcome? Chances are, perceived power played a larger role.

No matter how weak you consider your negotiating position to be, you're likely to have more power than you think. Even if you lack any formal authority or economic clout, you probably have many other forms of power, including:

- The power to negotiate fairly and intelligently
- The power to choose whether to sign the deal
- The power to point out the consequences of a failed agreement
- The power to deflect attacks by refusing to retaliate
- The power to demonstrate a way out of the conflict
- The power to maintain your personal integrity

People with high hopes achieve better outcomes!

### The Power of Hope

What each side hopes to achieve by negotiating, and how confident each side is of reaching a favorable settlement, has a huge impact on the negotiation:

- People with high hopes achieve better outcomes
- Skilled negotiators with high hopes earn better outcomes regardless of the amount of power they possess
- People with high hopes can direct negotiations better than people with low hopes
- High initial proposals improve the quality of the final settlement
- People with lower hopes make more unnecessary concessions

## The Process of Negotiation

Anyone who has tried to sell a house, or negotiate the price of a new car, knows that negotiation can require a lot of time and patience. It can be a very long journey from your initial negotiations to the signature that closes the deal.

No matter who you are or what approach you take, the negotiation process generally contains the same phases. These include setting an agenda, voicing demands and offers, working to minimize differences, and closing the deal. Ideally, each of these stages builds upon the gains made in the previous stages, allowing the two sides to move closer to an equitable agreement.

*One thing Alan learned from his research was that most jobs in Grand Junction were in retail trade or construction. However, times were tough for both sectors, and Alan knew he didn't stand much chance of getting hired.*

*"Well," Jack told him, "If you can't work for a construction company right now, maybe there's some service you can offer them. In an economy like this, business-to-business selling could be a pretty good bet."*

*Alan didn't think much of that suggestion, at first. But later that week, he talked to a friend from grade school named Nick Storch, who was working on a local construction project. He mentioned to Alan that the parking lot needed cleaning and pressure washing. The crew was understaffed because of layoffs, and didn't have time to do that kind of work. Nick knew someone in Fort Collins who did site clean-up for a living, but there was no one doing it in Grand Junction.*

*The more Alan thought about this, the more we felt it was a real opportunity. Construction and retail were the two biggest industries in town, and they both had lots that needed cleaning. And not just lots. Awnings, windows, shopping carts, equipment, and garbage bins needed regular cleaning, too. So did farm equipment, for that matter.*

*It sounded promising. All he'd need was a sturdy truck and some pressure washing equipment, and he'd be able to negotiate contracts with construction companies, strip-mall owners, big box stores, grocery stores, and farms.*

*Jack thought it sounded promising, too. However, he recommended that Alan bill himself as a specialist in environmentally friendly pressure washing. That meant avoiding dangerous additives like hydrofluoric acid, finding effective biodegradable detergents, keeping water use to a bare minimum, and preventing wastewater from going down storm drains.*

*After completing his market research and writing a simple but effective business plan, Alan took some of the money he and his wife had saved, and a small loan from his parents, and bought a used truck and a pickup-mountable pressure washer with a 150-gallon tank and a wastewater recycling system. At Jack's insistence, he chose a diesel model, so that he could run it on biodiesel and lower his overhead. He also looked into rainwater capture systems, so that he could fill his washer from a home storage tank, but between the permitting issues and the cost, he decided that this would have to wait until he had a few months of steady income.*

*Now, all he had to do was drum up some new business.*

### Identify Your Interests

Before negotiating, you must identify your interests. When you have clear goals, you project a confident, professional image that gives your counterpart a reason to take you seriously.

Focus on your interests, not your position!

Your interests can be very different from your position. Your **position** is what you say you want (more money, a faster turnaround time, a larger order size). Your interests are what you actually need in order to be successful.

It's important to understand the difference. Otherwise, you may spend a great deal of time quibbling over positions, only to end up with an agreement that doesn't satisfy your interests.

List your interests in order of their importance. These interests are the currency in which you will be dealing, so determine how much each is worth in relation to the others.

Next, consider all the options that would satisfy your interests. How many ways can your interests be met? What are you willing to do to get what you want?

You should also explore those terms of the deal that would satisfy your counterpart's interests. You'll enhance your position if you can conceive of options your counterpart hasn't considered.

### Identify Your BATNA

In addition to the interests you'll be pursuing through negotiations, you must also identify your **Best Alternative to a Negotiated Agreement**. This is commonly referred to by the acronym BATNA.

If negotiations don't work out, what are your options? What other opportunities do you have? Do you have offers from other investors if this one falls through? Or would failing to reach an agreement mean that your business would have to close its doors? It's essential to know exactly what's at stake!

It's also a good idea to identify the BATNA of the other party, to whatever extent that's possible.

### Identify Your Settlement Range

You probably know what you want out of your negotiations, but you also need to think about what you *don't* want! What's the very least you need to achieve in order to feel good about the deal? What is the point below which you can't go?

If you end up squarely in the middle of your settlement range after a tough negotiation, consider it a solid win!

Once you've set this bottom line, you've created a **settlement range**. At the top of the range is the best-case scenario, where you get everything you want. At the bottom is the worst-case scenario, where you walk away with the bare necessities.

Please note that by "bare necessities," we don't mean that you were allowed to keep your gold fillings and two pairs of pants. We mean the minimum you need in order to feel that the agreement, though not perfect, is worthwhile.

You shouldn't fixate on achieving your best-case scenario at all costs, but you also shouldn't make unnecessary concessions. If you end up squarely in the middle of your settlement range after a tough negotiation, consider it a solid win!

*Once he had his truck, his equipment, and his green cleaning supplies, the first thing Alan did was make a list of every construction project, every grocery store, and every big-box store in town. He even included the hospitals, the schools, the golf courses, and the country club.*

*Alan understood that before he could approach these prospects, he needed to prepare by educating himself about each business. Jack had pointed out that a hospital or a country club is a lot different from a mall. For instance, the hospital might want to know how loud the pressure* *washer was. They weren't as likely to care about noise at a mall, especially if Alan was working after hours.*

*In his business plan, Alan had carefully calculated how much it would cost to run the washer and the truck. He factored in living expenses and loan payments, too, and came up with an hourly rate that covered everything.*

*Just to be on the safe side, he also called up some pressure washers in Denver and Fort Collins, just to see what they were charging. His price seemed to be competitive, especially when he considered that Grand Junction was a smaller town and he had no real competition. He felt he had a fair price, and he was pretty sure everyone he talked to would agree. Why wouldn't they?*

## Overcoming Obstacles

You're sitting face-to-face with an investor, distributor, or supplier, and things just aren't working out. Perhaps you're unable to communicate with one another, or maybe you feel intimidated by the other party. Either way, there seems to be no way to reach an agreement. What should you do?

First of all, don't give up. This is the heart of the negotiation process: getting through the obstacle course to achieve your objectives. The following strategies can help.

### *Recognize manipulative tactics*

Whether you bring them to the other person's attention or not, recognizing manipulative tactics will improve your sense of control and confidence.

Here are several common manipulative negotiating tactics:

- **Stonewalling.** The negotiator refuses to budge from his or her position, rejects your proposals, and is indifferent to your efforts to communicate.
- **Bullying.** The negotiator attempts to intimidate or threaten you into giving in. This person may wage an assault on your credibility, your proposal, or your authority.
- **Deception.** The negotiator tries to trick you into giving in, taking advantage of your good faith by providing misleading or false information.

### *Open your ears!*

Being a careful listener is the best advantage you can have

If you really listen to what the other person is saying, you might find that an obvious solution has been right in front of you all along. Don't be tempted to use the time when your counterpart is speaking to formulate a clever response, or to plan your next entrepreneurial venture. Being a careful listener is the best advantage you can have.

To be a better listener, frequently summarize what the other person says, and ask for more information. Be patient. Realize that the payoff for listening is the ability to understand where interests intersect; this is how enduring agreements are made.

*Get in the other person's shoes*
Rather than getting frustrated with and retaliating against your counterpart's tactics, try stepping into his or her shoes for a moment. Try to understand and appreciate his or her point of view. (Be aware that doing this does *not* require you to make any concessions.) This approach is beneficial to you, and it can also disarm your counterpart.

When you consider another person's opinion, you have an opportunity to identify issues on which you agree. You may find that you have the same time pressures, cost considerations, or even the same personal dislike for negotiating. Whatever it is, recognize it and use it to form a bond.

*Lighten up and laugh!*
Why get stressed and worn out by negotiating? The way you approach negotiations can have a big effect on the results, so why not have a positive, easygoing outlook?

Humor can disarm even the most adversarial opponent. Take the opportunity to lighten up the discussion when possible. This can build trust and create a more relaxed environment.

*Slow down and regroup*
When negotiations get tense, people often retreat to their positions instead of focusing on their interests. They simply react, without thinking or listening to the other side. Many negotiations fall apart at this stage.

You have the power to break this deadlock. Step back, put aside your assumptions and emotions, and look at the negotiation as an outside observer would. Having cleared your head, you'll be ready to engage more effectively than ever.

Remember: You have as much right to set the pace of negotiations as your counterpart does. Exercise this right whenever you feel the need to. Calm yourself, reflect, and decompress. This will give your counterpart a chance to do the same.

One way to buy yourself some time is to say nothing. Silence is one of the most powerful tools a negotiator can use; it gives the other person nothing to argue with, and may throw off his or her momentum. This consolidates your power, and forces the other side to adapt to your pace.

Another valuable way to slow down the process is to review the progress you've made up to that point. Taking notes is helpful as well; it gives you a reason to pause periodically throughout the negotiation, while showing that you take the process seriously.

*Get off the hot seat*
No matter what the other person says, never make an important decision on the spot. Good negotiators always disengage, and go to a safe location to make their decisions. In this context, "safe" means a place where you're under no direct pressure to agree to a specific settlement.

Never make an important decision on the spot!

If pressured, try responding, “You’ve obviously put a lot of thought into this, and I’d like to do the same before I answer.” Or “I always get a good night’s sleep before I sign a contract.”

Even if you only have a few minutes to make a decision, you should still allow yourself some space and time to review your options. Never let yourself be pressured into a decision by a deadline imposed by the other side. If you feel this happening, test the deadline—you’ll soon find out how serious it is. Never forget: A decision made under pressure may be one you regret later.

*The first week he was in business, Alan had two appointments with prospective clients, and both of them turned out to be disasters. The first prospect he talked to was John Singer, the owner of a big grocery store not far from downtown. Singer said he’d consider hiring Alan, but only if he lowered his hourly prices and got the job done in an hour flat. Alan explained that his price was fair, given his green detergents and wastewater recovery system. Singer shrugged. “If I cared about any of that stuff, I might be willing to pay extra. But I don’t.”*

*The next prospect was a man named Heinz, who owned a couple of strip malls out on North Avenue. He demanded that the washing job include all the store facades and awnings, and he offered a set fee with no room for negotiation. Alan controlled his temper—barely—and walked out of the office without a contract.*

*Jack wasn’t surprised when he heard the news. “Everything comes down to negotiation,” he said. “It’s up to you to defend your case. You can’t blame them for wanting to get a good deal. You have to prove to them that they’ll get one if they hire you.”*

*Jack told Alan that he’d have to learn to negotiate from professionals; he needed more help than Jack could provide. Alan was skeptical, but as usual, Jack won out in the end, and Alan agreed to take a two-day negotiation class for small-business owners at Mesa State.*

### Walking Away from the Table

Know when to walk away!

No matter how committed you are to making a deal, there may come a point at which your best course of action is to stand up and calmly walk away from the negotiations. Knowing your “walk-away” threshold in advance strengthens your position, and gives you a solid footing from which to judge the other side’s proposals.

Different people reach this point under different circumstances, and at different points in the process. How do you decide when you will walk away? One thing you can do is consider the costs—in terms of time, money, relationships, productivity, personal integrity, and emotions—of walking away versus continuing to negotiate.

As a general rule, it's time to think seriously about walking away from negotiations when:

- Your counterpart's ethics clash with your own
- You're being forced to accept a deadline you can't meet
- Your counterpart is greedy and will make no compromises whatsoever
- You believe that your counterpart is unwilling or unable to follow through on his or her part of the deal
- You can achieve better results elsewhere
- You strongly dislike your counterpart
- You have clear evidence that your counterpart is dishonest, or the deal is illegal
- Economic conditions lower the value of the deal to your business

## Your Negotiating Partners

In the course of running your business, you're very likely to enter into negotiations with each of the following types of people. The basic information presented here will help you to be confident, professional, and well prepared.

### Lawyers

When hiring lawyers, the issues usually involve price. Most lawyers price their services in one of two ways:

- **On contingency.** The lawyer's payment is based on a percentage of the damages you win in a lawsuit.
- **Straight fee.** The lawyer's payment is based on hourly work.

Fees are always negotiable, so collect fee information from several lawyers prior to negotiating. Generally speaking, it helps to like and trust the lawyer you hire to represent your interests. Lawyers can be valuable advisors when you are negotiating with other parties. But remember that your lawyer is there to give you legal advice, not to handle the negotiations for you.

Your lawyer should give you legal advice, not handle negotiations for you

### Bankers

There are many types of banks; some serve consumers and some serve businesses. Your goal is to find a bank that understands your needs. Bear in mind that unlike many negotiating partners, banks are limited by a number of business factors:

- They must get principals to sign for unsecured loans
- They must perform balance-sheet tests
- They must avoid long-term debt
- They must charge higher rates for riskier loans
- They must ask for collateral to secure loans

*After two days of training, Alan had a good grasp of what he'd been doing wrong. He knew that in the future, he'd have to be confident enough to defend his interests, but also flexible enough to compromise on his positions.*

*One thing he realized was that he and his prospects had simply been butting heads on positions, and not finding any common ground. He needed to get them to put aside their position on price and time, and look at what was in their best interests. When they tried to dictate his hours or his price, he'd remind them that eco-friendly pressure cleaning would benefit their business and their image in the community.*

*Instead of explaining why he needed the money, he'd explain why the client needed his services. Instead of complaining that an hour's work wouldn't cover his expenses, he'd explain that an hour's work wouldn't get the job done right, which would reflect badly on both Alan and his client. Instead of saying that he couldn't afford to wash facades and awnings, he'd focus on the fact that the awnings and facades needed washing, and discuss what it would mean to the client's business if they stayed dirty.*

*Alan felt that he'd reached a turning point. He was ready to have another meeting with his prospects, and this time, he was going to make them see that hiring him at his price would be a win-win situation.*

### Venture Capitalists and Investors

Here are some issues you will encounter when negotiating with investors:

- **Share of equity.** This refers to the percentage of ownership the investor will have in your business.
- **Mix of straight versus convertible debt.** Convertible debt can be exchanged for equity (stock) in the company. Straight debt is simply money the business owes to a lender, and grants no rights of ownership to the business.
- **Consulting agreement.** This obligates the business to "buy" a given amount of consulting time from the investor.

Other issues include rights of first refusal on any sale of management stock, right to veto any new financing, and preemptive stock purchase rights. Be sure to document any agreements on paper, and always have your lawyer review them before you sign anything.

It's also wise to write up your terms before negotiating, so that you'll have them clearly in mind. Once you've drafted them, don't restructure them in negotiations without a very good reason. If you're seeking multiple investors, explain that you have non-negotiable standard terms. If you negotiate individual terms with each investor, you may regret it when it comes time to repay them.

## NxLEVEL® TECH TIP
BUSINESS RESOURCES AND THE WEB

As we've noted elsewhere in this book, there's a growing trend towards online contracts and digital signatures. Here are some features to look for in a digital signature service:

- **It must be tamper-proof.** Once the document is signed, any unauthorized change to the document must automatically invalidate the signature.
- **It must be secure.** Security provisions must be strong and reliable enough to protect against unauthorized use, and ensure that no party can deny having signed the document. As of this writing, only PKI-based digital signatures meet this standard.
- **It should work in multiple applications.** You should be able to add your signature to any type of electronic document. By the same token, your contract partner should be able to open and verify your signature once it's been added, without having to install a special program or plug-in.
- **It should include a graphic element.** Digital signatures need not have a visual component to be effective. But a digital representation of a written signature allows both parties to confirm at a glance that the document has been signed, and who signed it. Also, most people find it psychologically preferable to see a traditional "signature," even though it has no real bearing on the authenticity of the document.

### Suppliers
Since you'll probably rely heavily on your suppliers, it's wise to choose a supplier who shares your values and standards, and with whom you'll enjoy working. For more information on managing contractual relationships with your suppliers, see Chapter 46 *Supply Chain Management*.

If you're just starting out, you may have a hard time negotiating favorable payment terms, or specifying strict environmental or quality standards. One possible solution is to negotiate a long-term agreement. For instance, once you're comfortable with your sales forecasts, you might try ordering several months' worth of supplies, instead of a one-month supply. Of course, you'll need to spread out the payments over the life of the contract, and include an enforceable termination clause.

Before you approach a supplier, it's a good idea to research the company thoroughly. How many competitors do they have? How long have they been in business? What regulatory burdens do they face? Finding out the answer to questions like these can give you an idea of how important your business is to the supplier, and the amount of bargaining power this gives you.

Research your suppliers thoroughly before negotiating with them!

## Customers and Buyers

Customers are the final consumers of your product, while buyers purchase goods to alter and/or resell.

Negotiations with customers should be guided primarily by your interest in cultivating a long-term relationship. If you're in a service business, you'll probably be negotiating contracts that include price, delivery time, and project terms.

Negotiations with customers should be guided primarily by your interest in cultivating a long-term relationship

Negotiations with buyers are identical to those with suppliers; major issues include payment terms, late payment options, specification changes, contract changes, and termination.

### NxLEVEL® GREEN TIP

ENVIRONMENTAL BUSINESS RESOURCES

One of the most essential—and most difficult—aspects of running a green business is greening your supply chain. It's not enough to get verbal assurances or promises from suppliers. You need to set clear standards, write them into your contracts, and enforce them.

Here are some key points to remember when negotiating "green" contracts:

- **Show leadership.** It's wise to clean up your own business as much as possible before demanding changes at other firms. Your bargaining position will be stronger if you can point to successful green initiatives you've launched at your own business, and explain how they benefit you.
- **Set verifiable standards and metrics.** You and your partners must be able to agree on what goals need to be met, how those goals will be measured, what degree of transparency is acceptable (nondisclosure agreements may be necessary), and what constitutes noncompliance.
- **Incorporate green goals into your contracts.** These goals should be clear and specific, and refer by name to any certification, regulatory, or quality standards that guide your purchasing. If certain materials or practices are unacceptable, the contract needs to say so explicitly. It should also set forth remedies in case of breach of contract.
- **Plan for continuous improvement.** Greening your supply chain is an ongoing process, which will be affected by what your competitors are doing, as well as emerging technology and new regulations. Try to keep your supplier relationships flexible, and renegotiate your contracts as necessary to reflect changing conditions.

### Employees

In negotiations with employees, the major issues are compensation, benefits, duties, and the goodwill you hope to engender between you and your employee. For this reason, it's best to know as much as possible about the person's interests, goals, and ambitions before entering into negotiations with him or her. For more information on this subject, see Chapter 23 *Managing Human Resources*.

It's best to know as much as possible about an employee's interests, goals, and ambitions before entering into negotiations

When cash is tight and your employees want raises, it's important to understand that the request for a raise is sometimes a reflexive response to stress or dissatisfaction. Perhaps your employee doesn't need more money so much as a more flexible schedule, more recognition, more autonomy, more cooperation from co-workers, or even just a longer lunch break! You may have to ask some polite, probing questions to find out exactly what's on the employee's mind, so that you can work together on a win-win solution.

### Independent Contractors

Negotiations with independent contractors typically focus on cost, parameters, deliverables, environmental and quality standards, intellectual property rights, and deadlines. As with other negotiating counterparts, you should have as much information as possible about your prospective contractors before negotiating.

*Alan decided to go see his first two prospects again. But this time, he was prepared. He and Jack had looked at where Alan could afford to compromise, and where he had to stand firm. Alan had also practiced his negotiating strategies with his wife, which was a big help; she challenged him with objections he hadn't thought of, and helped to come up with good responses.*

*Alan explains: "If he told me he wanted the work done in an hour, I'd point out that he'd get a half-finished job. I'd say something like, 'If it took an hour to do a good job mopping your floors each night, would you tell your janitor to do it in half an hour? Why pay someone to do the job halfway? What does the money you saved matter, if your customers come in and the floor is dirty? It's the same thing with the parking lot. Either pay to get it spotless, or leave it dirty. Paying to get it halfway clean is the worst of both worlds. You're putting your positions ahead of your interests: spending money and getting nothing to show for it.'"*

*His practice paid off. After he explained to John Singer that eco-friendly pressure cleaning was a good way to differentiate himself from his competitors, and would also help him to avoid wastewater regulations, Alan signed his first contract.*

*Alan knew that negotiating with Mr. Heinz would be a little tougher. He was the competitive type, who always wanted to negotiate on his own turf, and made lots of demands. Alan decided he'd be willing to lower his hourly rate a little if he could get more business in return.*

*During the meeting, he restated what he was offering to do for Mr. Heinz. He explained the benefits each would gain if they were able to strike a deal. Better yet, he pointed out that the fact* *that Mr. Heinz was willing to hire him at all showed that he understood the work needed to be done. Mr. Heinz looked thoughtful at that point, and Alan knew he'd scored an important point.*

*Alan was willing to make some concessions. He offered a discounted price, and told Mr. Heinz he'd be happy to do the facades and awnings. But in return, he wanted to come once a week, instead of twice a month.*

*Mr. Heinz thought for a while, and agreed. Alan had his second contract, and was off and running with his new business!*

## Conclusion

The win-win approach to negotiating yields more for everyone: it creates trust and respect between you and your counterpart, increases mutual gains, and enhances your prospects for profitable business deals in the future.

When both sides are willing to address issues directly and honestly—instead of wasting time on posturing and self-aggrandizing bluster—they usually find that a mutually satisfying agreement is easy to reach. Agreements reached in this way tend to last longer, and are more beneficial to both parties. For every deal you hope to close, win-win negotiation is the best course of action.

# Chapter 42
# CONTRACT MANAGEMENT

*About This Chapter:*
- *The importance of contract management*
- *Contract management software*
- *How to exceed expectations*

## Introduction
Contract management means implementing practices that keep your contractual relationships running smoothly, such as scheduling meetings with your partners, setting performance checkpoints, creating a stable operating environment, and establishing a method of achieving goals. Delivering exceptional performance under contract requires continuous, consistent management. Ideally, you and your partner will get to know and trust one another during this process.

A signed contract is a very valuable asset for your business, especially if it's with a major customer. It's surprising how many businesspeople, exhilarated with the thrill of the hunt, neglect deals they've closed. Your contracts represent a promise of future deals, but only if you manage them professionally.

Your contracts represent a promise of future deals, but only if you manage them professionally

## The Importance of Contract Management
In today's globalized world, contract management is immeasurably important. Outsourcing and offshoring, working with freelancers and partners, the shift to simplified e-procurement systems among government and big business, selling overseas via e-commerce...all of these things require conscientious attention to contract terms and performance. In addition, most small business have leases, software licenses, maintenance agreements, warranties, Website hosting agreements, and dozens of other contracts to manage.

The fact that more large firms are investing in infrastructure and software to help with contract management and compliance means that your firm's contract performance will be under considerable scrutiny, and will be held to a strict standard of accountability.

Failing to manage your contracts can have serious financial consequences. It can cause you to miss out on time-sensitive incentives and discounts, and it can also lead to inefficiencies, errors, wasted effort, and missed deadlines. Studies show that costs associated with inadequate contract management can reach as high as seven percent of a business's operational expenditures.

## Nurturing Your Partnerships

Nurturing a contractual partnership means understanding each other's performance standards, time constraints, business priorities, and management culture. How does your partner business make and implement decisions? What are its competitive strengths? What does it value in its business dealings? Understand these things, and you'll be able to meet requirements before they're requested of you.

You must agree on how each party to the contract will verify and measure progress

The first step is to review the terms of the contract with your partner. You must agree on how and when each side is to perform its part of the deal, and how each will verify and measure progress. Here are some basic suggestions:

- Review the timetable for successful completion of the contract
- Break the contract into smaller pieces based on the timetable and performance goals (e.g., units to be delivered, deadlines to meet)
- Determine how and when to communicate
- Define the responsibilities of each participant
- Identify plans for managing breaches of contract, or substandard performance
- Define the margin of error allowed for performance targets
- Establish meeting times and dates to review the status of the contract
- Review payment terms

## Create a Contract Specialist

It's an excellent idea to make someone within your business responsible for keeping track of contractual issues. On a day-to-day basis, this person will ensure your business's compliance with the terms of each deal you sign, and become the communication link between your business and your partner. This needn't be the employee's only job, and you needn't create a new department or a fancy title. You simply need to formalize responsibility and accountability for managing contracts.

Who you designate depends on the nature of the contract. Does managing the contract require specific technical knowledge or good people skills? Does it require daily contact, or only weekly or monthly contact? Who in your business has the skills, attention to detail, and time to do the job well? Usually, a contract manager must coordinate compliance between all departments affected by each contract, so someone with good communication skills is a must.

Creating a contract specialist calls for the same logical steps you used to create your management structures: identify your needs and goals, allocate responsibility and authority, set standards for performance, and create yardsticks to measure performance. Sound familiar? We hope so!

It's important that you understand and approve of the system that this employee uses. If the employee is on vacation, or decides to quit, you need to be able to take control of compliance efforts seamlessly. Having a contract oversight system that only one employee understands is a recipe for disaster!

*The project came in on a rainy May morning. "It's a small job, but a big client," Sarah told Carol over the phone.*

*Sarah Templer and Carol Mignon were partners in a graphic design firm called Clear Spot Design, based in Monterey, California. Sarah was talking about the design of a product white sheet for an upcoming trade show. This was a project that had come via a previous client's referral (Carol made a note to herself to send a thank-you note and small gift to the referring client). The budget wasn't large, but neither was the job. Or so Sarah thought.*

*Sarah outlined what she knew about the project. It was for a new product that was still in beta testing. Scott Finney, the manager on the client side, was a new marketing director who had been promoted following a management shuffle and a string of layoffs. There was no copy written yet; that part of the project was being done by the client's other advertising agency.*

*All of this sounded very confusing to Carol, but because the project was so small (a four-page, four-color document that was due in two months), she agreed it was a good opportunity for Clear Spot to get access to larger projects down the road.*

*In her earliest conversations with Scott Finney, Sarah realized that the budgeting and timing were going to be very tight for this project. It was clear that Scott was trying to get a lot of work for as little money as possible. By carefully defining the deliverables in her proposal document, Sarah worked to align Scott's expectations with his budget. She also consulted with Carol to figure out if they could reasonably hope to produce the sheet for the budget he was proposing. After many discussions, Sarah and Carol agreed to do the project for less money than they'd initially estimated. With some reluctance, they decided that the smaller profit on the job would be offset by the access to future jobs with the firm.*

*Even so, the tense budget discussions had left a bad feeling in Sarah's stomach. Was this a sign of things to come?*

## Contract Management Software

Most contracts are paper-based, so unless you revisit them frequently, it can be hard to monitor and enforce compliance. Fortunately, contract management software systems can automate your compliance throughout the contract life cycle. They act as a central repository for all contracts, and integrate the functions of existing procurement and operations applications. They can also speed up procurement, by automatically generating supplier contracts and streamlining contract renewal.

You need to understand how your contract management system works, and where to find essential documents

Contract management software can track performance, compliance, and deliverables, and alert you when it's time to perform contractual duties. Most important, it reduces the risk of losing vital documents, by creating an electronic backup of all your contracts and contract-related data.

Here are some more potential benefits of contract management software:

- Instant access to contracts through a searchable central repository
- Monitoring contract milestones and deadlines
- An e-mail based reminder system can alert personnel when it's time to fulfill contractual duties
- Standardizing processes and terms
- Avoiding unwanted automatic renewals
- Reducing material and service costs
- Validating invoices against contract terms
- Keeping track of rebates and discounts
- Ability to generate client profiles
- More efficient workflow and time allocation
- Improving organizational control and oversight
- Confirming receipt of goods and services before permitting payment
- Capturing system data for accounting programs

Build organizational structures that support your goals before buying software to implement those goals!

Bear in mind that software applications don't solve problems unless your business understands them, adapts to them, and uses them. A well-organized, motivated team that is committed to exceptional service can do wonders with contract management software. A team that's confused or dispirited won't be helped by programs of this type.

Look at it this way: You couldn't build a house by rounding up your employees, handing them hammers and saws, and telling them to get busy. Before they could use their tools effectively, they'd need a blueprint to guide them, a thorough knowledge of how to build things according to code, and someone to oversee their performance.

Businesses are no different. Too many firms buy expensive software products to "solve" problems that actually come from a lack of management structure, or low morale.

**Some Things to Look for in Contract Management Software**

- ❑ Flexibility
- ❑ User-friendly interface
- ❑ Template and clause libraries
- ❑ Security
- ❑ Compliance workflow designer
- ❑ Ability to integrate with other applications (e.g., word processing and e-mail programs)
- ❑ Compliance alerts
- ❑ Searchability (accounting system tie-in)
- ❑ Contract renewal management

## How to Exceed Expectations

Next, let's focus on managing your performance as the provider. Given the choice between simply meeting the terms of your contract or exceeding them, you should always do more rather than less!

Exceed your client's expectations whenever you can!

We've already discussed the importance of maximizing the value you offer your customers. In this case, your customer is the person or business with whom you've signed a deal. These relationships are crucial to your business's performance, so you should value and nurture them as you do your customer relationships.

Depending upon your type of business, exceeding expectations can mean different things. If you write software, exceeding the contract might entail taking extra time to tailor a software program to a particular customer's needs.

If you're a producer of specialty sauces and your customer is a small chain of cafés, exceeding expectations might mean researching wines that complement the food on your customer's menu.

Finally, if you're a tax preparation consultant, exceeding expectations might mean paying a house call to help your customer organize his or her documents.

Here are several of the most basic ways to exceed expectations:

- **Be speedy and professional.** All companies should deliver rapid, professional service when and where their customers need it. The better you know your customer, the better you'll be able to anticipate needs and meet them in advance of being asked. Exceeding expected delivery time is one of the most powerful statements you can make, but you should never sacrifice quality and professionalism for speed.
- **Follow up on service.** Check with your partner (in person or over the phone) to make sure that all questions or issues have been resolved. Once again, a great deal of your business's success rides on your ability to look back on your performance with a critical eye and rate how timely, appropriate, and professional it was.
- **Minimize unnecessary charges.** Make sure your invoices aren't cluttered with petty extra charges for small spare parts or minor service details.
- **Share your expertise.** Just as you want your suppliers to enhance your business's competitiveness, you should work to make your customers more competitive. Share your knowledge with them, and look for ways to increase its value to them.
- **Always be accessible.** You can do this by being physically located near their office, or by making yourself easily accessible via phone, e-mail, Twitter, or pager.
- **Get involved.** Your personal commitment to your partner is a strong indicator of professionalism, reliability, and the importance you place on the relationship.

## NxLEVEL® GREEN TIP
ENVIRONMENTAL BUSINESS RESOURCES

**Green Contract Management**

You're only as green as your supply chain, so if one of your contract partners drops the ball, it's likely to reflect badly on your business. This is one of the many reasons that it's important to choose partners who share your business's green goals.

When managing green contracts, it helps to have an **environmental management system** (EMS) that provides clear standards and metrics to your suppliers and partners. If you can create this document collaboratively with your suppliers, managing contracts will be easier.

A flexible approach is best. In some cases, you may need to specify a particular material or policy. In other cases, it's best to specify desired results, and give your partner some leeway on how to accomplish them.

You also need to encourage transparency. For instance, your suppliers should be contractually required to reveal the sources of their materials, the percentage of recyclable content, and so forth. If you're supplying goods, especially to large businesses or the government, you will have to meet similar standards.

Last, the contract should specify a remedy in the event that your supplier fails to meet the specified standards (e.g., if your supplier provides you with a non-organic input for an organic product).

*"It's not here...again," Sarah told Carol over the phone three weeks into the project. They were awaiting copy for the white sheet they were designing. Scott had promised they'd have it that morning, nearly five days later than they had agreed to on the project timeline.*

*"There's not even an e-mail from him," Sarah said. "This is really getting ridiculous." Indeed, it was the worst project Sarah had ever worked on. Scott was late answering e-mails, and inconsistent in his feedback and directions. It was clear that he lacked the confidence—and perhaps even the authority—to make important decisions about the project. All this combined to make him irritable and unpredictable. As Sarah said, Scott was "a nightmare client."*

*According to their time tracking, they had already used up nearly 50 percent of their allotted hours for the project. And they hadn't even gotten the finished copy yet, let alone begun dealing with reviews, revisions, and printing.*

*Worse still, in their eagerness to cater to Scott's skittishness about money, they had left out of their contract any reference to delay costs, or fees for overruns. Sarah and Carol both knew that they were already approaching overrun hours. The delays were made worse by the fact that several new projects were due to kick off in the coming week. If this one was delayed, it would affect all other projects at Clear Spot. Things were stressful, they were almost certainly going to lose money, and the client was a real pain. Sarah was beginning to wish they'd written an escape clause into the contract!*

Every opportunity you have to speak with your partner is an opportunity to improve cooperation and performance

### Staying in Touch

Communication is so important to nurturing your business relationships that it bears special discussion here. When we say "communication," we're not talking about the occasional phone call from you to your partner. We're talking about an ongoing dialogue in which you and your partner coordinate performance, review targets, and work to improve your relationship. Personal relationships evolve with personal contact, so remember that every opportunity you have to speak with your partner is an opportunity to improve cooperation and performance.

You have many means of communicating with business partners, including:

- Personal visits
- Toll-free phone line
- A company blog
- Semi-social meetings
- Text messaging
- Virtual meetings
- Cellphone
- Newsletter
- E-mail
- Regular mail
- Pager
- Social networking sites (e.g., Twitter)
- Video and audio livecasting
- Regularly scheduled meetings

Scheduled communication should never replace impromptu, face-to-face communication. By communicating with your partners more effectively than any of their other partners, you will distinguish your business as special, and gain yet another competitive advantage.

### Got a Problem? Fix It!

It's human nature to avoid ugly or embarrassing situations. No one enjoys feeling uncomfortable or acknowledging mistakes. However, when you ignore problems, they tend to grow. At some point in your business dealings, you'll make mistakes—all businesses do! What matters most is that you improve and grow by learning from these mistakes.

Consider this scenario: you ship an order to a customer five days late, and when it arrives your customer calls to tell you that you sent too few of a certain item. What do you do? Acknowledge the problem and take responsibility for it! As the president of your business, any problem—large or small—is ultimately your responsibility.

Here are the fundamentals of crisis management and problem resolution:

- Identify the problem
- Acknowledge your partner's frustration or annoyance
- Understand what caused the problem
- Take full responsibility
- Fix it fast!
- Explain how you'll prevent the problem from happening again

Speedy and sincere resolution of problems helps your business to learn, grow, and develop long-term relationships

Partners who feel that you've treated them with respect and given them the attention they deserve are some of the best allies your business can have. Likewise, people who feel that you have dealt with their problems professionally may become some of your most loyal customers. Speedy and sincere resolution of problems helps your business to learn, grow, and develop long-term relationships.

### Making Sure You Receive Exceptional Service

Let's talk for a moment about how to get the most out of the contracts you sign with outside providers such as bookkeeping services, manufacturers, technical support, sales management companies, and market research firms. Things to keep track of include:

- The timeliness with which they deliver
- The means by which you communicate your needs and expectations
- How invoices are received and organized
- Opportunities for their product to enhance or complement yours
- How their product or service is inspected to meet quality standards
- How problems with quality or performance will be overcome
- How, when, and by whom final payment is authorized
- Ideas for negotiation of future contracts

### At the End, Start Over Again!

One of the most important components of wise contract management is a built-in potential for change and improvement. Review past contracts, and then look ahead and ask yourself:

- How can you better serve your partners' needs or enhance value?
- How can they better serve your needs?
- Which needs have not been met?
- How can you improve communications?
- How can you collaborate to streamline performance?
- Where does synergy exist between your businesses?
- How can you sell them another deal?

Always look at current work as laying the foundation for a future contract. Leverage your existing relationships, and look for ways to form others. Develop a track record and loyal business partners, and you'll have a solid foundation upon which to grow.

Always look at current work as laying the foundation for a future contract

*"Listen, Sarah. Scott doesn't know what he's doing. Our reputation is on the line with this job. If it's terrible, we're the ones who'll look bad. I say we do the job, accept that we're losing money on our time, and blacklist this guy!"*

*Carol had a way of putting things in perspective for Sarah. She also had the benefit of distance: she didn't have to be on the phone every day with Scott, gently prodding him to provide copy, to schedule review meetings which he canceled, and to remind him of the project timeline and budgeted hours. Sarah was sick and tired of dealing with it all.*

*One thing she did agree to do was to keep a detailed record of all her communications to and from Scott. She kept her own e-mails calm and polite, and let the facts speak for themselves. When Scott responded aggressively, she politely but firmly restated the timeline of events, and repeated her request for Scott to deliver the content.*

*Eventually, the copy arrived from Scott…more than two weeks later than they had expected. Carol worked almost all night to finish the layout. Sarah managed to get the finished design to the printers one day later, with a promise that the piece would be printed and shipped in time to hit the deadline. At last, the project was over!*

*But the headaches weren't. Scott tried to hold up payment, arguing that the finished piece wasn't what he'd contracted for. Fortunately, they'd gotten him to sign off at certain stages of the design process, which they were able to prove to his superior. They also submitted their e-mail conversations. A couple of months later, Clear Spot had been paid in full, and the president of the firm was very impressed with their contract management skills. Since then, they've done several jobs for the same firm, with no problems. As for Scott…he was out of a job!*

### Review Your Performance

The importance of reviewing your business's performance can't be overemphasized. You can only improve by understanding and critiquing your past performance. This applies to all aspects of your business. Reviewing your performance entails:

- Reviewing actual versus anticipated results
- Identifying strong and weak points
- Identifying opportunities for change and improvement
- Establishing a timetable for the next contract period
- Soliciting and listening to feedback from your contract team

## NxLEVEL® TECH TIP
BUSINESS RESOURCES AND THE WEB

Most contract management software is designed for huge firms with multiple departments. However, the increased need of small businesses for contract management solutions is leading some companies to design applications that fit the size and budget limitations of smaller firms.

Blueridge Software's **Contract Assistant** is a good example. It includes a complete electronic record of contracts, multiple alarms for missed deadlines and unwanted auto-renewals, one-click sorting, and easy searching. For a free trial or online demo, visit **www.blueridgesoftware.bz**.

**CobbleStone Systems** offers a customizable contract management system that sends e-mail alerts to contract managers, and allows you to attach supporting documents to contracts. Visit them at **cobblestonesystems.com** to see a free demo, view an online slide show, or try their return-on-investment (ROI) calculator.

## Conclusion

Ensuring your business's consistent, high-quality performance of contractual obligations requires allocating specific responsibilities within your business, and encouraging open communication between yourself and your business partners. New and emerging technology can help you achieve this goal with a minimum of confusion, as long as it's backed up by an organizational culture dedicated to customer service.

By properly valuing and managing contractual relationships, you can gain a significant advantage in even the most competitive markets.

# Chapter 43
# MANAGING GROWTH

*About This Chapter:*
- *To grow or not to grow?*
- *Planning for growth*
- *Problems and solutions*
- *Strategies for growth*
- *Tools for growth*

## Introduction

Some businesses grow with little effort on the part of their managers, simply by taking orders, delivering products, and collecting payment from an expanding base of customers.

Other businesses grow because they made a strategic decision to do so. This may involve finding additional financing to expand product offerings, increasing production capability, extending geographic reach, or tapping into new markets.

The biggest challenge confronting you as an entrepreneur is to choose the right time and the right way to grow your business. This chapter will help you do exactly that. It explains why you might want to grow, and discusses tools and strategies that work.

The biggest challenge confronting you is to choose the right time and the right way to grow your business

## To Grow or Not to Grow?

Suppose your business is thriving and profitable, and your employees are happy and productive. Why would you change *anything*, let alone face higher risk and increased debt by trying to grow?

There are many reasons why businesses choose to pursue growth:

- Increasing profits
- Taking on new challenges
- Achieving economies of scale
- Getting volume discounts on inputs and materials
- Enhancing the company's status
- Acquiring a more diverse customer base
- Targeting new customer segments
- New technologies open new markets

The benefits of growth aren't limited to your market presence or bottom line. Well-managed growth can mean exhilarating and fulfilling times for your entire business team.

*When the call came, Joe McGuire wasn't prepared for it.*

*It was a job offer from June Multimedia, a fast-growing digital production company based in Los Angeles. They were expanding operations, and wanted to grow their office in Joe's hometown of Atlanta, Georgia.*

*June Multimedia's core business was recording and editing video and sound pieces for other companies. Now, they were developing their own CD-ROM titles, which they would market under their own name. They were impressed by Joe's extensive editorial and project management experience, and wanted him to head their new children's media department. This meant managing new projects, and helping with June's transition into producing original material. They offered him a generous salary, and invited him to hire his own team.*

*It was the best job offer Joe had ever received, but the timing couldn't have been worse. Six months earlier, he had left his full-time job as an editor at a children's book publishing house in order to dedicate himself to his own small production company, Let's Learn Edutainment. In that time, Let's Learn had already completed and sold two educational titles, and had many other well-developed plans for future projects.*

*Joe loved working for himself. He wanted to stay in his business and make it grow, but he was worried that he lacked the money and personnel to do so. "Maybe this is a sign," he thought. "Maybe I should just hang it up and take this terrific job!"*

*What he really needed to do was reassess his business before making any decisions.*

## Growth Means Profits

A truly thriving business is one in which profit is maximized

When we talk about growth in this book, we are referring primarily to profit growth. Although sales volume, market share, and employee growth can all be indicators of success, a truly thriving business is one in which profit is maximized. This is particularly true for smaller, entrepreneurial growth companies.

While no strategy automatically produces a high-growth company, the following considerations are of prime importance:

- Every successful growth company starts by preparing a business plan dedicated to growth.
- Profit growth is the most important metric. All others types of growth (volume, market share, number of employees, size of the company) increase costs, and are therefore contrary to profit growth.
- Policies should allocate assets to maximize profit. Allocating money to the wrong company objectives is a sure way to slow growth.

- Company and product branding is critical to profits, as they are difficult to perfect and difficult for competitors to overcome. Products that don't fit your brand, and maintain or increase your competitiveness, should be cut back or discontinued.
- Customer knowledge and management is the most important focus in a growth company. All other issues should be subordinated to customer sensitivity.
- Time spent on things that don't maximize profit will slow your growth. Dedicate your team to perfecting the things that really matter.
- Cost controls are important, but companies cannot save their way to growth.
- Growth strategies begin and end with the company's leader. Your personal commitment and vocal leadership are essential, and can't be delegated.
- All employees and stakeholders must pull together to be successful. Their participation begins in the planning stage, and does not end as long as they are associated with the company.
- Employees are your most important resource. Care about and manage people, not data. Motivate them, empower them, and reward them for a job well done.
- To be successful, make others successful!

Customer knowledge and management is the most important focus in a growth company

### Is Growth Right for You?

The benefits of growth are clear, for some businesses. But does that mean you should grow, too? Will your business really perform better, or achieve more, by being larger than it is now? Think carefully before you leap into the task of growing your business. Growth for growth's sake will waste precious resources and energy.

Your strategic choices should be calculated to increase competitiveness and profits. To achieve this, you need not necessarily be larger than you are now. If you can better serve your market by being small, then by all means stay small.

If you do decide to grow, bear in mind that this can make managing your business more complicated and time-consuming. Also, you may have to give up a certain amount of day-to-day control, so consider how comfortable you feel about delegating authority.

Growth will affect your customers, too. If your business is known for personal, attentive service, then you need to think about whether growth will change your image. Don't get so caught up in looking for new customers that you forget the ones you already have. As your business evolves, your goal should be to grow only as much as will allow you to serve your customers more effectively and profitably.

Last, you'll need external capital to grow, and might have to give up some equity in your company to an outside investor.

### Is Your Business Ready For Growth?

The most common obstacles to successful growth are insufficient planning, and failure to follow an existing plan.

However, there may also be organizational obstacles to growth:

- Insufficient access to capital
- Insufficient expertise
- Insufficient contingency planning and risk management
- Unwillingness to change
- Inability to work with growth partners
- Inability to change processes and procedures

The best foundation for growth is the area where you truly excel!

Generally speaking, you can't grow safely unless you have a rock-solid core business that is strongly competitive within its market. As the leader of your business, you must be absolutely committed to this core business before you consider growth. You should know it inside and out, and you should also be an expert on the current state of your target markets, and any trends that affect them.

It's seldom wise to diversify into a type of business in which you lack expertise. That doesn't mean that you shouldn't consider new product lines, or new possibilities for old ones. But the best foundation for growth is the area where you truly excel.

That said, given the proper research and risk analysis, new product lines, customers, or markets may be an ideal way to grow your business.

### Are You Ready For Growth?

As we noted earlier, entrepreneurs are born innovators. But once they reach a certain plateau of success, it's natural for them to worry about rocking the boat. Such fears are normal, and are worth examining in more detail. It's often a great help to identify the source of the worry, and assess how realistic it really is.

Here are some of the worries you might have, as an entrepreneur considering growth:

- **Fear of failure.** How much do you have invested in your business? Is it possible that you could lose everything? If you feel like there's too much at stake, it's a good sign that you should postpone growth until you're in a more positive situation.
- **Fear of success.** Are you worried about what will happen if your business grows? Will you still have time for family, friends, and leisure activities?
- **Fear of giving up authority.** The bigger your company gets, the less direct control you'll have over it. Are you worried about having to give up personal control of certain aspects of the business?
- **Fear of responsibility.** Growth is a gamble, and the outcome will affect the lives of your employees and their families. Do you feel that this is too big a responsibility for you?
- **Fear of humiliation.** Are you worried that if you take a chance and fail, people won't take you seriously if you try to start over?

There's no doubt about it: change can be very frightening. On the other hand, the most exciting and positive events seem to happen in times of crisis: people develop new skills, challenge themselves, and discover their hidden potential. Growth without uncertainty and crisis is simply not possible.

This doesn't mean that your business can't grow unless it's subjected to some disastrous near-meltdown. By "crisis," we simply mean a point at which you must let go of old ideas in order to adapt to new circumstances.

**Is It Time to Grow?**

Do you think now is the time to grow? It's best to have all these elements covered before embarking on a growth plan.

1. A tried and true business model that has been refined over time, and is profitable.
2. A clear commitment by you and your employees to a mission statement and to the core values that underline the goals of the company.
3. Unique processes and procedures that have been set down in writing.
4. An absolute understanding of your current customers, and a focus on learning about future customers.
5. A demonstrable market demand for your products.
6. A pledge to provide additional training for your employees to enable them to meet the challenges ahead.
7. An emotional and intellectual openness to change.

*Joe telephoned June Multimedia and arranged to meet with them the following Monday. He told them he needed some time to evaluate their offer.*

*He had to think fast, but carefully. First, he took a hard look at his business. He knew what his current revenues and expenses were, and he had projections for upcoming projects. But he didn't have a clear picture of his business model.*

*Who was his ideal customer? What sort of project was most suited to his strengths and interests? Which production duties had to be done by Let's Learn, and which could he outsource to other businesses? Should he grow his business?*

*Joe had never taken the time to update the business plan that he'd created over two years before, when he was working full-time for the children's book publisher. He decided that before he made a move, he would revise his business plan.*

## Planning for Growth

Successful entrepreneurs distinguish themselves not only by a keen understanding of their markets, but also by their ability to plan for growth. They identify trends that are likely to affect the business environment. They plan for their financial needs, and begin laying the groundwork for additional financing long before they need it. They create management controls to sustain performance, utilize budgets to safeguard cash, and identify the staff they'll need in order to grow their business.

Most important of all, they revisit and update their business plans.

### Update Your Business Plan

Even the best business plans become obsolete when conditions change

Let's say that after careful consideration, you decide that now is the time to grow. The next step is to review and revise your business plan. Even the most carefully researched, ingeniously written business plan becomes obsolete when conditions change. Your target customer profile or market segment can shift, economic conditions can change, your competitors can introduce groundbreaking products, or a new technology can emerge.

Remember: Your business plan will be used by investors, customers, bankers, suppliers, partners, consultants, and employees to gauge your firm's potential. Ask yourself the following questions; your answers will guide the evolution of your business plan:

- Does my business plan accurately reflect my business today? Are my original goals and standards still reasonable? Are my assumptions still valid?
- What threats and opportunities does my business face?
- What are my business's strengths and weaknesses?
- Can my business operate more efficiently?
- What resources does my business require?
- Am I meeting quality and service goals?
- Am I serving the customers I targeted in my business plan?
- Has the competitive landscape changed?
- Do new regulations apply to my products, employees, or raw materials?
- Have my customers' needs changed? Has my ability to meet their needs changed?
- Has cost structure and pricing in my industry changed?
- Are there any new technologies that affect my ability to compete?
- What new product or market growth opportunities are available?
- How much financing will I need, and where will I get it?
- Will I need to hire new staff?

### Financial Considerations

If you want to grow, you will probably need more money than your business can generate. That's why it's best to cultivate external financial resources *before* you need them.

**External financing** for your growing business can come from:

- Public investors
- Private investors
- Peer groups and cooperatives
- Professional investment funds (venture capitalists)
- Foundations (grants for special causes)
- Corporations (joint ventures and equity investments)
- Commercial banks
- Investment banks
- Government grants and loan guarantees

**Internal financing** can come from:

- Reinvestment of profits from sales
- Sale of assets
- Credit from suppliers (extended payment terms)
- Customers (payments in advance)
- Employees (stock purchase plans, wage/salary concessions)

Use your knowledge about your business to select the financing methods that are right for you. Consider the length of time the funds are available, the costs involved in acquiring them, and the amount of control over your company you are able to retain.

Use your knowledge about your business to select the financing methods that are right for you

Securing capital will require selling lenders or investors on your track record, business plan, employees, personal vision, professionalism, and prospects for growth. Here is a checklist for use in the capital acquisition process:

- Update your business plan
- Document your business's track record
- Identify new opportunities, problems, and challenges
- Prepare a sales forecast, pro forma budget, and cash flow analysis
- Show your business plan to prospective funding sources and ask for feedback
- Identify how much money you need, over what period of time
- Review your financial and marketing ideas
- Update your targeted sources of financing often
- Be straightforward, direct, and honest
- Be confident and optimistic, but realistic
- Show conviction and passion

*Joe spent the entire week rethinking and preparing his business plan. When he had reviewed the marketing aspects of his business, he committed them to paper. He wrote, revised, took a break, and checked his work several times.*

*When he was done, Joe felt he had identified Let's Learn's greatest strengths: conceptualizing new projects, and assembling teams of people to perform the production work. He decided to focus on pitching concepts and projects to large, national content providers. His projects could be adapted to any medium, including DVD, CD-ROM, and the Web.*

*Joe estimated that in order to meet his professional targets and personal income goals, Let's Learn would have to produce, on average, eight major projects a year. That would require him to move out of his home office into a larger office space, hire two additional project managers, and invest in new equipment.*

*It would be a lot of work, but Joe was eager to face new challenges. He felt confident that his business could continue to be profitable and grow. By Sunday morning, he had made the decision to turn down June Multimedia's job offer.*

## Problems and Solutions

Failing to manage growth can affect every area of your business's performance

Failing to manage growth can affect every area of your business's performance. Major pitfalls include:

- Experiencing only limited, short-term growth
- Inability to maintain consistent performance standards
- Unprofessional behavior
- Low employee morale, and high employee turnover
- Loss of profitability
- Loss of customer loyalty
- Diminished quality
- Slowdown in business learning and competitiveness
- Inability of overworked leadership to provide direction
- Cash crunch and bankruptcy
- Inefficient use of resources
- Stress and burnout
- Loss of focus on core objectives
- Poor communication among employees

In this section, we'll look at some of the challenges that growth often poses for small businesses, and offer some potential solutions.

### Moving Too Fast

Having enthusiasm for your business is admirable. But being in a hurry can result in poor decision-making, which often causes problems in the long run. Lowering your price before market acceptance for your product takes hold, changing your products in midstream, or deciding to do everything yourself, are just a few examples of potentially bad decisions caused by being in too much of a hurry. Prior planning allows you to act more quickly, and to solve problems before they become disasters.

*Solutions*

- Slow down long enough to analyze the long-term consequences of your decisions. Review decisions before you implement them, particularly in the early stages of new business development.
- Avoid making rash financial decisions. Entrepreneurs regularly make the mistake of putting their life savings into a project in order to avoid going through the bank lending process or some other time-consuming process. More money will not cure all the problems you face!

### Growing Too Fast

A common problem among businesses that have latched onto a significant technological breakthrough, or tapped into a fast-paced trend, is that there may be a much greater demand for the product than anticipated. While this may seem like a problem you would love to have, growing too fast can destroy a business that lacks access to growth capital. Too often, businesses go from booming sales to bankruptcy, because they fail to notice the warning signs of out-of-control growth. Here are some problems that signal trouble for growing companies:

- Cash flow problems and difficulty paying bills
- High employee turnover
- Overlooking the details of running the business
- Customer complaints
- Failure to focus on the business's core competencies
- Diminished quality of products and services

*Solutions*

- Create safeguards to keep your business on track, by limiting your business to a set level of customers, a specific geographic region, or a particular order size. These limits aren't permanent; they just keep growth manageable for a given period of time, so that you can plan intelligently for the next stage of growth.
- Take time to anticipate ramp-up costs if yours is a rapid growth business. If you have limited personal access to additional financing, create a cash flow model that determines how much additional funding you'll need to keep pace with demand.

- While it may not be possible to include all of the potential expenses of growth, a reasonable estimate of these costs is essential in determining ongoing needs during this high-growth stage.
- Remember that as your business grows, your workload will increase. Some businesses fail because the owners are too busy making products or filling orders to take care of essential management tasks. The ability to delegate responsibility and authority at this stage is crucial.
- Look for the next level of financing early. Bank negotiations for second-round funding can be slow, especially when there's a short length of time between the first round of funding and a request for expansion funding. Also, initial public offerings (IPOs) are very time-consuming to prepare and coordinate.

### Avoiding Innovation

It's not unusual for successful, growing businesses to settle into comfortable patterns of behavior, and miss out on good opportunities to stay innovative and competitive. Such businesses can become complacent about their success, and ignore technological developments, changes in customer demand, or competition. Soon, growth slows and fizzles, leaving the business owner wondering what happened.

*Solutions*

- Never stop learning. Stay aware of emerging issues by reading trade journals, and attending industry trade shows and Chamber of Commerce functions.
- Keep close tabs on what your competitors are doing, and do your best to understand what market conditions are driving their decision-making.
- Encourage innovative thinking. Always ask yourself and your team, "Can we do this better?" and "Are we being as creative and efficient as possible?" Don't take any materials or processes for granted...there's always room for improvement!
- Understand your customers. Has the market for your products or services changed? Are your customers' needs and preferences changing? Have their habits changed?

Don't take any materials or processes for granted...there's always room for improvement!

### Ignoring Employee Management Issues

As a business grows, its character inevitably changes. The solo entrepreneur transforms into a team of people that may include full or part-time employees, independent contractors, suppliers, advisors, and assistants. In the process, small businesses often focus on sales and meeting orders at the expense of the people who make those sales possible: employees. This results in poor communication, loss of efficiency, and low morale.

Also, if growth forces you to hire new personnel, your regular employees may feel threatened or crowded, or worried about their future.

*Solutions*

- Allocate responsibility by creating and updating an organizational chart for your business, including written job descriptions. Who reports to whom? For which tasks is each person responsible? What deadlines apply? How frequently will you evaluate performance? Who has what authority?
- Reassess and update employee compensation and incentives at least once a year.
- Set clear objectives for each person's performance. Update these objectives frequently with a formal performance evaluation system.
- Before you hire any new workers, meet with your current employees, and explain your plans. Where possible, ask for their help and insight in creating and structuring new positions. In some cases, it may be wise to let current employees apply for these new positions, before you start interviewing outsiders.
- Invite existing employees to participate in creating new job descriptions and interviewing prospective team members.
- Treat your employees as you would like to be treated.

Treat your employees as you would like to be treated!

## Space Considerations

Growth may require you to seek out a larger office, factory, or warehouse, in order to make room for additional equipment, materials, inventory, and personnel. You may also need to remodel in order to provide a larger break room or meeting area, and more restroom facilities.

Too many growth-oriented business owners take the risk of moving to new facilities in advance, after guessing what their space needs will be. At best, this is a gamble. If it fails, you may find that you've committed yourself to paying extra money for a space that's larger than you need in the short term. Decisions about facilities should be made calmly and with a clear head.

Also, consider that moving your operations may be complicated, distracting, and confusing. If you're truly committed to growth, you won't want to hobble yourself with these problems at the outset.

*Solutions*

- Look for an extended period of growth—or a very solid promise of it—before making any big moves.
- If your office is getting a little cramped—but is functioning well—you can always think of it as a temporary sacrifice to make a move more feasible. (Be sure to explain this to your employees!)
- If cramped facilities are making it hard to get things done, you might consider a creative, short-term solution, like renting or subletting a separate facility for one or two of your departments until you can afford an ideal space.

### Technological Limitations

Growth often requires new equipment, new computers and networks, faster Internet connections, and so forth. Before you grow, you need to be certain that your business systems and equipment are up to the job.

*Solutions*

- Look at all the systems that help you run your business, from accounting software, to inventory management systems, to ordering and shipping methods, to your vehicle fleet, to computer software and hardware, to Web presence and e-mail. Will you be able to meet your goals with the existing systems, or will you have to upgrade? Business owners who overlook the strain that growth puts on these systems often end up underestimating the total cost of growth.
- Remember that new business systems have a learning curve. Also, they need to be tested thoroughly to ensure that they're right for your business. Always allow ample time to evaluate new systems and work the bugs out.
- If your suppliers offer training on new software or equipment, you should take advantage of it. You should also keep up with upgrades and new capabilities.
- Many businesses neglect the expense of buying new software licenses when they grow. If you're adding personnel, be sure to check whether you need to buy additional copies of necessary programs, or switch to a Web-based service.
- When you can't afford to create an in-house capability for a specific business function, or it's not really a core competency, consider outsourcing it.

Remember that new business systems have a learning curve

*Joe spent Sunday afternoon reviewing the strengths and weaknesses of his business. He had assembled a good team of part-time and contract professionals who helped him produce his projects. He had a multimedia designer with expertise in digital editing and animation. He had two close friends with whom he collaborated on new concepts and production management.*

*But Joe often felt like he didn't have enough time to manage projects properly. Sometimes, he was too busy even to record his project hours and materials expenses. He realized that what Let's Learn needed most was:*

- *A business manager to organize project billing and expenses, payroll, overhead expenses, and equipment repairs*
- *A team of three full-time project managers*
- *Office space*
- *Project management tools and resource scheduling to improve time management*
- *Equipment upgrades*

*He calculated that these things would cost Let's Learn over $300,000 for the first year. He knew he couldn't afford to borrow that much money. How else could he finance his growth?*

## Strategies For Growth

Your business is profitable, you're up to date on the dynamics of your market, and you know the direction in which you want to go. You want to take your business to the next level, either by increasing your customer base, tapping into a new market, or offering additional products or services. You need a strategy to accomplish this.

Here are the factors that differentiate growth strategies:

- Level of risk
- Speed at which they allow growth
- Cost of growth
- Implications for the future of your business
- Degree of managerial control they allow you to retain

### Vertical Growth

**Vertical growth** happens when you increase sales of an existing product within an existing market. This tends to be the least risky form of growth, because it usually doesn't require a large increase in manufacturing, personnel, or warehousing costs. It also tends not to disrupt business processes.

### Horizontal Growth

**Horizontal growth** happens when you offer new products, or seek out new markets for existing products. The riskiness of this strategy varies, depending on how new and different a given product or market is. In some cases, it may require nothing more disruptive than creating a new marketing plan, adding additional sales people, or offering your products online. In other cases, it may require a great deal of new capital, as well as substantial changes to business structures and processes.

### Demand Innovation

In recent years, growth for most firms has been sluggish at best. But some companies have managed to beat this trend by investigating the idea of **demand innovation**. Demand innovation is different from product innovation, in that it focuses on business opportunities that stem from customer use of your product, rather than on the products themselves.

For example, your product may be used in tandem with other products, or it may serve multiple users, or it may serve a single user in multiple ways. These uses may create new customer demands, some of which may never have occurred to you. They may lead you to offer installation, maintenance, or training services. Whatever the case, sale of your product becomes a jumping-off place for discovering new service offerings that will meet a wider range of customer needs.

A different choice of materials or processes may give you access to a previously unavailable market

### Redesign

Redesign is another opportunity for growth. A different choice of materials or processes may give you access to a previously unavailable market. Some analysts feel that we're in the midst of a design revolution, in which basic assumptions about materials and processes are being questioned, and design innovation provides the greatest opportunities for growth. Innovative packaging, cradle-to-cradle design, use of recyclable and sustainable materials...all these things can lower production costs while increasing consumer appeal and growth opportunities. For more information, see Chapter 24 *Managing Green.*

### Acquisition

Growth through acquisition of an additional business depends on:

- Tax considerations
- The business goals of the participants
- The industry/type of companies involved
- The regulatory environment
- The amount of assets involved

The starting point for growth by acquisition is an evaluation of your prospective acquisition:

- Cash flow
- Assets
- Sales, cash, profitability, and break-even projections
- Market position
- Management team
- Organizational culture
- Advantages of merging (synergy with your business)
- Legal considerations
- Management of the new business entity

### Joint Ventures and Partnerships

Growing by entering into a partnership is an increasingly common strategy for big and small businesses alike. It entails choosing a partner with complementary skills, technologies, customers, or products, in order to achieve things neither business could do alone. Joint ventures are very popular ways to:

- Minimize risk
- Achieve economies of scale
- Create synergies
- Gain technical know-how
- Expand geographic reach

- Acquire patented products, technology, or processes
- Expand the customer base
- Lower costs by pooling expenses
- Increase product offerings

Just because you manage a small business doesn't mean that a joint venture or partnership can't offer you the same benefits it offers bigger companies. All of the benefits listed above apply to your business just as much as they apply to the Microsofts and GEs of the world. They help you serve your customers, be profitable, and increase your competitiveness in the market. Alliances and partnerships can be as complex or simple as you choose to make them, but the principle always remains the same: You need to identify what each side contributes to and takes away from the deal.

### Going International

As we discussed earlier in this book, the combination of the Internet and the forward march of globalization has made international business an attractive option for growth. In order to determine if exporting or importing is worth pursuing, you will need to prepare a professional international marketing plan.

### Consulting

It may be that over the course of your business, you've built up a certain type of expertise, or developed the ability to solve certain types of problems for your suppliers or partners. If so, you may be able to grow by making that expertise available to others.

*It was Sunday night. The next morning, Joe had to give June Multimedia his answer.*

*Suddenly, he realized that the perfect solution was right in front of him. Why not take advantage of their interest in him by proposing a partnership between June Multimedia and Let's Learn Edutainment?*

*Both companies would benefit from the partnership. Let's Learn could move into June Multimedia's office space, share their receptionist, and contract with their studio to handle all film and pro audio work. Let's Learn would save money by not paying rent and would have, in effect, its own in-house production studio.*

*In exchange, June Multimedia would get an in-house content creation department. Joe would bring along his team, and give June Multimedia first rights on jointly marketing Let's Learn's titles. June Multimedia would also expand its revenues through the additional production work, and they'd learn the content creation and project management business from the inside out.*

*It seemed like a perfect strategy. Joe calculated that if June Multimedia liked the idea, he would need only $150,000 for the first year of growth. After that, he calculated that the business would be self-sustaining, and able to pay additional managerial salaries out of earnings.*

*On Monday, Joe turned down the job, but made the joint-venture pitch to June Multimedia. They were interested enough to request a face-to-face meeting. They liked the idea of sharing office space, and having Joe and his entire creative team onsite. And they really liked the fact that he would bring four projects already in the works!*

## Tools for Growth

In a period of growth, whether planned or unplanned, good management techniques are the best tools you can have at your disposal.

### Cash Management

Good cash management strategies show lenders and investors that you know how to run a profitable business, and will be able to service your debt. This is why you should cultivate relationships with prospective funding sources while your business is doing well.

Your ability to manage cash skillfully determines your business's ability to grow. By contrast, poorly managed cash can drain your business's vitality in the blink of an eye. Here are several of the biggest drains on cash that a business can have:

- Interest payments on debt
- Cash tied up in excess inventory
- Uncollected accounts receivable

Projecting, monitoring, and conserving cash is not one of the more exciting parts of managing a business, but it can be the most important! If you're not good at tracking spending and calculating your cash balances, enlist the help of someone who is.

### Team Management

The success or failure of your growing business hinges on your ability to think strategically, delegate when necessary, and manage people, time, and resources. Your task is to ensure the internal health of your organization during these turbulent, exciting times. This means creating a system of checks and balances that will allow your business to perform consistently, professionally, and profitably.

The key to being a good leader is creating a good team!

The key to being a good leader is creating a good team. This means gathering committed, inspired people who will work together toward shared goals.

As discussed in Chapter 22 *Team Building and Leadership*, these people need not all be full-time employees, but they do need to be aligned on goals and in close communication with one another. You can't grow your business alone, so start building a high-performance team now!

## NxLEVEL® TECH TIP
BUSINESS RESOURCES AND THE WEB

Here are a couple of Websites that may help you to manage your growing business.

**Outsourcing Interactive** (www.outsourcing.com) offers information on strategic leveraging of outsourcing resources and capabilities. This site features outsourcing products, advisory services, training programs, and issue sessions; a discussion area; outsourcing information tools; an online archive of outsourcing articles, briefing papers, and statistics; and a summary of the Outsourcing Institute's Survey of Outsourcing Users.

**Business Know-How** (www.businessknowhow.com) provides information for small-business owners who are looking for inspiration or practical suggestions on starting or managing a successful business. It is also a place for entrepreneurs to share the insights and expertise they've acquired with others.

### Time Management
Understanding time management will improve productivity and performance, lower your stress level, and enhance relationships with employees, suppliers, and customers. Here are some basics of time management:

- Rank tasks by importance: ***A*** tasks are urgent and important. ***B*** tasks are important, but not urgent. ***C*** tasks are neither urgent nor important.
- Set realistic goals. If you keep falling short of your expectations, maybe they're too high.
- If possible, break your tasks into smaller blocks of time, with frequent breaks, to avoid burning out.
- Stress, anxiety and depression can make completing tasks more difficult. You may need to solve underlying problems like these before you can make real progress.
- Consider using time and project management software to create task lists and automated reminders.
- Delegate authority and responsibility when necessary.
- Maintain strict boundaries between work and personal life.

### Stress Management
You can do everything right and still fail if you don't keep stress within manageable limits. Stress management isn't just a good business practice; it's also vitally important to your health and happiness. Developing good habits now will help you when the going gets tough.

Stress management is vitally important to your health and happiness

Here are some tips on reducing the amount of stress in your life:

Make time to relax and enjoy yourself!

- **Set clear cut-off times for your workday.** We've said this before, but it's impossible to overemphasize it. Whatever problem you face, you'll be better able to deal with it after putting it aside long enough to relax, unwind, and get a good night's sleep. Thinking obsessively about your problems may *feel* like work, but it rarely leads to solutions. The ability to step away from a problem, and come back to it later feeling refreshed and alert, is one of the most useful skills an entrepreneur can develop.
- **Take time off.** It may be necessary to work on a weekend from time to time, but if it happens consistently, you're headed for trouble. If you can't relax and enjoy yourself regularly, you won't be able to think clearly. And if you can't think clearly, you won't make good business decisions. Perhaps you can't afford to hire help, but you should still consider other options, like barter and internships.
- **Get adequate exercise.** Obviously, you need to exercise for the sake of your health. But it can also help to reduce stress, and keep you from tossing and turning when you should be sleeping. Before beginning an exercise program, be sure to get advice from your family physician.
- **Eat well.** We all know entrepreneurs who seem to live on donuts and coffee, and others who end up eating take-out food for every meal, because they have no time to shop or cook. Don't fall into these traps! Part of structuring your workday should include making time to eat healthy, balanced meals; a good breakfast is especially important. Different people have different needs, so ask your doctor for advice on eating right and staying fit.
- **Get adequate sleep.** You should do your best to get at least seven hours of sleep, if you possibly can. Apart from worrying about business, some of the most common causes of poor sleep include having alcohol, caffeine, or heavy food within three hours of bedtime. Try to improve your sleep by changing habits like these, instead of taking medications that can affect the quality of your sleep, and may be habit-forming or have unwelcome side effects.
- **Practice stress-reduction techniques.** For many people, this could mean a specific discipline like meditation, yoga, exercise, or prayer, all of which have been shown to lower stress levels in people who practice them daily. Others may try to identify specific daily stressors, and make an effort to transform them into something pleasant. For instance, if their commute is stressful, they might do something to make the drive more rewarding, like listening to books on tape, or podcasts about a favorite hobby, or learning a language from tutorial CDs. Maintaining a sense of humor can be a big help, too!

*Joe realized that the partnership didn't solve all of his growth-management issues. If he had this much trouble managing his own time, how could he manage a larger team for his growing business? He decided he needed help in managing his time and delegating responsibility, so he attended a seminar on time management, which was sponsored by his local Chamber of Commerce. There, he learned that he needed to break down how he actually spent his time.*

*Joe created a job description for himself and each member of his team. This was a simple list of duties and responsibilities that each person needed to perform. It prioritized tasks and outlined how projects would be scheduled and monitored. His own job description reminded him that his greatest value to Let's Learn was in high-level strategic planning and project promotion. Therefore, he would focus his efforts on coming up with new project ideas, pitching projects to buyers and distributors, creating alliances, and prioritizing and scheduling production. All other tasks (including billing, expenses, payroll, training, and day-to-day contact with contractors) he would delegate to other employees.*

*Within three weeks, Joe had hired his two friends and an interactivity designer as part of his full-time team. Within six months, the June/Let's Learn production team had finished its first multimedia project, "Freddy Frog in the Amazon." Members of both teams worked well together, and continually learned from one another.*

*Joe McGuire could hardly believe his luck. Nine months before, owning a full-time business had been just a dream. Now he'd negotiated a partnership with a national production house, applied for and received his second round of financing, and was managing his own team. Let's Learn had come a long way!*

### Focusing on Innovation

The role that innovation plays in attracting and keeping customers cannot be overemphasized. Whatever your business does, countless competitors are trying to do it better. Inventors all over the world are working on products that could supersede your product and put you out of business. In other words, what's great today may not be good enough tomorrow.

What's great today may not be good enough tomorrow!

Of course, it's hard to focus on innovation when you're trying to make payroll every month. Add to that the fact that many small businesses get used to doing things a certain way—for the same customers, and with the same employees—and you begin to see the difficulty of embracing change and innovation. That isn't to say it can't be done, but it does mean that it will take a special effort to make it happen.

Part of this effort is planning and restructuring for a focus on innovation. You can start by using your business plan as a tool for growth through innovation. Then, prepare yourself for the difficulties ahead. If you aren't emotionally and intellectually ready to innovate, your employees won't be either.

Treat failure as an opportunity for learning!

Speaking of your employees, you should harness their innovative power by empowering them to act and think in creative ways, without facing censure when things don't work out perfectly. Treat these events not as failures, but as moments for learning.

You can also turn to your best customers for ideas. As everyday users of your products, they may be able to help you make incremental or even breakthrough changes. Last, consider getting a fresh perspective by inviting outsiders to help you with innovation.

Here are some other good ways to create a culture of innovation at your firm.

- Mix it up! Allow different ideas, products, customers and employees to intersect in ways that they haven't before.
- Experiment. Relax your processes and procedures a little, to allow for "happy accidents."
- Encourage a healthy diversity of views. People have different talents and look at the world in different ways. Some see the big picture while others are better at the little details. You need to encourage both types to come together and attack problems.
- Reward people for trying and for succeeding. When things don't work out, learn from it so that you'll do better next time.

## NxLEVEL® GREEN TIP
ENVIRONMENTAL BUSINESS RESOURCES

One of the hottest topics in green design is **sustainable innovation**. Here are some sites that will keep you up to date on what your competitors are doing, and help you to innovate at your own firm.

**Invention Machine** (www.invention-machine.com) "drives sustainable innovation by enabling global organizations to consistently generate breakthrough ideas that accelerate product development. A leading provider of innovation software, Invention Machine empowers engineers and scientists to conceive and validate right ideas the first time, so they can quickly and easily deliver market leading products."

**Eco Innovation Network** (www.eco-innovation.net) aims to "better understand and alleviate barriers to eco-innovations, and offers a pool of opportunities and informational resources."

**Innovation On Purpose** (innovateonpurpose.blogspot.com) is a blog dedicated to "ideas, conversations and approaches for sustainable, repeatable innovation."

### Forecasting and Financial Management

Forecasting and planning are the cornerstones of well-managed growth. It's very important not to ignore these critical functions before, during, and after a growth period. We have discussed these issues at length throughout this book, but here are some additional things to consider:

- Everyone in your business should be involved in forecasting future costs and sales. Giving each department input into the process will produce company-wide data and encourage employee buy-in.
- Many employees resist planning efforts because they don't see what's in it for their department or for them. It's your job to explain how their activities fit into the big picture, and motivate your team to make their best efforts.
- Use the best tools available to you to do this work. Software packages and networked hardware can aid you in developing a sales forecast, and driving it through the rest of the accounting system as the plan is put in action.
- Define your goals and objectives at the outset of your planning efforts. This will go a long way towards helping you achieve and maintain the results you want.
- Focus your efforts on the projects, products, and customers that offer the greatest potential for revenue and profit.
- Company-wide goals should be linked to company-wide rewards, not individual departments. Remember, you're all in this together!
- Nobody is perfect. Therefore, your forecast won't be perfect, either. Aim for continuous improvement, not perfection.

Aim for continuous improvement, not perfection

Once you begin to implement your growth plan, financial management becomes more important than ever. Chapter 37 *Budgeting*, Chapter 38 *Cash Flow Management*, and Chapter 44 *Financial Management* will be well worth revisiting at this point.

## Conclusion

The biggest challenge growing businesses face is maintaining professional, consistent performance. Too often, they fail to serve customers, move away from their core competencies, and experience cash management problems. In the worst cases, they lose control of their profitability, resulting in a crisis where their very survival is on the line.

Your business plan, your personal objectives, and your personal stress levels are perhaps the most important things to consider as your business grows. Businesses that fail to prepare a cohesive plan can fall into the trap of reacting rather than acting.

Managing customers, cash flow, team members, stress, and technology are just a few of the challenges you'll face. Planning now to meet and overcome these challenges will greatly increase your business's chance of thriving during a phase of rapid growth.

# Chapter 44
# FINANCIAL MANAGEMENT

*About This Chapter:*

- *Financial management basics*
- *Financial ratios*
- *Accounting software*
- *Surviving economic downturns*

## Introduction

As the leader of a growing business, you should be able to read financial statements as easily as you're reading these words. This is the life's blood of your venture, after all. If you hire sloppy people to do your accounting, you're in trouble. If you're using the wrong accounting software, you're in trouble. But if you don't know enough about financial management to recognize sloppy accounting and inadequate software, you're *really* in trouble!

The only way to avoid these serious errors is to learn about, understand, and practice financial management skills.

There's no substitute for hands-on management of financial data!

## Financial Management Basics

A growing business presents many challenges. The first step in keeping your business afloat is staying on top of budgeting, cash flow management, and sources and uses of funding. Even if you decide that you need outside help, there's no substitute for hands-on management of financial data.

Remember: There's a financial component to every single decision you make in your business. If you're not getting the right financial information when you need it, or you don't have the skills you need to interpret it, you have no reliable basis for assessing whether your decisions are wise.

### Budgeting

A budget projects sales, collections, purchases, and expenses over a period of time, in order to anticipate surpluses and deficits.

The traditional budgeting model is based on revenues from the preceding year. The problem with this is that some expenses—or departments, or processes—may end up snowballing as time goes on.

If last year's advertising efforts paid off, should you automatically increase your advertising budget this year? Not necessarily. It may be that given your niche and location, the money you spent last year is more than sufficient for this year. Don't let budget expenditures become mindless traditions.

**Zero-based budgeting**—which requires you to justify all expenditures for each new period, instead of just amounts in excess of the previous period's funding—can be a good way of avoiding such mistakes. However, it requires a lot of paperwork and time, which adds up to higher expenses. As always, it's necessary to find a healthy balance.

You should review your budgets frequently. Are you carrying expenses out of habit? Are the expenses necessary for your current goals? Did you update your costs to reflect market conditions? Never be afraid to challenge your assumptions.

### Cash Flow Management

No skill is more critical than the ability to manage cash

We discuss cash flow management throughout this book. This redundancy is no accident. For growing companies, no skill is more critical than the ability to manage cash. As a general rule, you should analyze your cash flow on a weekly basis. And of course, using the cash flow statement to determine how much capital you need for growth is an absolute must.

In your first few years of operation, comparing the monthly cash flow statement against actual inflows and outflows can help you determine how well you've planned. This is an essential exercise for entrepreneurs who are managing a growing company.

*Max Scheler and Ernie Cassirer had worked for years in graphics software development, and they eventually came to a point where they wanted to put the software they'd made to work for them. They understood the programs and the systems, after all, and they were both skilled graphic artists. Max also had a flair for writing.*

*They decided to pool their skills and their money, and formed a graphic arts partnership called Diamond Lens. They rented space in a stand-alone building near a mall in their hometown of Zanesville, Ohio.*

*Once they began to advertise, they quickly found that there was plenty of business, both individual and corporate, and for the first year things went well. They located some outside investors to back their first expansion, and within a few months they'd hired fifteen employees, and were thinking about looking for a bigger space.*

### Sources of Funds

As we mentioned earlier, the major sources of funds are sales revenues, equity capital, debt capital, and proceeds from the sale of assets.

Let's look at them once more, this time from the standpoint of financial management.

- **Sales revenues** comprise the greatest part of any company's financing. Ideally, they'll cover your expenses and provide a healthy profit margin. However, projected sales figures can't take market fluctuations into account. Thus, an important part of financial management is planning for and minimizing the effects of downturns, seasonal or otherwise.
- **Equity capital** comes either from a business's owner(s), or from the sale of shares of ownership. The entrepreneur who weathers a financial storm with his or her own money is taking a risk. If the storm was entirely unforeseen, and the financing was acquired haphazardly, the risk is multiplied. Equity capital is appropriate primarily for long-term needs. Thus, it should be considered carefully, long before it becomes a necessity. Handling a short-term financing need with equity capital shows a dangerous lack of planning and foresight.
- **Debt capital** is borrowed money. Obviously, you don't want to borrow money unless there's something to be gained. The creation of a good credit rating is a consideration. To that end, a line of credit from a lending institution is often the most effective and profitable option.
- **Sale of assets** is generally appropriate only when neither equity nor debt capital is available. Obviously, you shouldn't sell off assets you need. Unfortunately, deciding what is or isn't necessary usually isn't as simple as saying "Hey, we don't need these old steam-powered staplers anymore," or "Maybe we can sell off our hoop-skirt division!"
- **Venture capital** is most frequently used by second-stage growth businesses. It's usually provided by a firm that specializes in loans to ventures it considers promising. Venture capital success is measured in terms of rapid expansion, and quickly escalating sales and profits.

An important part of financial management is planning for and minimizing the effects of downturns

## Financial Ratios

Financial ratio analysis is a method of assessing the financial health of your business by means of data taken from its financial statements.

Financial ratios can tell you a lot about your business's strengths and weaknesses. They can tell you whether your financial condition is getting better or worse, and help you to identify and remedy problems before they spiral out of control. They can also tell you whether you're holding too much or too little inventory, or collecting receivables too slowly.

There are four basic types of ratios:

- **Liquidity ratios** analyze your business's ability to meet short-term obligations and unexpected debts.
- **Asset management ratios** show how efficiently your company handles operations and assets.
- **Profitability ratios** show your return on sales and capital.
- **Capital structure ratios** show the extent to which your business is financed by debt.

Credit analysts look at liquidity and capital structure ratios to assess a company's financial risk. Equity analysts are more interested in asset management and profitability ratios, which help them to assess how successful a business is likely to be.

### Benchmarking

Ratios become meaningful only through careful comparison to pertinent data

A ratio is simply one number divided by another. It becomes meaningful only through careful comparison to pertinent data. Benchmarking is the process of comparing current data with that of other businesses in your industry, or with your own past or future data.

The data you use for comparison can be internal, or external.

- **Internal ratio analysis** means comparing a present ratio to a past (or expected) ratio, in order to see changes over time.
- **External ratio analysis** means comparing your business's ratios with those of competing firms, or with industry averages, in order to see whether you're doing better or worse than your peers.

If you wish to compare your business to other companies, or to industry norms, there are a number of sources for this information.

- **Trade associations** within a specific industry routinely publish pertinent data for and about their members.
- **Private firms** such as Dun & Bradstreet and Standard & Poor's publish industry ratios. Dun & Bradstreet's *Key Business Ratios* (kbr.dnb.com) is a good example.
- **Government sources** offer all sorts of industry data. *US Industry and Trade Outlook* is a good example. The *Outlook* is currently being converted to a Web-only resource (www.ita.doc.gov/td/industry/otea/outlooknews.htm). In the meantime, you can visit the Office of Trade and Industry Information's Data and Analysis page (ita.doc.gov/td/industry/otea).

Benchmarking tells you nothing unless the comparison is justifiable. For example, suppose ratio analysis tells you that your customers take an average of 22 days to pay. If you sell funnel manifolds for lab filtration, you're probably in pretty good shape. If you run a corner grocery store, you're in serious trouble!

### Liquidity Ratios

| Ratio | Formula | | Source |
|---|---|---|---|
| **Current Ratio** | $\frac{\text{Current assets}}{\text{Current liabilities}}$ | | Balance Sheet |
| **Quick Ratio** | $\frac{\text{Current assets - Inventory}}{\text{Current Liabilities}}$ | | Balance Sheet |
| **Inventory to Net Working Capital** | $\frac{\text{Inventory}}{\text{Current assets - Liabilities}}$ | | Balance Sheet |
| **Fixed Assets to Net Worth** | $\frac{\text{Fixed assets}}{\text{Current liabilities}}$ | x 100 | Balance Sheet |

### Asset Management Ratios

| | | | |
|---|---|---|---|
| **Inventory Turnover** | $\frac{\text{Net sales}}{\text{Inventory}}$ | | Income Statement / Balance Sheet |
| **Average Collection Period (in days)** | $\frac{\text{Accounts receivable}}{\text{Annual sales}}$ | x 365 | Balance Sheet / Income Statement |
| **Receivables Turnover** | $\frac{\text{No credit sales}}{\text{Average receivables}}$ | | Ledger / Balance Sheet |
| **Payables Turnover** | $\frac{\text{Accounts payable}}{\text{Purchases for year}}$ | x 365 | Balance Sheet / Ledger |
| **Net Working Capital Turnover** | $\frac{\text{Net sales}}{\text{Average working capital}}$ | | Income Statement / Balance Sheet |
| **Asset Turnover** | $\frac{\text{Net sales}}{\text{Total assets}}$ | | Income Statement / Balance Sheet |
| **Fixed Asset Turnover** | $\frac{\text{Net sales}}{\text{Fixed assets}}$ | | Income Statement / Balance Sheet |

### Profitability Ratios

| | | | |
|---|---|---|---|
| **Gross Profit Margin** | $\frac{\text{Gross profit}}{\text{Sales}}$ | x 100 | Income Statement |
| **Net Profit Margin** | $\frac{\text{Net profit}}{\text{Net sales}}$ | x 100 | Balance Sheet |
| **Receivables Turnover** | $\frac{\text{EBIT}}{\text{Current assets - Liabilities}}$ | x 100 | Income Statement / Balance Sheet |
| **Return on Assets** | $\frac{\text{Net profit}}{\text{Total assets}}$ | x 100 | Income Statement / Balance Sheet |
| **Return on Investment** | $\frac{\text{Net profit}}{\text{Net worth}}$ | x 100 | Balance Sheet |

### Capital Structure Ratios

| | | | |
|---|---|---|---|
| **Debt to Equity** | $\frac{\text{Total debt}}{\text{Total Equity}}$ | x 100 | Income Statement |
| **Debt to Assets** | $\frac{\text{Total debt}}{\text{Total Assets}}$ | x 100 | Balance Sheet |
| **Interest Coverage** | $\frac{\text{EBIT}}{\text{Interest expense}}$ | | Income Statement |
| **Coverage of Fixed Charges** | $\frac{\text{EBIT + Lease}}{\text{Interest + Lease}}$ | | Income Statement |

Liquidity ratios reveal how capable your business is of meeting short-term obligations and unexpected debts

### Liquidity Ratios

Liquidity ratios reveal how capable your business is of meeting short-term obligations and unexpected debts. Banks typically use them to evaluate loan applications; the terms of bank loans often require the borrower to maintain a minimum ratio.

***Current ratio***

This is the standard measure of a firm's ability to meet current obligations. A ratio of 2 is usually healthy; it means that your business has two dollars of liquid assets for every one dollar of debt. A ratio of 1 or less usually indicates financial woes, while a ratio over 3 may indicate that you're not making the most effective use of your assets. It's a good idea to analyze your current ratio monthly.

***Quick ratio***

The quick ratio is identical to the current ratio, except that it excludes inventory from the calculation of current assets, because inventory is usually one's least liquid asset. The optimal quick ratio is 1 or higher.

***Inventory to net working capital***

This ratio tells how much of your funds are tied up in inventory. Keeping track of this ratio is vital to the financial health of your business. If this number is higher than average for your industry, you may be carrying too much inventory.

***Fixed assets to net worth***

This ratio calculates your percentage of fixed assets compared to total equity. When this percentage rises above 75 percent, it generally indicates vulnerability to market fluctuations and unforeseen expenses, because capital is tied up in things like machinery instead of being available for everyday expenses.

*In order to make the contacts they needed, cement relationships, and produce appropriately lavish promotional material, Max and Ernie had to spread themselves and their money pretty thin. Before long, Max found that he was spending a lot of time on the road, rustling up business in Cleveland, Cincinnati, Pittsburgh...even Chicago. Hotel, gasoline, and restaurant costs were adding up alarmingly.*

*"Burn rate" is the pace at which a venture consumes cash. Diamond Lens was developing a serious burn rate! On top of the money that was flying out the door for travel expenses, promotions, and increased employee wages, a good deal of money had been earmarked for a new set of machines in a new facility. New folding and binding machines were serious investments, as were the new crew of four to run them, and the new facility.*

*Still, Max and Ernie felt that it was pointless to send their binding jobs out when they could do the binding themselves for a lot less money. At least, that's what their somewhat optimistic projections told them.*

### Asset Management Ratios

Asset management ratios measure whether your operations are providing the most benefit for the lowest cost. For this reason, they're sometimes called efficiency ratios. However, the emphasis on efficiency sometimes misleads small-business owners. It's just as important to be effective as it is to be efficient. What use is it to go efficiently in the wrong direction?

Asset management ratios measure whether your operations are providing the most benefit for the lowest cost

A tunnel-vision focus on efficiency tends to indicate a product orientation, while a focus on effectiveness indicates a customer orientation. Ideally, you should strike the proper balance between the two.

*Inventory turnover*

This ratio tells you how often your inventory turns over in the course of a year. Again, inventory is usually the least liquid form of asset, so a high ratio is usually a sign of business health. That said, a very high ratio may indicate that you're not keeping enough inventory on hand, which could leave you vulnerable to stockouts and other supply chain problems, as well as to surges in consumer demand. Then again, it may simply mean that you sell perishable goods. Conversely, a low turnover may be worrisome, because products tend to deteriorate if they sit on the shelf for too long.

To calculate your inventory turnover ratio, add beginning inventory and ending inventory, and divide the sum by two. This will give you your average inventory. Then, divide your cost of goods sold by average inventory.

If you can't figure out your beginning and ending inventory, simply divide net sales by inventory.

*Average collection period*

This ratio tells you how quickly your customers are paying their bills. Generally, your average collections period shouldn't be more than 10 to 15 days longer than your credit terms. If you allow different credit terms for different transactions, calculate the average collection periods separately.

*Receivables turnover*

This ratio reveals how quickly customers pay you, on average. A high ratio suggests that your credit and collection activities are efficient. If this number is below your industry's average, your terms or collections may be too lenient.

*Payables turnover*

How quickly does your company pay its bills? A high payables turnover ratio means there is a relatively short time between your purchases and payments. A low ratio may indicate cash flow problems. Note that your payables turnover should be longer than your receivables turnover.

*Net working capital turnover*

This ratio measures how efficiently net working capital (i.e., current assets minus current liabilities) is being used to generate sales. A low ratio suggests an inefficient use of working capital. A high level suggests that working capital is being stretched too thin.

*Asset turnover*
This ratio shows the amount of sales generated for every dollar's worth of assets. A high number is desirable here. Note that this ratio reflects pricing strategy: a low profit margin generally leads to high asset turnover, while high profit margins lead to low asset turnover.

*Fixed asset turnover*
This ratio shows how efficiently your business is using its fixed assets to generate sales. The higher this ratio is, the better. A shrinking ratio indicates that you may have too much money tied up in buildings, machinery, or other fixed assets.

## Profitability Ratios

Profitability ratios measure the financial performance and growth potential of your business

These ratios measure the financial performance and growth potential of your business. They're one of the most important methods of assessing your business's financial health.

*Gross profit margin*
This ratio indicates the margin you earn on sales. Gross profit is the amount of sales dollars left after you deduct the cost of goods sold. Generally, this ratio should remain stable over time.

A decline in your gross profit margin may mean that your product costs are rising faster than your prices. A high margin is usually positive, but it can also indicate overpricing.

*Net profit margin*
The higher your net profit margin is, the more effective your company is at converting revenue into profit. If your business is having cash flow problems, calculating your net profit margin can help you set prices that generate an adequate profit. If this ratio declines, it may signal serious financial trouble.

*Return on capital employed*
This is a measure of the returns that your company earns from its capital. To calculate return on capital employed, divide **earnings before interest and tax (EBIT)** by the difference between total assets and current liabilities.

*Return on assets*
This ratio measures the earning power of your assets, compared to those of similar businesses in your industry. A ratio below the industry average may indicate inadequate productivity of assets.

*Return on investment*
This ratio shows you what you've earned on your investment in the business during a given accounting period. You can compare this return to potential earnings from the stock market, T-bills, CDs, and the like. As an active investment that's risky and labor-intensive, your business should be giving you a much better return on investment than passive investments like stocks and bonds.

### Capital Structure Ratios

Capital structure ratios measure the financial risk your business faces, based on your level of debt.

Capital structure ratios measure the financial risk your business faces, based on your level of debt

*Debt to equity*

This ratio compares what your company owes (debt) to what it owns (equity). If necessary, you can improve this ratio by paying off debt, or retaining a higher amount of earnings in the business until after the balance sheet date. Another option is to repay revolving debt (e.g., a line of credit) before the balance sheet date, and borrow it again after the balance sheet date.

*Debt to assets*

This ratio reveals the proportion of your company's assets that are financed through debt. If the ratio is less than one, most of your assets are financed through equity. If the ratio is greater than one, most of your assets are financed through debt. A high debt to asset ratio may indicate a serious danger of bankruptcy.

*Interest coverage*

This ratio measures whether your profits are sufficient to cover interest and other finance costs. The higher this ratio is, the better off you are. A ratio below 1 indicates that your company is having problems generating enough cash to pay its interest. Ideally, the ratio should be over 1.5.

*Coverage of fixed charges*

This ratio measures your firm's ability to meet all of its fixed commitments. Working capital loans often require you to maintain this ratio at a specific level.

*While business was good, Diamond Lens got away—sort of—with its less than ideal cash management policies. But by late 2008, the market was starting to slump, and Ernie was getting worried about Diamond Lens's ongoing cash flow problems. He decided to conduct some simple ratio analyses. He looked at a variety of capital structure, profitability, liquidity, and asset management ratios, and they confirmed the sinking feeling he'd had for a while. Their money was going out faster than it was coming in…a lot faster.*

*There was no getting around it: Diamond Lens was dangerously overextended. Fortunately, Ernie knew a good accountant from the old days at the software company. He'd be just the person to help them take a hard look at their revenues, assets, expenditures, and projected expenditures.*

*When Max and Ernie sat down with the accountant, they knew they were sitting down to plan for the survival—or the dissolution—of their venture. The first thing they had to do was create a new business plan that started with the hard realities of their present situation. As the accountant explained, a business plan can't help you if it no longer fits the facts.*

## Accounting Software

There are many accounting packages available to small businesses. The best of them allow non-accountants to accomplish such chores as inventory management, payables, receivables, and invoicing, while automatically taking care of entries, balances, and so on.

Accounting software is not a substitute for knowledge of best practices in accounting!

Remember this, though: Accounting software doesn't work miracles, and it's not a substitute for knowledge of best practices in accounting. To get the most out of accounting software, you have to understand what you're putting into it, and why.

Think of it as a glorified calculator: it can speed up tasks, but it can't run your business. Having software that can calculate economic order quantity is a godsend, but only if you understand what EOQ is, and how to gather the accurate information required to calculate it.

When you choose an accounting system, you need to make a commitment to learning to use it appropriately, and understanding what it does. You also need to commit to training your employees. Don't make the mistake of dropping a 400-page manual into an employee's lap, and telling him or her to get busy! There are few more reliable ways to alienate your employees that to force new software on them in this way.

Before you buy a system, consider how long it'll take to get the appropriate people truly proficient. When you buy a program, it's natural to want to get it up and running that afternoon. But instead, you need to set a sensible, realistic roll-out date that will allow the transition to happen smoothly.

Problems with your accounting system can be fatal to your business, so don't roll out a new system until you're confident it'll work. You may also want to maintain a temporary back-up system, just in case anything goes wrong.

### What Do You Need?

The type of accounting system you need depends, among other things, on the type of business you run. If you sell products, you'll certainly need the ability to track inventory, shipping, and so forth. If yours is a service business, you may want to have a client and project management system of some type.

But at a minimum, you'll need a system that handles taxes, invoicing, purchasing, and all the basic accounting features. If you have employees, you'll also need a payroll module.

Consider whether you have any unique requirements that will require you to customize your software. But resist the temptation to buy features that won't save any time or solve any problems. Lists of features can be dazzling, so you need to remain skeptical and focused. Just because a program can do something, doesn't mean it needs to be done at your business.

### Choosing Accounting Software

Here are some important criteria for choosing accounting software:

- **Ease of use.** How steep is the learning curve? Can an average user figure the program out without first getting a PhD in calculus? Realistically speaking, how long will it take you and your employees to become proficient? Remember to factor employee training costs into the price of the system!
- **Hosting.** Traditionally, companies have done their accounting in-house. But now, many companies are looking into on-demand accounting programs hosted on the Internet. Such systems are usually offered on a subscription basis, and may be more affordable than buying your own software, in the short term. A good on-demand system will also reduce start-up time, offer excellent security, prevent technical headaches, and offer a free trial period. Research your options carefully!
- **Range.** In addition to general ledger, accounts payable, and accounts receivable, what other modules or tools does it offer? Do you actually need them, or are they merely interesting or attractive? It's a bad idea to clutter up your system with features you don't need.
- **Flexibility.** Can the program easily be customized to suit your needs? Does it integrate seamlessly with other business applications, as well as e-mail and word processing programs? Is it compatible with your accountant's system? Does it allow you to share information easily between a variety of computers? Can you customize files and labels?
- **Security.** Does it let you or your accountant examine the details closely during an audit? Is it secure? Does it prevent unauthorized access to your data?
- **Add-ons.** Will it accommodate growth? Will you have to make multiple upgrades as you grow? A good system will allow you to grow without having to retrain employees. If you're planning for a certain level of growth within a year or two, make sure your system will still meet your needs at that level.
- **Help.** Does the software program have an adequate help utility, help desk, or community user forum? Is the firm reputable and popular enough that it's likely to stay in business indefinitely, so that it'll be able to offer support over the long haul?

It's a bad idea to clutter up your system with features you don't need!

It's a very good idea to seek advice from your accountant. He or she may be able to suggest a package that's just right for your business.

That said, the most important thing you can do is try out the system you're evaluating. Free trials—whether downloadable or online—and online tutorials are the only reliable way to get a feel for a system's pros and cons. Of course you'll want to read lots of software reviews, and get recommendations from fellow entrepreneurs. But that's no substitute for hands-on experience.

## NxLEVEL® TECH TIP

BUSINESS RESOURCES AND THE WEB

Here are some popular accounting programs designed with small businesses in mind.

**A-Systems Visual Bookkeeper** (www.a-systems.net) is a low-cost accounting package that includes GL, AP, AR, payroll, cash management, purchase order, contact management, sales order, and inventory functions.

**Simply Accounting** (www.simplyaccounting.com) is one of the only small-business accounting products offering English and Spanish versions (Premium edition only) on the same installation disc.

**Peachtree Accounting** (www.peachtree.com) is an accounting suite for small and mid-sized businesses, providing traditional GL, AR, AP and payroll functions, as well as advanced reporting, financial analysis tools, increased inventory capabilities, contact management, and time and billing.

**SAP Business One Solutions** (www.sap.com/usa/small business) offers on-demand access to real-time information through an integrated system containing financial, customer relationship management, manufacturing, and management control capabilities.

**QuickBooks** (www.quickbooks.intuit.com) is a well known personal and business accounting package. They also offer QuickBooks Online, which allows "anywhere access and data encryption technology to safeguard your information."

Accounting can be time-consuming and frustrating at the best of times; you don't want an application that makes matters worse. Watch out for cramped and cluttered screens, non-intuitive navigation, and confusing jargon. A good system won't give you carpal tunnel syndrome, or send your blood pressure through the roof by making you negotiate an infuriating electronic maze. Pick a program that's easy on your eyes, your brain, and your fingers.

Pick a program that's easy on your eyes, your brain, and your fingers!

## Surviving Economic Downturns

Most of this chapter has dealt with issues relating to growth. But financial management is just as important when the economy slows down. Well-managed companies don't just survive lean times; they also become more competitive in the long term, because they come up with innovative ways to cut costs, optimize efficiency, and win customer loyalty. In some cases, they even create new products and services that leave them in a better position than before the downturn.

Here are some basic rules for managing your finances in a shaky market:

- **Revisit your budget and your business plan.** When the economy changes, your plans needs to change with it. Expenses that aren't crucial may need to be cut, scaled back, or postponed. New target markets may need to be abandoned, or approached differently. (Don't approach this task in a strictly negative mindset, by looking for costs to slash and dreams to abandon. Revising your plans and budgets may lead to positive ideas you wouldn't have thought of in better times.)
- **Don't stop advertising.** When times are tough, the last thing you want to do is reduce your visibility. On the contrary, you need to make customers more aware that you offer great service or exceptional value. This is a good time to look for low-cost guerilla marketing techniques to keep your business in the public eye.
- **Innovate.** Consumers often welcome new tactics and new approaches during a downturn, not least because they find it inspiring to see someone overcome adversity in clever and interesting ways. Since recessions are partly psychological, businesses that can present themselves as part of the solution may do better than those that don't. Also, when the economy is doing badly, journalists tend to look for stories about local businesses that are holding their own. Come up with an interesting promotion, and you could find yourself getting lots of free publicity.
- **Reduce inventory.** This can free up space, time, and money when you need it most. If you have products that aren't selling, consider holding a sale or an auction, or returning them to your suppliers. In some cases, you may also need to consider discontinuing a product line in order to focus on your most profitable products.
- **Keep your team informed and inspired.** They have a vested interest in your success, and may be willing to tighten their belt if the alternative is being laid off. They may also have good ideas for cutting costs or boosting sales. If they do stand by you, be sure to reward them when business gets back to normal.

In hard times, keep your team informed and inspired

- **Keep an eye on your supply chain.** If vendors, customers, or partners are having financial problems, it may affect your ability to fill orders or get paid. Consider asking partners directly how things stand. Failing that, you can always run a credit report, or look them up on Dun & Bradstreet.
- **Form partnerships and alliances.** Other businesses are struggling, too, and are looking for ways to weather the storm. Maybe you can cut costs by sharing a space, or an ad campaign, with a complementary business. Maybe you can split the cost of a piece of equipment you both need. Or maybe you can cut costs by exchanging services. In addition, it often helps simply to talk. A weekly meeting with likeminded business owners, where you compare notes and share strategies, could help to maintain your morale, and might lead to new opportunities when conditions improve.
- **Offer incentives.** Special offers, contests, reduced prices, free services, and added value can all help to attract customers who are worried about their own finances.

- **Prioritize your overdue bills.** Some debts can cause more problems than others, and these should go to the top of your payment pile. In particular, don't try to cut corners by ignoring payroll taxes, property taxes, license fees, and other payments that are due to local, state, and federal government. These agencies can impose fines, place a lien on your property, or even shut down your business altogether. It's also wise to keep your lawyer and accountant happy, for obvious reasons.
- **Keep your creditors informed.** If you're having trouble paying your bills, be honest about the problem. Stay in close contact with your creditors and vendors, and offer them a realistic payment schedule—one you have every reason to believe you can stick to. Remember that their survival may be at stake too, and look for solutions that will help both businesses to stay afloat.

## NxLEVEL® GREEN TIP

ENVIRONMENTAL BUSINESS RESOURCES

With green entrepreneurs attempting to calculate the Triple Bottom Line, and lawmakers increasingly requiring businesses to address the threats posed by climate change and other environmental concerns, demand is growing for green accounting software. While this technology is still in its infancy, it will almost certainly become an increasingly common tool in coming years.

You can get a headstart on the competition by visiting the United Nations Environmental Programme's **Virtual Resource Center on Green Accounting** (www.unep.ch/etb/areas/VRC_index.php), which comprises a searchable database of various materials and Internet links related to integrated environmental and economic accounting.

*As part of their new plan, the first thing Max and Ernie did was contact their funding sources to let them know what was going on. Next, they contacted their customers and made a serious effort to get caught up on their receivables. They'd found that their average payables turnover was completely out of sync with their average receivables turnover, which meant that they were sending money out before it came in! They also contacted their suppliers and negotiated their own discount terms as customers of reasonably long standing (this was something they should have done much earlier).*

*They gave up on buying the binding and folding machines, and chose to lease them instead. They began to sound out the job market for experienced binders who might've been let go elsewhere, or were new to the area. Max started working from the office, by phone.*

*Within four months, they'd cut their burn rate in half. When the market picked up again, they were in solid shape and ready to take full advantage of it!*

## Conclusion

Ultimately, the amount and quality of knowledge you have about your financial situation determines the upward or downward curve of your business. Planning for growth, in particular, requires accurate information.

As an entrepreneur, it's incumbent on you to base your decisions on current, relevant, accurate data. Your commitment to gathering these data and utilizing them is an important means of ensuring that the growth you plan for will become a reality.

# Chapter 45
# DEALING WITH LARGE ORGANIZATIONS

*About This Chapter:*
- *Doing business with the government*
- *Preparing to sell*
- *Submitting an offer*
- *How to work with prime contractors*
- *Dealing with big business*
- *ISO standards*

## Introduction

There are many good reasons for a big company or a government agency to do business with a small firm like yours. The most important one is that entrepreneurs are flexible, forward-looking innovators, and can respond to changing market needs faster than larger, more bureaucratic firms.

This has been especially significant in regards to green and organic business. Countless entrepreneurial companies have been bought out or funded by larger businesses who want instant access to green consumers, or are hoping to establish a more eco-friendly brand image.

Other businesses and organizations seek out small businesses because they have procurement standards to meet. Their goal may be to create a greener or more efficient supply chain; cut their costs by outsourcing; deliver more innovative services; meet higher technical or quality standards; or fulfill a mission (or a legal obligation) to support small, minority-owned, or woman-owned business. Whatever the motivation, new technology that simplifies procurement and contract management has made this an excellent time to pursue these exciting opportunities.

Selling to the government or a big company requires you to make changes in the way you normally do business

That said, dealing with large businesses and the government can be daunting. It entails some risk, and requires you to make changes in the way you normally do business. You may have to put more resources on the front end in your marketing efforts, prequalification procedures, and budgeting to prepare your business to meet different standards. And your administrative costs may be higher due to the increased recordkeeping and procedural requirements of the larger organization.

Also, big businesses and the government are sometimes slow to pay invoices, which can put a strain on cash flow. However, with careful planning you can learn to meet the requirements of doing business with larger organizations.

The US government is the largest purchaser of products and services in the world!

## Doing Business with the Government

The US government is the largest purchaser of products and services in the world. Of the $250 billion the government spends annually on procurement, nearly 20 percent goes to small businesses. Here are some other facts:

- There are 1,200 US government buying offices around the country.
- The US government buys almost everything, so it's likely that it will buy what you make.
- Government agencies are able to make small purchases (less than $2,500) using the Government Purchase Card, which means improved cash flow to those companies that accept credit cards.
- Doing business with the US government may help you diversify your markets.

What's the downside? Paperwork! Virtually every aspect of selling to the government is complicated, and most businesses will find it impossible without expert help.

### Government Small Business Programs

During and after World War II, it became clear that the government needed suppliers of all types of goods and services in the event of emergency. As a result, the Small Business Act of 1958 was enacted, in order to require that more contracts be awarded to small-business owners.

The government recognizes several types of small businesses:

- **Small Business.** Each industry has a NAICS (North American Industry Classification System) Code, which is categorized by the number of employees, or a maximum amount of annual revenues. If your average annual receipts fall under the amount designated for that NAICS code, your firm is considered to be small by definition. To learn your NAICS code, visit **www.census.gov/eos/www/naics**.
- **Small Disadvantaged Business.** At least 51 percent of your business must be owned and managed by socially and economically disadvantaged people (i.e., Black, Hispanic, Asian, and Native American minorities).
- **Woman-Owned Small Business.** To qualify, your business must meet NAICS code standards and be 51% owned, managed, and controlled by women.
- **Veteran-Owned Business.** A veteran-owned business is one that is 51% owned by a veteran. You may self-certify as a veteran-owned business. Service-disabled veterans must have their disability confirmed by the Veterans Administration.
- **HUBZone Business.** This program provides contracting preferences to small businesses located in and hiring employees from historically underutilized business zones. The SBA can tell you if there's a HUBZone in your area.

The US government has allocated a percentage of procurement dollars to be spent with small businesses. New legislation requires that all federal purchases above $2,500 but under $100,000 must be reserved for small businesses, unless the contracting officer can't get offers from two or more small businesses that are competitive on price, quality and delivery.

There is also the SBA's 8(a) program, which sets aside a certain number of sole source or limited competition awards for small disadvantaged businesses.

### Government Procurement Policy

Before you make any attempt to sell to the government, you must have at least a basic grasp of government procurement rules.

Before you make any attempt to sell to the government, you must have a basic grasp of government procurement rules

*Federal Acquisition Regulations (FAR)*

The Federal Acquisition Regulations (FAR) system is the roadmap for doing business with the government. It creates standard policies for government acquisition of supplies and services. It advises agencies on what type of solicitation or contract to use, how to evaluate bids, and how to administer the contract once they award it to a vendor. The FAR also informs vendors of their contract rights. You can get comprehensive, up-to-date information about FAR and procurement policy from AcqNet (www.arnet.gov).

Note that individual agencies, such as the Department of Defense, may have supplemental regulations.

*Procurement Center Representatives (PCRs)*

The SBA's Procurement Center Representatives (PCR) program can help you to win federal contracts. There are three types of PCRs:

- **Traditional Procurement Center Representatives** initiate set-asides for small business, recommend small-business sources to federal buyers, and counsel small firms on winning government contracts.
- **Breakout Procurement Center Representatives** encourage small businesses to compete for contracts.
- **Commercial Marketing Representatives** identify, mentor, and market small businesses to prime contractors (see below). They also help small businesses find and obtain subcontracts.

You can find PCRs at SBA procurement-area offices and federal buying centers.

*Procurement Technical Assistance Centers (PTACs)*

Procurement Technical Assistance Centers are local procurement resources funded by the Department of Defense. They offer technical assistance to businesses who want to sell to federal, state, or local government. To find the PTAC near you, go to **www.dla.mil/db/procurem.htm**.

*Hutt Design began as the all-consuming hobby of brothers Tim and Jim Hutt, who had raced their bikes since they were old enough to walk. They'd ridden motocross, road bikes, mountain bikes, and even cyclo-x. Through trial and error, they'd taught themselves everything there was to know about bike repair and maintenance.*

*After a few years, they began designing and making some of their own replacement parts. Jim, the more technical of the pair, was a consummate tinkerer. Tim was more social and creative. Where their talents intersected was fertile entrepreneurial ground indeed!*

*Theirs was a niche business that relied on its best seller: a patented rubber/silicone brakepad. They sold to high-end bike manufacturers; these dealers assembled and sold bikes to customers who were passionate riders, and not at all price-conscious.*

*Jim and Tim imported their patented rubber and silicone mixture from a chemical company in Salvador, Brazil. It was shipped in block form to their small operation in Flint, Michigan. There, the brothers and their team would mold and shape the rubber into brakepads, and ship them to bike manufacturers all over the country. By 2008, this was a $3.5 million business!*

### Researching Government Markets

First, determine which government offices are located near your business. (Be careful not to stretch your boundaries so far that you risk failing to perform; this will endanger future government business opportunities.) As you look at your geographic opportunities, consider the following guidelines:

- **Size.** Consider your size and the geographic area you can handle. If you're a very small business, you may want to select a small area at first. If you're already a larger business, you may want to go for an entire state.
- **Location.** Where are you located in relation to government facilities? Large, populated areas have more government opportunities than smaller, rural areas.
- **Experience.** How much experience do you have, and how good are you at what you do? If you are new and still learning, you may want to stay close to your core competencies.
- **Type of business.** If you can manage your business from a distance, your selling area can be much larger.

If you can manage your business from a distance, your selling area can be much larger

### Where Are Government Buying Offices?

After deciding how large a geographic range you can handle, identify the government buying offices within your targeted geographic area. There are ten regions grouped by the SBA. Identify your region, then go to your local SBA office and ask for a listing of the buying offices in your region.

### General Services Administration (GSA)

As its Website explains, the GSA is "the acquisition and procurement arm of the federal government, offering equipment, supplies, telecommunications, and integrated information technology solutions to federal agencies." It has an annual operating budget of about $16 billion, roughly one percent of which comes from taxpayer dollars, and it oversees $66 billion in procurement annually.

The GSA is particularly interested in green goods and services, and actively promotes green procurement for federal agencies. It also seeks out small businesses that can provide services and products nationally, regionally, and locally. All GSA contracts over $25,000 are advertised on FedBizOpps (www.fedbizopps.gov).

The GSA regular holds workshops for vendors who are seeking government contracts. You can find a schedule of these events at **www.gsa.gov**.

## Preparing to Sell

In order to sell to the government, you need to have three numbers:

- **NAICS code** (see above).
- **Taxpayer Identification Number**. This is issued by the IRS (if you're a sole proprietor, you may use your Social Security number).
- **DUNS number.** This nine-digit ID number is available for free from Dun & Bradstreet. Contact them at 800-333-0505.

The first step is to register your firm with **Central Contractor Registration (CCR)**, a government-maintained database of companies who want to do business with the government. This database is searchable by government agencies on the basis of such parameters as expertise, size, location, experience, ownership, and so forth. You can register online at **www.ccr.gov**.

Next, contact the Office of Small and Disadvantaged Business Utilization (OSDBU) of the agency you wish to do business with, and request:

- A copy of their publication *Forecasts of Contracting Opportunities*
- The names of past vendors of your product, and what they charged (this is available under the Freedom of Information Act)

The OSDBU can also provide you with a directory of agency buying locations, and advise you on the types of goods and services that the agency regularly purchases. Many agencies promote outreach programs and offer "how to" publications that provide assistance in understanding their procurement programs. Check the specific agency's Website for more information. You should be able to download the ***Forecasts of Contracting Opportunities***, and find helpful instructions on competing for contracts.

### E-Commerce Capabilities

In order to do business with the federal government, you must be able to access the Internet, and have some knowledge of e-commerce (e.g., you must be able to send invoices and receive payments electronically). If you don't have the proper skills and computer equipment, you'll need to get them.

The Department of Defense uses a paperless ordering and receiving system called **Wide-Area Workflow (WAWF)**, which allows you to submit and track your invoices and receipt/acceptance documents over the Web. You can find system requirements and an online tutorial at **www.wawftraining.com**.

### Marketing Suggestions

Wherever possible, arrange marketing visits to agency project and program personnel.

- Provide catalogs and brochures to key personnel within the agencies.
- Participate in agency market research by attending pre-solicitation conferences.
- Many federal agencies hold small-business fairs that explain how to do business with the government and provide information regarding program activities. Some have the added feature of making on-the-spot purchases from small-business attendees.

## Submitting an Offer

After you've completed the steps above, it will take the buying office a couple of weeks to get your company loaded into its automated bidders list. Once you're in the database, you must wait until a solicitation comes in for the you sell. (The automatic bidder list rotates offers among bidders, so that the same bidders are not always selected.)

### Types of Solicitations

There are three types of solicitation:

*Invitation for bid (IFB)*

IFBs are also known as **sealed bids**. IFBs are for standard, "off-the-shelf" items with a value in excess of $25,000 (they're usually over $100,000). Generally, an IFB will include a description of the product or service the government agency wants; instructions on bidding by the deadline; conditions for purchase, packaging, delivery, shipping, and payment; and contract terms.

Your bid is legally binding if it's accepted by the government!

Each bid is opened and read aloud in public (you don't have to be present), and the lowest bid wins. Your bid is legally binding from the date it's accepted by the government.

*Request for quotation (RFQ)*

RFQs are issued in order to gather comparative information on the price of simple, standard goods and services with a value below $25,000. Like IFBs, they're awarded on the basis of price. Unlike bids, your quote does not constitute a binding contract.

*Request for proposal (RFP)*
RFPs are negotiated contracts, so price, requirements, and the like are open to discussion. RFPs are usually for goods and services of a technical or highly specialized nature, so your expertise (and other criteria) will be considered along with your price.

If there's something in the RFP that you don't understand, you can submit written questions to the contracting officer. However, note that the officer's response to such questions will be distributed to all bidders. To avoid giving useful information to your competitors, you must word your questions carefully.

*By mid-2008, things were changing considerably for Hutt Design. Sales were slowing, and many competitors were going out of business or being acquired, as the industry went through a normal consolidation process. Hutt Design would have to adapt or die!*

*Jim and Tim spent many late nights looking for ways to leverage their design and rubber-molding expertise to get new customers. They needed to look outside the bike industry, but where?*

*At the same time, Tim was looking to buy a new pick-up truck. He was test-driving many models, and he kept seeing trucks fully loaded with accessories he didn't want. Cupholders, jump seats, front and back seat heating, and yet more cupholders. What was it with cupholders?*

*Before long an idea struck him. Tim had always had a gripe with car cupholders: they never fit the beverage container that he was using. They allowed the can or cup to shift and slosh and spill. The rubber that lined the inside of cupholders was brittle, and couldn't fit a range of cup sizes and shapes. What if he and his brother could design a better cupholder, and mold it out of their special rubber/silicon formula?*

## Responding to Solicitations

Although you may have prepared hundreds of commercial offers during your career, doing business with the government is different and difficult. Here are some things to keep in mind:

- **Always respond.** Respond even if you don't offer a bid, quote, or proposal. This is very important, because "no response" names are deleted from the bidders list.
- **Be on time.** The government won't accept late submittals.
- **Complete all paperwork**. If you are unable to answer a question, contact the appropriate official for assistance.
- **Be careful.** Don't overlook any items that might affect your price.

Always respond to solicitations, even if you don't offer a bid, quote, or proposal!

While the lowest price will always be the main consideration in awarding a federal government contract, several other factors may influence the decision. Past performance is becoming a significant factor. Even though a company may not have federal contracting experience, references from previous non-federal buyers may influence a federal purchasing official who is attempting to secure the best product or service.

“Best value” is another factor that federal contracting officials sometimes use when awarding a contract. For instance, if your company offers faster delivery, a better warranty, or a better product, it may win the contract even if it doesn’t offer the lowest price. Best value is a factor in awarding contracts only when the solicitation states it, and includes a description of the agency’s evaluation criteria.

*Preparing documents*

If you’ve never written a bid, quote, or proposal before, you should seek expert assistance. Your local SBDC can help you prepare these documents. Visit **www.sba.gov/sbdc** to find the center near you.

If you’ve never written a bid, quote, or proposal before, you should seek expert assistance

You can also hire firms or freelancers to write proposals for you, but bear in mind that this can be pricey. Some firms may charge as much as $25,000.

## NxLEVEL® TECH TIP

BUSINESS RESOURCES AND THE WEB

Here are some useful sites for businesses that wish to pursue government contracts.

**GSA Vendor Support Center** (vsc.gsa.gov) offers links to business opportunities and vendor training.

**Defense Logistics Agency Small Business Programs Office** (www.dla.mil/db) administers the Department of Defense Procurement Technical Assistance Program, which provides assistance in marketing products and services to federal, state and local government.

**State Contracting Opportunities** (www.smallbusinessnotes.com/choosing/contracts/statecontracts.html) offers a list of links to the purchasing departments of all 50 states.

**The Federal Technology Center** (www.theftc.org) promotes economic development by facilitating technology transfer between government and the private sector, and by helping small businesses compete for government contracts.

For women who want to do business with the federal government, we recommend visiting **Womenbiz.gov** (www.womenbiz.gov). Even if you’re not a woman, you’ll find that this is a very user-friendly site with a great collection of procurement links.

## Types of Contracts

Here are the major types of governmental contracts:

Federal contracts may have terms and clauses that don't appear in commercial contracts

*Firm fixed-price contract*
The contractor agrees to supply a product or service at a fixed price that won't change during performance. This is probably the most commonly used government contract.

*Fixed-price contract with economic price adjustment*
Allows the price to be revised in case of a specific economic contingency. There is usually a limit to upward adjustment, but none to downward adjustment.

*Cost-plus-fixed-fee contract*
All of the contractor's costs are paid by the government, plus a fixed fee. The amount of the fee is negotiated prior to award, and doesn't change during the contract regardless of any changes in the cost of performance. This arrangement gives the contractor very little incentive to control costs, since the fee remains the same whether actual performance costs are high or low. It can only be renegotiated if there is a change in the scope of the work.

*Cost-plus-award-fee contract*
Provides for reimbursement of allowable costs incurred during performance, and for both a base fee (profit) and an award fee (more profit).

*Time and materials/labor-hour contract*
Used by the government to buy labor at a fixed price (including all overhead, general and administrative expenses, and profit), and materials at cost.

*Indefinite-delivery contract*
These are generally used to procure common supplies, commodities, or repair services. There are three classifications:

1. **Definite quantity contracts** provide for delivery of a known quantity of a supply or service over a known period of time.
2. **Requirements contracts** provide for the filling of all requirements for a specific supply or service during a specified contract period. The quantity to be bought during the contract period is unknown at the time of award. This type of contract guarantees the contractor that all requirements for the supply or service contracted will be purchased from his or her business, and specifies a maximum amount to be procured. Deliveries are scheduled on the basis of orders placed with the contractor.
3. **Indefinite quantity contracts** provide for a contractor to furnish an indefinite or unknown quantity of a supply or service during a fixed period of time. They specify a minimum quantity the government will purchase, and a maximum quantity the contractor must deliver during the contract performance.

Be sure that you understand the terms and conditions of each bid request prior to submitting your bid

There's an infinite variety of contracts, most of which are based on the types above. Be sure that you understand the terms and conditions of each bid request prior to submitting your bid, because you'll be legally bound to the terms and conditions set forth in your submittal. Failure to understand the contract terms can cost you dearly.

Federal contracts may have terms and clauses that don't appear in commercial contracts. The SBA's Office of Government Contracting can help you understand these provisions.

### Learning From Unsuccessful Bids

If your company fails to win a contract, you may ask the contracting officer for a debriefing. He or she will explain why your bid was rejected, and how to improve your chances of success in the future. Be sure to take advantage of this invaluable free service!

#### *Certificates of Competency*

Sometimes, the government may decide to reject your bid even though you have the lowest price. This can happen if the contracting officer feels that your small business lacks such key qualities as competence, capability, capacity, or credit.

In this event, your case will be referred to the SBA, who will give you the opportunity to apply for a **certificate of competency (COC)**. If you wish to apply, you must give the SBA sufficient documentation to establish your firm's competency (e.g., letters of credit, current financial status, supplies or vendor quotes). If the SBA gives you a COC, the contracting officer must award the contract to you. (The COC applies only to the disputed contract.)

### Post-Award Activities

Congratulations—you won the bid! Now what? Here are a few pointers:

- Complete all paperwork exactly as requested
- Deliver exactly what they ordered, exactly when you promised it
- Immediately report any problems that occur, always citing "cause and cure" (what happened and why, how, and when you will fix it)
- Thank them for their business!

*Jim liked the cupholder idea, and they got to work on it right away. Tim spent two weeks on market research, and things looked good. Jim and his team created several prototypes. Their new cupholder design was flexible; it stretched to fit many different cup shapes. And it could easily be adapted to fit into different types of vehicles.*

*Almost immediately, Jim began addressing the logistics of mass-producing the cupholders for auto manufacturers. He concluded that they simply didn't have the capacity to produce the cupholders themselves. Auto manufacturers would need large quantities, and would have very* *stiff quality and process requirements. They would need to find a manufacturer with whom they could work very closely.*

*How they would ship their rubber to this manufacturing partner was an issue, too. Many elements of their business would have to be reinvented and relearned.*

*There was no doubt about it: they'd have to be smarter and more strategic if they were to compete in this league!*

**NxLEVEL® GREEN TIP**

ENVIRONMENTAL BUSINESS RESOURCES

A number of procurement regulations require federal agencies to purchase green (i.e., biobased, recycled content, and energy efficient) products, which creates a vast market opportunity for vendors who can meet their needs.

The **Office of the Federal Environmental Executive** (ofee.gov) offers several resources for small businesses that wish to learn about green procurement. The green purchasing page at **ofee.gov/gp/gplinks.asp** provides links to the green procurement policies of all major federal agencies, from the Department of Agriculture to NASA. You'll also find a page of links for online and classroom training at **ofee.gov/gp/training.asp**.

### Mentor-Protégé Program

Mentor-Protégé programs establish business relationships between major contractors and small and disadvantaged 8(a) businesses. They're available to small businesses; small disadvantaged businesses; woman-owned small businesses; veteran-owned small businesses; and HUBZone businesses. Check with your target agency's OSBDU for more information.

These programs offers the following types of assistance:

- Assistance with general business management, engineering, and technical matters
- Noncompetitive award of subcontracts
- Progress payments for subcontract performance
- Advance payments under subcontracts
- Loans and investments

Some states offer similar programs. Check your state's Website for more information.

### Business Matchmaking Program

Business Matchmaking is a partnership between the SBA and Hewlett-Packard. It matches small businesses with procurement representatives from government agencies and major corporations. Business Matchmaking is free to buyers and sellers. For more information, visit **www.businessmatchmaking.com**.

## How to Work with Prime Contractors

**Prime contractors** are those "Big Business" companies—like IBM, Bechtel, and Lockheed—that are always winning huge government contracts. When these firms are awarded major contracts, they're required by law to subcontract a portion of the work to small and disadvantaged businesses.

All the marketing and sales techniques mentioned previously come into play here. Since prime contractors generally operate under the government's procurement rules, many of the same principles apply.

If you work with contractors, be prepared to do your share of the paperwork

- **Do your paperwork.** Paperwork is very important to government contractors, a fact borne out by the mass quantities of paperwork government contracts require: certified payrolls, written change proposals, materials submittals, quality control plans, and much, much more. Most contractors dislike paperwork for two reasons: first, many don't know how to do it; second, it costs them money. If you work with contractors, be prepared to do your share correctly.
- **Keep your contacts informed.** The subcontracts manager needs to know what is going on to keep supervisors and the government advised.
- **Do the work correctly and on schedule**. This is the best way to ensure repeat business.

Here are some of the most important differences between the government procurement and prime contractor procurement systems:

- **Bid openings.** Contractors are generally not required to hold public bid openings or disclose bid opening results. Some have public openings, and some don't.
- **Solicitation publication**. Contractors are not required to publish solicitations at **www.fedbizopps.gov**.
- **Determinations of non-responsibility.** Prime contractors are not required to refer determinations of non-responsibility to the Small Business Administration for review.
- **8(a) and other government programs.** Prime contractors don't use the Small Business Administration's 8(a), SDB, or HUBZone Programs to make awards to small disadvantaged businesses.

- **Full and open competition.** The Competition in Contracting Act, which states that the government must allow all responsible sources that request a solicitation package to submit a bid, doesn't apply to prime contractors. They must achieve effective price competition, so they need only enough bids to ensure a fair, reasonable price.

## Dealing with Big Business

Dealing with big companies can benefit your business in many ways. For instance:

- By selling directly to big business, you indirectly enter new markets. This may help diversify your markets.
- Your company can learn from its association with large professional companies.
- A long-term contract with a large company can stabilize your cash flow.

A long-term contract with a large company can stabilize your cash flow

Like government agencies, large private companies have standards for procedures, policies, and professionalism. It helps to remember the following:

- No matter what business you're in, your business is service. Determine what your big business partners want and deliver it.
- As a smaller company, your core competencies include speed, focus, and teamwork. Use them to your advantage when dealing with big business.
- As a niche or specialized company, do what you do best. Be honest about your capabilities and stick to your specialty.
- Be professional in everything you do!

Competition is very keen when you attempt to sell to companies in the Fortune 1000. Therefore, you should research these companies very thoroughly before you approach them. On the other hand, many large businesses are looking to do business with entrepreneurs. A number of them—including FedEx, Cisco, and Sprint—have formed an association to promote partnership with small business. Go to **www.warrillowsummit.com** for more information.

*Recently, a business writer from the Detroit Free Press interviewed Jim Hutt for a feature article about innovative small businesses.*

*"It's been an interesting and tough road," Jim told her. "When we jumped from the bike industry to the auto industry, that was a real challenge. We had to rethink everything!"*

*In the intervening years, Hutt Design had struggled to create a niche for itself: selling cupholders to Ford Motor Company's truck and van division. Hutt had succeeded by carefully researching how and where they bought their inputs and turned them into finished product.*

*Along the way, the company had traveled many unexpected paths. It purchased its rubber from a company in Brazil; shipped it to a maquila plant in Monterrey, Mexico; and trucked the finished cupholders to Ford Assembly plants in Mexico and Canada. This was a maze that neither brother could have foreseen navigating years before, but it made their company what it is today.*

*"In order to sell to Ford," Jim told the reporter, "we had to jump through many hoops…all of which made us a stronger company. Ford required that we use certain processes for inventory control, expense tracking, and supply chain management. This helped us a great deal. It gave us much greater control over our work with our own supplier in Brazil, and our maquila too. We could exchange order details, alter design specifications, adjust inventories quickly. We were forced to be well-organized and aggressive in order to meet Ford's needs."*

### Marketing and Selling

All the approaches to marketing and personal selling mentioned elsewhere in this book apply to big business. The key is to commit to a marketing plan, and be patient and persistent.

Let's take a moment to review the key elements of marketing strategy, and focus in particular on specific strategies for targeting larger companies. Once again, the first step is understanding your customers. Start by answering these questions:

- What is the nature of my customer's business?
- What is the single most important competitive factor for them?
- What are their core competencies?
- Who are their competitors, and where is their industry headed?
- What do they look for in partners?
- What is their culture?
- What standards must you meet, and what metrics are used to measure them?
- What is their buying process? Who are the decision-makers, users, gatekeepers, and influencers?

Tailor your marketing mix to the large corporation's needs

Look at the business from every possible angle. Imagine that their issues are your issues (since they will be if you win their business). With these insights in mind, tailor your marketing mix to the large corporation's needs.

### Partnering with Big Businesses

Increased risks, global competition, new technology, changing environmental standards, and the demand for faster cycle times have created a climate in which businesses are partnering more than ever. However, **joint ventures** and partnerships have been used for a long time by entrepreneurs eager to expand their businesses or enter new markets.

Other reasons small businesses pursue partnerships include:

- Gaining access to new technology or expertise
- Broadening their geographic scope
- Increasing sales
- Sidestepping or complying with trade or environmental regulations
- Achieving economies of scale
- Building synergy with complementary skills, products, or processes
- Pooling costs and performing innovative joint research

A joint venture is a business entity comprising two or more active business partners. These are also called strategic alliances or partnering agreements, and can involve a wide variety of business, nonprofit, or governmental organizations.

When considering a partnering agreement with a larger business, the first stop should be your attorney's office. The key to a successful agreement is understanding what each side wants, needs, and brings to the partnership. Know what your choices are, and tally the costs and benefits of each (financial as well as strategic, including competitive risks and benefits) before you enter any agreement. A good fit between each party's personality and business culture is also crucial for a successful partnership.

## ISO Standards

Contracting with government or large businesses may require you to meet stringent ISO 9000 quality standards. As described in Chapter 9 *Export and Import*, ISO 9000 standards establish internationally recognized criteria for quality management.

Contracting with government or large businesses may require you to meet stringent ISO 9000 quality standards

To achieve ISO 9000 certification, your company must meet ISO standards for quality assurance in its operations, as certified by a third-party registration agency. Note that it's the quality assurance system itself, *not* your product or service, that wins certification.

ISO 9000 is increasingly becoming a specification in military and government contracts. Such government agencies as NASA and the FAA require suppliers to comply with ISO 9000. Many large businesses also require ISO 9000 compliance from their suppliers. And even in agencies and companies that *don't* require it, certification may give your firm a competitive edge (under "best value" award provisions, for instance). Some contracts may require you to meet ISO 14000 standards, which apply to environmental management, or ISO 1901, which combines the 14000 and 9000 series into a single protocol that guides the auditing of quality *and* environmental management systems.

It's important to understand that ISO 9000 isn't some sort of magic bullet for business problems. It's a commitment to a specific way of doing things, which may or may not make sense in your business. Certification will mean little if you fail to live up to the demands of the system. Also, some critics have charged that ISO 9000 can limit creative problem-solving by ritualizing quality processes at the expensive of innovation.

Above and beyond these problems, it can be expensive and time-consuming to get certified. Many Small Business Development Centers offer group classes in ISO 9000 certification on a sliding scale, based on the size of your company and the number of participants. Actual certification may cost several thousand dollars.

We recommend that you undertake plenty of research—and lots of self-appraisal—before seeking ISO certification.

*One benefit of Hutt Design's dealings with Ford was that Tim and Jim got a crash course in Six Sigma quality. Six Sigma focuses on eliminating defects and reducing variation; it's defined as 3.4 defects per million opportunities. Once Hutt Design was chosen by Ford, it became part of the company's supplier development initiative. Ford's experts in Six Sigma standards came to work with Hutt Design almost immediately.*

*These consultants helped Hutt define quality objectives for their products, and better allocate resources to meet those objectives. They created baseline opportunities for improving quality, and helped implement tasks. Finally, they helped to assess and document Hutt's improvements.*

*It became clear to Jim that Ford viewed Six Sigma as a continuous process. At times, it became tedious to remeasure, revise, and rethink their manufacturing processes. But the results were clear: better quality and a more competitive product.*

*Jim explains how Hutt Design streamlined its organization around better supply chain management. "We made someone accountable for implementing each supply chain task, whether it was managing supplier communications, monitoring our suppliers' performance, or keeping tabs on the costs. If quality of goods dipped, delivery time slowed, or response time altered, we'd know it before it got out of hand."*

*With revenues of $10 million in 2009, Hutt Design has its primary operations in Flint, and a cooperative office in Juarez, Mexico. It sells to one of the largest US automakers, and hopes to grow its capacity to serve others.*

## Conclusion

If you decide it is time to go after government and big business contracts, prepare to do things differently. These large organizations have their own way of doing things, so there will be more paperwork and bigger challenges. The key to a successful business relationship is to lead with those characteristics that give you a competitive advantage: innovative thinking, clear focus, speed, flexibility, teamwork, and individualized customer service.

# Chapter 46
# SUPPLY CHAIN MANAGEMENT

*About This Chapter:*
- *Current theory and practice*
- *Sourcing materials, products, and services*
- *Methods and means of doing business*
- *The green supply chain*
- *The future of the supply chain*

## Introduction

The concept of the **supply chain** is at the heart of contemporary trade and transportation. Briefly put, the supply chain comprises all of the interdependent business processes that go into selling a product, from sourcing to manufacturing to distribution to takeback and recycling.

All parts of the supply chain should be analyzed in the context of the entire system

No part of the supply chain is viewed in isolation; all parts must be analyzed in the context of the entire system. For example, a marketing plan requires input from people in finance, who know how much money is available; from suppliers, who integrate their products into the manufacture of your products; from people in shipping, who know the transportation issues; and from manufacturing people, who know what their production facilities can and can't do.

Every business has its own supply chain, and simultaneously has its position in the supply chains of other businesses. All planning and decision-making, from determining the site for a new facility to choosing partners, must be based on an understanding of your supply chain, and your position in your partners' supply chains.

## Current Theory and Practice

In some ways, "supply chain" is a misleading metaphor. "Supply cable" is a better one. A chain suggests links in sequential order, while a cable is constructed of continuous, intertwined strands. You can think of each of these strands as a **channel**—a set of interdependent processes and activities that impart value or utility to the product, and which extend from the beginning of a supply chain to its end.

For example, the manufacturing channel refines raw materials, assembles component parts, and creates a finished product. The logistics channel delivers the product when and where customers need it. The human resources channel recruits, trains, and maintains an efficient workforce. And the communications channel binds all the other channels together in their complementary functions. To complete this analogy, note that the strands of a cable are much weaker apart than they are together.

A channel is a set of interdependent processes and activities that impart value or utility to the product

Each channel has subchannels, which are functional areas within channels where value is partially, but not completely, instilled in the product. Subchannels are located at specific points of the supply chain; they don't extend from one end to the other.

Here are some of the major channels, with their typical subchannels:

- **Communications channel.** Subchannels include conflict resolution; information technology (e.g., data processing, e-mail, Internet); negotiation.
- **Finance channel.** Subchannels include accounts receivable and payable; audits and budgeting; financial reporting and tax compliance; costing and forecasting; insurance and risk management; investing and investor relations; credit issues.
- **Human resources channel.** Subchannels include hiring; training; compliance with legal obligations; job design; employee morale; compensation; workplace safety.
- **Logistics channel.** Subchannels include contingency and other strategic planning; customer service; order processing and fulfillment; consolidation, distribution, and other sorting activities; facility and inventory management; site selection; materials handling; packaging; purchasing; transportation; warehousing.
- **Manufacturing channel.** Subchannels include analysis and design; capacity planning; development and testing; forecasting; production scheduling; quality control.
- **Marketing channel.** Subchannels include market research and analysis; branding and brand management; distribution strategy; pricing; promotion; product management.

*Al Bishop lives in Framingham, Massachusetts—an area that might be termed an East Coast Silicon Valley. As Bill Gates and Steve Jobs once did, Al designs and even manufactures software in his garage. He creates encrypted master files on his server, protected by a firewall he built himself. Customers download his software after purchasing it with credit cards.*

*Al employs two techs to keep his server running smoothly; they also help maintain and update the content on his site. His girlfriend Vinita Kumar, an MBA student who hails from New Delhi, India, helps Al with marketing and customer relations. She's also an equity holder in the limited partnership they've forged, which they call Al's Innovation Factory, LLP. The Factory has a few software products that have earned enough profits to fund Al's dream of creating the best virtual reality adventure ever.*

*From the time Al learned to read, he'd been fascinated by myths and legends. It was only natural that when Vinita recounted stories from Hindu mythology, his imagination was stimulated and he designed a game called Thugee, which he based the ancient cult of Kali.*

*"We'll tailor it for India," he told Vinita. "The gaming market is hopping there, and when we fly back to meet your family, we can write off some of the expenses as a business trip!"*

## Sourcing Materials, Products, and Services

**Sourcing** means acquiring raw materials or components for your products. Here are some critical questions that relate to sourcing:

- What level of quality is needed?
- Where are the sources located, and who controls them?
- What environmental, social, and energy impacts do these sources have?
- What are the cultural, economic, legal, political, and physical aspects of the supply environment?
- What trade-offs are involved in choosing a source (e.g., what would be the pros and cons for McDonald's of procuring beef from Argentina rather than America?)

Quality is the first thing to consider when sourcing

### What is Quality?

Quality is the first thing to consider when sourcing. There are three primary ways of assessing it:

- **Quality as an absolute standard** is the typical layperson's conception (e.g. "pure" gold; the baseball player with the most home runs; grandma's cherry crème pie, which takes the award at the county fair every year). The standard is objective in that it can be measured, and subjective in that most people agree that the measurement denotes absolute quality. The concept is often used commercially. For example, **Six Sigma** has the goal of zero defects, which is an absolute standard of quality.
- **Quality as serviceability** is less easy to understand intuitively, but it's easy to explain. For instance, when you need food to maintain your body in good physical condition, any food with the appropriate mix of nutrients will do. It's not necessary to eat a hunk of grandma's cherry crème pie every day in order to stave off starvation. The award-winning pie is unsuitable in some cases, and unnecessary in others. By the same token, if you're in the construction industry, would you use high-quality teak or redwood for the studs behind the gypsum wallboard? And if you own a diner, would you use prime beef for your $12.00 rib-eye steak? You wouldn't, because a lesser grade of beef is serviceable for that price.

- **Quality as meeting defined requirements** is often confused with the other two definitions. It may be the most important in terms of commercial sourcing, because the supply chain is customer-driven. If you think of customer requirements as the "demand" part of "supply and demand," then it's easy to understand "supply" as the activity of meeting those requirements.

Which definition of quality applies to your business? If you're a jeweler, or a precision machinery manufacturer, your answer will be very different from that of the owner of a fast-food diner.

*Martial arts games are increasingly popular among young people in India. And just as in the United States, Indian parents are concerned about inappropriate content. At Vinita's insistence, Al engaged the services of Rajasuya Markets, an export sales management company in India. For a reasonable price, the firm conducted market research on the concerns of Indian parents, and the tastes of the demographic groups that buy martial arts and other computer games in urban India. Based on this information, Al developed a design concept about which Vinita grew increasingly excited.*

*Martial arts action is very popular in Bollywood movies. Vinita is a fan of these films, and explained to Al that much of the action that Bollywood fans like is choreographed artistry with staffs and sticks. Al decided to incorporate this into his game. He also built a rating scale based on his survey information. The normal retail package would lack material that most Indian parents would find objectionable. However, after e-mailing an encrypted proof of purchase to The Factory, consumers could buy up to six keys, tied to an individual game's serial number, that would unlock darker, more adult-oriented levels of play.*

*Since piracy is rampant in India, Al built in protection of his intellectual property to foil unauthorized copying of Thugee. Knowing that the Indian government encourages joint ventures rather than imports, Al and Vinita again used the services of Rajasuya Markets to help identify Indian partners.*

## Locating Sources

Where do your raw materials and components come from?

Where do your raw materials and components come from? What alternative sources exist? In a globalized marketplace, these questions are more important and complex than ever. Even if your raw materials or components come from a warehouse a mile away, that warehouse may receive them from suppliers all over the world.

Here's an example of how business operations can be affected by the lack of alternative sources. Anybody who lived in the United States between the 1950s and 1980s can tell you that the formerly glorious chrome regalia of American automobiles has all but vanished. Is today's lack of chrome bumpers, hood ornaments, and decorative swaths simply a matter of changing tastes, or is something else at work?

As a matter of fact, chromium (from which chrome is derived), became more expensive and harder to get in the 1970s. The world's primary sources were Rhodesia (emerging then as Zimbabwe), and the Soviet Union. As the United States adopted a stern stance towards the white separatist government of Rhodesia, it became increasingly impossible to rely on the African source. And of course, trade with the Soviet Union was always problematic. Accordingly, auto designs began to reflect the difficulties of sourcing chromium.

By the time relations with Zimbabwe improved, and the Soviet Union began to collapse, automobile and truck designs already made less use of chrome. Consequently, there was less commercial demand for it.

The moral of this story is that no part of the supply chain—from the source, to a mass retailer or a backwater general store—can be explained outside of its context in the worldwide network.

### Sharing Information

In the modern supply chain, everybody needs access to information via a common communications system. When information is unavailable or incomplete, all activities within the supply chain suffer. Lack of transparency also breeds suspicion, and hides problems and inefficiencies.

In the modern supply chain, everybody needs access to information via a common communications system

Here's an example of how your supply chain might suffer from bad information. Suppose you run a small garage in Maine. It's a cold, snowy winter. Suddenly, a combination of weather-related events results in nearly twenty customers with cars that need to be repaired ASAP. Your customer service philosophy leads you to smile, accept the work, and assure everybody that you can get the job done "in a week or so."

Three weeks later, two-thirds of the work isn't done. You have irate customers beating on your door, and calling you on the phone. Some demand that you do the work for free, because you've cost them money. A transmission arrives, and your workers install it only to find it's defective, so you've lost labor that you can't bill out. You're still waiting on parts, too, because you had no idea what your sources could or couldn't supply during a period of unexpectedly heavy demand and bad weather.

This is not necessarily a scenario involving a short, domestic supply chain. These days, automotive parts—even cheap rebuilt ones—are often globally sourced.

Accurate, timely, useful information, made available to supply chain partners via your communications channel, is key to weathering disruptions (or ideally, avoiding them altogether). Among other things, this means synchronizing databases and IT applications, coordinating production schedules, and tracking orders and shipments.

*Synchronizing databases*

With a **personal digital assistant (PDA)**, you can enter new contact information in the field, and immediately synchronize it with your database back in the office. From there, it's a short step to your partners being able to access the same information around the city, state, country, or world from their PDA, laptop, or desktop.

"Sounds nice," you might say. "But isn't there some information that I want to keep confidential, like employee Social Security numbers?"

Absolutely! Synchronized databases aren't all-or-nothing propositions. Combined with different levels of access for different types of users, selective data sharing makes for optimum transparency in an entrepreneur's supply chain. It also allows partners to mine combined data resources.

Suppose you're an antique dealer, and you have a working arrangement with other dealers to acquire interesting pieces with good market potential. Each dealer travels around the country, developing extensive supplier and customer contacts. In the process, each of you creates—and continuously updates in real time—a combined database of sources, the collectibles that they offer, and their potential markets.

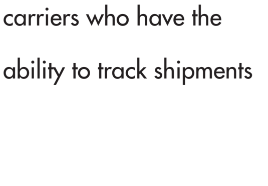
*Coordinating production schedules*

Coordinating production schedules might make you think of complicated manufacturing processes and sophisticated Materials Requirements Planning (MRP) applications. However, it need not be that complex. Suppose you run a contracting firm that specializes in installing tile, and it sources its quality tiles from suppliers in Mexico.

If you suddenly got lots of installation jobs from a new housing development, your suppliers would normally be pleased. But what if it happens when one supplier is on vacation, another is swamped in orders from other buyers, and the third can only meet a third of your needs?

If you'd alerted your suppliers to your marketing push in the new housing development, and had discussed their near-term production capabilities and scheduling, none of you would've been taken by surprise. As the new jobs came in, the suppliers could've avoided shortfalls by distributing work among local subcontractors.

Lack of coordination between the contractor's marketing goals, and the suppliers' capabilities and schedules, breeds inefficiency, which translates into lower profits. The moral is, coordinate with your suppliers.



You should always choose carriers who have the ability to track shipments

*Tracking orders and shipments*

You should always choose carriers who have the ability to track shipments, so that your customers can track their orders. This might not be a matter of commercial necessity, but customers who can see that their order was shipped, and has arrived at a nearby hub for delivery at their door by 9 am the following day, will be happier than those who are wondering when their order will arrive. Even in cases where your suppliers choose the carrier, you can influence that choice by making your concerns about supply chain transparency and reliability known in advance.

**Radio frequency identification (RFID)** tags allow you to track production inputs and finished products through the supply chain. RFID capability is especially important if you intend to work with government agencies, prime contractors, and big-box retailers, many of whom require it as a condition of doing business. But even if you don't, the growing affordability, accuracy, and versatility of RFID has made it increasingly attractive to many small-business owners, who can also use it to keep track of files and equipment.

RFID capability is essential if you intend to work with government agencies, prime contractors, and big-box retailers

## A Collaborative Effort

Sourcing in the modern supply chain requires good collaboration, which of course means working jointly with others. However, supply chain collaboration goes far beyond working together. It requires all parties to be aware of the interdependence between their business and their suppliers, and to see it as a means to commercial survival and profit.

Interdependence and cooperation don't mean that each collaborator in the supply chain is in an equal power relationship. Each party has different resources, and a different ability to affect outcomes. Part of information processing is coming to an understanding of those relationships, so that you can co-manage them effectively.

*Al and Vinita spent a month reviewing their prospective Indian partners, during which time they contacted several firms. They eventually selected three finalists, and made a business trip to India. There, they met with the principals of each firm (and Vinita introduced Al to her family).*

*After several rounds of discussions and socializing, Al and Vinita were successful in entering into a joint venture arrangement with Maya Enterprises, a medium-size Indian game manufacturer that was looking to expand its portfolio. Al and Vinita convinced them that Thugee would enable them to make a very powerful entrance into the lucrative market for martial arts games.*

*The agreement between The Factory and Maya Enterprises detailed the responsibilities of each party and set up a performance schedule, complete with specific milestones.*

*After returning home from the trip to India, Al quickly finished work on the prototype of Thugee and registered its copyright with the US government. Through legal services furnished by Rajasuya Markets, he also registered the copyright in India. Vinita, equipped with formal legal documentation (including power of attorney to represent The Factory), then brought an encrypted CD back to India and met with the principals of Maya Enterprises.*

*After performing some tests, Maya Enterprises accepted the CD. Under the terms of their joint service agreement, The Factory and Maya Enterprises inaugurated a new Indian company, Thugee Games, Ltd. Maya Enterprises owned 51 percent, and The Factory owned 49 percent. The Factory, in the person of Vinita, assigned Thugee Games a license to produce and distribute Thugee and other games.*

## NxLEVEL® TECH TIP
BUSINESS RESOURCES AND THE WEB

**Supply Chain Brain** (www.supplychainbrain.com) is an excellent online resource that focuses on global supply chains and logistics. The site offers a newsletter, search services, and online subscriptions. One of the most useful features of this site is the Supply Chain Library, a "comprehensive selection of case studies and detailed reports for executives seeking an intelligent and informative guide to achieving supply-chain excellence."

**LogisticsWorld** (www.logisticsworld.com) is a directory of logistics resources on the Internet, which acts as a gateway to thousands of sites related to logistics management, transportation, supply chain management, warehousing, distribution, maintenance, manufacturing, management, reliability, mathematics, business, and quality. The site features a Virtual Library of Logistics, and also gives professionals in the fields of transportation, logistics, and supply chain management the opportunity to enter their business or company information in its Logistics Directory.

## Methods and Means of Doing Business

Customers and products—in their cultural, economic, political and social contexts—drive all the processes and activities that comprise the supply chain. This has given rise to a demand-driven "pull" philosophy, which states that the customer's need for a product determines production levels and all other activities in the supply chain.

The measure of a supply chain is its responsiveness to customer demand

According to this philosophy, the measure of a supply chain is its responsiveness to customer demand.

### Just-In-Time Delivery (JIT)

JIT is an example of a modern business method based on the pull philosophy. The idea is that meeting customer demand when and where it's necessary eliminates waste in processes and resources, optimizing value for the buyer and seller.

If you subscribe to the JIT philosophy, your vendors will continually be holding inventory for you. These materials are, in essence, your work-in-process, and are stored by your vendors until you give them the go-ahead to deliver them.

JIT means frequent deliveries and smaller order sizes, so it requires smaller warehouses, efficient transportation, and an up-to-the-minute inventory management system.

*The downside of JIT*
JIT can cause problems if you don't have a contingency plan for disruptions in your supply chain. There's also a risk that JIT can decrease innovation, due to its homogenizing constraints. Innovative thinking becomes harder when the whole system is directed towards a sometimes abstract ideal of efficiency. For some businesses, "efficiency" becomes an end in itself, at the expense of a customer orientation. This can be dangerous.

If part of the appeal of your product is that it comes in a handmade wooden box, but you can speed up delivery and lower costs by replacing the wooden boxes with cheap plastic boxes, should you do it? Is the trade-off worthwhile in the long run? Will customers still notice or care about your product? Businesses don't always ask themselves basic questions like these. But the most efficient supply chain in the world is useless unless you can attract and keep customers.

In the wake of September 11, 2001, flaws in JIT systems became more apparent, leading some businesses to carry more buffer inventory. Caterpillar, unlike some corporations hit by the four-day stoppage of air traffic, was fortunate to have good contingency planning. Assembly line shutdowns at its plants lasted only a few hours. At competing plants, they lasted for days.

One of the hazards in the business world is that abstract concepts like JIT can replace independent thought, and sometimes even common sense. A useful tool like JIT becomes a sort of Holy Grail, the assumption being that as long as its rules are adhered to, nothing can go wrong. But things can *always* go wrong, as the events of September 11 dramatically demonstrated.

For a large business, mistakes may be expensive, but not fatal. But smaller businesses need to remain flexible and able to adapt. No system is flawless, and no supply chain is perfect; that's why you must always have alternatives and contingency plans. Small businesses should use JIT processes when and where it makes sense to do so. JIT is a tool, not an end in itself.

Smaller businesses need to remain flexible and able to adapt

*Vendor Managed Inventory (VMI)*
VMI is similar to JIT, except that inventory is monitored and managed by the vendor on behalf of the customer, based on an expected level of demand. Ideally, VMI increases efficiency while reducing inventory levels, replenishment times, and inventory costs. This methodology generally requires software applications that enable vendors and customers to share information. Like JIT, VMI can leave businesses vulnerable to supply shortages and other disruptive events.

*Customer Managed Inventory (CMI)*
CMI involves setting up an automated system to monitor and order inventory from your suppliers before you run out. This reduces the amount of inventory you need to keep on hand, while speeding up delivery times. A good CMI system will also anticipate fluctuations in demand (e.g., seasonality) and vary order placement accordingly.

CMI is a complex system that requires a fair amount of technological and organizational sophistication. That said, it's likely that such systems will become more affordable and easier to use in years to come, and will be embraced by forward-thinking entrepreneurs.

### Point-of-Sale Systems (POS)

POS systems use barcodes or other scanning technology to achieve a real-time snapshot of supply and demand

POS systems are another tool based on a "pull" philosophy. They use barcodes or other scanning technology to achieve a real-time snapshot of supply and demand. These data drive ordering, inventory management, and distribution. The following outline of resources and processes explains how POS works.

*Resources*

- An enterprise application thoroughly integrates the production process through a common communications network and database. The application may be named Manufacturing Resources Planning (MRP II), Enterprise Resources Planning (ERP), Advanced Planning and Scheduling (APS), or some variation on this theme. POS is a module of the enterprise application; others include customer relations management software, facilities management software, and warehouse management systems.
- Scanning and tracking technology includes barcodes and the laser scanners that read them, as well as wireless RFID. This technology tracks products through the system, and creates snapshots of customer demand.

*Processes*

- When a customer places an order, that information is distributed across the supply chain, so that suppliers send the raw materials or component parts to the production line.
- The product is manufactured in part or in whole. If in part (form postponement), the components are dropshipped to a hub distribution center for assembly.
- The goods are shipped to a retail outlet or other pickup point, or direct to the customer. Upon shipment and/or arrival and pickup, they're scanned and entered into the system database.
- Supplier and internal inventories are updated, based on the scanned data. The marketing department has a clear record of how many customers ordered which products. These days, there is often a record of which customers ordered which products. For example, Safeway customers can obtain a "Safeway Club Card," which gives them a preferred customer discount on many items in the store. The card also serves as an identifier against which scanned barcodes are processed at the checkout counter.
- The sales record is used as an immediate forecast of customer demand in the next week(s). This is probably the most accurate record possible from which to extrapolate longer-term strategic equipment, financial, production, and sales forecasts.

The benefits of analyzing POS data include better management of retail or wholesale inventories; targeted advertising; training employees in good customer service techniques; and making information on store offerings and policies easily accessible to customers. Small businesses can benefit greatly from a POS system. If you can integrate it with other supply chains of which you are a part, its value increases exponentially.

Small businesses can benefit greatly from a POS system

The POS system can be linked to several different suppliers or collaborators. Suppose you run a pharmacy in a small town, and you've eased your inventory management burden with modern cash registers and barcode-scanning equipment. Naturally, your pharmacy sells optical lenses; some manufacturers, such as Opticon (www.opticonusa.com), invite you to link your POS system to them via the Internet. As sales occur, the system shows when lens stocks have reached a certain minimum level, and a reorder is placed automatically. All other products can be managed in the same way.

These advanced POS capabilities are a variation on the theme of Just-in-Time, and both are logical outcomes of a pull philosophy built around the supply chain.

*Vinita returned to Framingham, confident that beta tests would be prepared and promoted according to their performance schedule. Based on forecasts made by Maya Enterprises, Al and Vinita anticipated that the beta tests, sold to a limited test market over the next few months, would generate a small profit and replenish the funds expended on the two business trips to India. Thereafter, business trips would be rare, because Al and Vinita would teleconference via broadband connections and use file transfer protocol (FTP) to exchange encrypted updates.*

*Thugee Games, Ltd. had the responsibility for creating an appealing marketing campaign targeting the demographic groups shown by Rajasuya Markets' research to be the biggest game buyers. The marketing plan for Thugee Games called for sales via a site maintained on a server in India, and distribution to retail outlets.*

*Once Thugee had established a presence in India, The Factory would build upon the phenomenon and market the game in North America. Al would develop updates to Thugee, and had ideas for several new variations on the martial arts and Hindu mythology themes.*

## The Push Method

The old way of doing things, by contrast, is called the "push" method. It was built around the concept of economies of scale in manufacturing, and is an example of why we should use a systems approach, in which no part of the network is considered outside of its relation to the rest of the system.

In the push method, only economies of scale in manufacturing were thought to be significant. The more of a product you could manufacture in one production run, the lower the per-unit cost of that product. Once the product was made, it was the job of the sales force to push the product onto customers.

When customers bought in droves, things were great. Otherwise, the carrying costs of unsold inventory quickly ate up the savings accrued through economies of scale. Workers were laid off and production lines idled. Sub-strategies were then employed to realize some value from unsold inventories, such as rebate programs, or selling the stock for pennies on the dollar to resellers and liquidators.

## The Green Supply Chain

A greener supply chain often proves to be a more efficient and cost-effective one

Studies show that green procurement practices and supply chains are increasing in popularity at every level of business. Although this is due in part to the growing visibility of environmental issues, and to steady consumer demand, many businesses are driven to implement these policies primarily because they wish to weed out inefficient processes and unnecessary inputs. They've learned that in many cases, a greener supply chain proves to be a more efficient and cost-effective one, because it requires a business to identify waste, underutilized resources, inefficient channels and subchannels, redundant production stages, unreliable partners, and inefficient or outdated equipment.

In order to green your supply chain, you have to understand it. Therefore, the first step is to develop a complete picture of your supply chain, and your position in the supply chain of your partners. Having done so, you can either urge your suppliers to minimize their environmental impact, or seek new suppliers who will. The greener your suppliers are, the greener your business will be by default.  By the same token, environmental policies that fail to address supply-chain issues will be superficial at best. As we said at the outset, no part of the supply chain should be viewed in isolation.

Each stage of the product life cycle should be considered in turn. How is the product manufactured? Where do the materials come from? Can you source them locally to reduce fuel use? How and where is it stored? If it needs to be refrigerated, how efficient is your cooling system? If it needs to be kept warm, how drafty is your building?

What packaging materials do you use? Can you make them greener, or get rid of some of them altogether? Can you use rubber address stamps instead of printed labels and tape? What shipping methods do you use? If you sell locally, can you rely on bicycle deliveries, or electric vehicles? What happens to your product at the end of its life? Can you refurbish the product, or reuse its container? Should you take it back to ensure that it's properly recycled?

These are the sorts of questions businesses are asking as they attempt to arrive at a set of standards and metrics that each business in the supply chain can meet. While it may sound complicated, the very nature of the supply chain ensures that countless businesses, products, and services are being created to help business owners adapt and improve. From software programs that optimize delivery routes to save on fuel costs, to consulting firms that can offer suggestions on streamlining production, reducing inventory, and saving energy, small-business owners have plenty of tools, and many sources for help and advice.

## NxLEVEL® GREEN TIP
ENVIRONMENTAL BUSINESS RESOURCES

The process of defining and creating green supply chains has only just begun, and will rely heavily on the collaborative nature of modern technology for its success. The following Websites offer a look at the opportunities and obstacles involved in greening local, national, and global supply chains.

**Green Logistics Forum** (www.greenlogisticsforum.com) "is dedicated to turning environmental business goals into real collaborative achievements by providing a forum in which all areas of the transportation and logistics industry can come together to discuss the issues and make firm plans to green their logistics in a informed and strategic way." The site offers a free e-newsletter.

**Green Suppliers Network** (www.greensuppliers.gov) was established by the US Department of Commerce and the US Environmental Protection Agency to "help small and medium-sized manufacturers stay competitive and profitable while reducing their impact on the environment."

**The Lean and Green Supply Chain** (www.epa.gov/oppt/library/pubs/archive/acct-archive/pubs/lean.pdf) is a terrific document full of practical advice on cutting costs through green accounting and supply chain management. It includes step-by-step guidelines on making environmentally and financially responsible decisions.

## The Future of the Supply Chain

If we asked you to imagine a world organized around the supply chain, you might ask, "Isn't that the world in which we live?"

Not exactly. The organizing principle of the current system is the nation state, which developed in Europe in the 1400s and 1500s, as an emerging national consciousness allied itself with the state apparatus of control (e.g., laws, bureaucracy, and legislators).

National consciousness embraced the concept of self-determination, which stated that each nation had the sovereign right to govern itself and determine its own laws, policies, and future. In a word, nation states have sovereignty; individuals, businesses, nonprofit organizations, and supply chains do not.

Is this situation changing? Some people argue that we are witnessing a transition from the self-determination of nations to a globalist culture based on the collaborative culture of the supply chain. Others believe that this is an oversimplification, and that the conflict between the homogenizing influence of business and the polarizing influence of national, religious, and cultural difference can never be "won" by one side or the other, and will continue for the foreseeable future.

Either way, here are some trends that are likely to continue as the world increasingly organizes itself around the supply-chain concept:

- Machine-generated data and "conversation" will increase. Products will talk to inventory programs, which will talk to manufacturing machinery, which will talk to production inputs, which will alert trucks that they're ready to be picked up.
- As interdependence becomes more complex and cross-functional, it will cut across traditional organizational lines at all levels.
- Standardized communications and information systems will integrate demand-driven processes and activities globally.
- The growth of artificial intelligence, and the increased automation of regional and global processes, will allow supply chains to optimize their own activities without human input, and to anticipate and respond to shocks and disruptions.
- A greater emphasis on green and sustainable supply-chain functions on the part of private business and government will force many smaller and international businesses to conform to these standards. Similar standardization will be necessary in other areas, too, as the needs of the supply chain increasingly dictate the behavior of vendors and manufacturers (cf. mandatory RFID tagging).
- Increased technological convergence and interoperability will make many supply-chain functions instantaneous, and accessible anytime, anywhere.
- As the global system becomes more interrelated, it will become more vulnerable to natural disasters, human error, terrorism, and economic turmoil. Disrupting the supply chain at one point may create a cascade effect that will affect many regions at once. The need to build security features into supply chains, and to protect vulnerabilities with surveillance and force, will accordingly increase, which will inevitably create *new* vulnerabilities.

Expect a greater emphasis on green and sustainable supply-chain functions

The trend towards collaboration represents a sea change in business culture. Instead of seeing other businesses as adversaries, we increasingly look beyond competition to find complementary strengths on which to build alliances and partnerships. The logic of collaboration in the supply chain is that certain expectations are created among collaborators, among them:

- Willingness to communicate and share information (including information that formerly would've been considered proprietary)
- Contribution of added value
- Quality performance
- Standardization

There are downsides to the logic of collaboration, of course. For instance, increasing transparency may put the security of your business at risk. Also, as larger businesses embrace new technologies, and insist that their partners do the same, there's a serious danger that these technological standards could form an impassable barrier to entry for small businesses.

Increasing transparency may put the security of your business at risk!

Another downside is that the concept of "value" is open to interpretation. In the context of standardized communications and information systems, the desire to put everybody "on the same page" can easily lead to groupthink. What happens if the page that everyone's on is *wrong*?

Despite these and other problems, it's safe to say that the capabilities and tools that are being created by the combination of new technology and a demand-driven business model will eventually change the way all businesses buy, manufacture, sell, ship, and dispose of products and materials. The likelihood is that there will be areas of synergy between the new and the old ways of doing things, which will create unheard-of opportunities for individuals to innovate, communicate, and generate wealth.

*A decade earlier, it's likely that Al and Vinita's operation—if it had gotten off the ground at all—would've been done in the more costly fashion of manufacturing games on CDs or floppy discs in the United States; exporting them via air or sea; perhaps labeling and packaging them in India; and hiring an export marketing firm like Rajasuya Markets to handle distribution and retailing. The costs may well have been too big a barrier to entry for a small enterprise.*

*Furthermore, the Indian government has enacted stronger protection of intellectual property. Piracy is still widespread in India, but modern encryption methods and stronger laws are having a positive effect.*

*What Al and Vinita did any entrepreneur can do, anywhere in the world. Today, markets are global, and competing in geographically distant markets may be easier and more rewarding than having a brick-and-mortar presence locally.*

## Conclusion

Managing supply chain operations means understanding each step in each of the business processes under your control. It also requires recognizing your business's position in the supply chains of other businesses.

How does your company create its products? What are its sources, and what affects them? Which tasks are performed most efficiently by your company, and which by its partners? At which steps is value added for the customer? How can this value be increased?

How can you make your supply chain leaner, greener, and more responsive to customer demands?

These are the sorts of questions you need to ask when analyzing your supply chain. By integrating and harmonizing your supply chain functions, you can speed up manufacturing and shipping, lower your costs, achieve economies of scale, maintain high standards of quality, improve your competitiveness, increase innovation, meet or exceed environmental standards, and strengthen strategic partnerships and alliances. All of this results in a competitively priced, quality product that satisfies consumers.

# Chapter 47
# PROJECT MANAGEMENT

*About This Chapter:*
- *What is project management?*
- *The project manager*
- *The process of project management*
- *Project management tools*
- *Closing out a project*

## Introduction

Project management is an invaluable tool for entrepreneurs who want to have better control over one-time studies or future actions that influence costs and revenues. (Note that most projects that are undertaken in a business setting can ultimately be linked to cost reduction or revenue generation.)

Project management is a very handy skill to learn. Using it consistently can greatly improve the management and profitability of an entrepreneurial business.

Project management skills can greatly improve the management and profitability of an entrepreneurial business

## What is Project Management?

There are many different definitions of project management, the specifics of which usually depend on the context in which project management techniques are being used. For example, a large construction company defines it this way: "Project management is utilizing specific techniques to examine and control a one-time event, undertaken to achieve a particular aim or goal by the application of money, time, manpower, skills, and tools to a problem." By contrast, the Project Management Institute defines it as "the application of knowledge, skills, tools, and techniques to project activities to meet project requirements."

For our purposes, projects can be defined as specific, unique, well-defined events with a definite start and finish date, which are always undertaken with a degree of uncertainty and risk. Project management is the careful process of planning, organizing, staffing, and resource allocation that allows for the successful completion of project goals.

Bringing a project in on time and under budget is the holy grail of project managers everywhere. But few of them manage it without a good grasp of the project management practices that we will discuss in this chapter.

Shrewd entrepreneurs use project management to plan, achieve, and measure a wide variety of tasks and goals

Shrewd entrepreneurs utilize project-management techniques to plan, achieve, and measure a wide variety of business tasks and goals. Here are some examples of activities for which project management is useful.

- Determining whether to buy or lease new equipment
- Developing and introducing a new product
- Opening a new manufacturing site
- Entering a new market
- Marketing overseas
- Greening your business
- Selecting suppliers
- Opening a new division
- Moving or expanding your office
- Designing or upgrading a Website
- Assessing, buying, installing, and training employees on new software
- Seeking new financing
- Negotiating and executing a joint venture
- Writing or revising a NxLeveL® Business Plan

Consider your own business. What business functions or team members might benefit from better decision-making, budgeting, and efficiency? Project management is the ideal tool for making improvements like these.

### The Elements of Project Management

There are four basic elements that must be managed in order for your project management efforts to be successful.

*Scope*

**Scope** is the actual definition of the project, stated in terms that include the time it will take to complete, and the monetary budget that is available to complete it.

One of the most common and serious problems in project management is the inevitability of "creep," which is what happens when the scope of a project expands without an equivalent increase in time and budget. Usually, creep occurs in the form of small, incremental changes that, when totaled up, amount to a significant expansion beyond the original scope of the project.

Managing scope is critical, because if you fail to maintain control you will inevitably fail to manage the other three elements of project management.

### *Time*

Time must be allotted for every single aspect of the project, and is usually stated in months, weeks, days, and hours.

It's usually hard to estimate the amount of a time a project will take. The difficulty of assigning tasks to the correct personnel, plotting out the interdependence of necessary activities, and determining critical paths can seriously complicate the task of estimating the completion time for each stage of a project. Unfortunately, most entrepreneurs tend to underestimate the time necessary for successful task completion, which can have a variety of negative consequences.

Most entrepreneurs tend to underestimate the time necessary for successful task completion

### *Resources*

Resources comprise all of the equipment, material, technology, and people that must be brought together and managed in order to undertake and complete a given project. Of all of these considerations, finding the right person for the right job is usually the most important (and the most difficult).

### *Money*

The estimated cost of a given project is normally expressed in a monetary budget, which outlines the cost estimates, contingencies, and profit margins associated with the tasks at hand. Listing the resources utilized in a project in monetary terms is one good way of keeping track of your progress and measuring your success or failure.

*Exports Unlimited was formed in 2008 by three guys who were lucky enough to stumble upon an unserved market.*

*John Merky, Bill Voulangas, and Samir Mahdawi had known each other professionally for years. They were all involved, one way or another, in the furniture business.*

*John was in furniture case goods sales. In 2007, he was sent by his company to Dubai to open a regional sales office. John knew a lot about wood furniture, but almost nothing about international business.*

*One thing he did know, after a couple of business trips to Dubai, was that there was a huge market in the Middle East for someone who could package furniture and furnishings into project bids for the large construction projects that were underway in these foreign markets. Hotels, offices, retail spaces, and infrastructure projects were being built by the hundreds, and all of them needed furniture and furnishings.*

*Beyond that, each of these construction sites had a work camp to house and feed temporary workers, who'd come from all over the world to work on these construction projects. These camps also needed furniture and furnishings.*

*Since the prime contractors for these projects required full turnkey bids for all products, from forks to sofas, it was necessary to source the products from many manufacturers, most of which John knew nothing about.*

*There was no doubt about it: if he were going to take advantage of this opportunity, he'd need some help. John thought about his pals Bill and Samir, and wondered if they might like to start a company with him.*

**Project Phases**

- **Initiation.** In this phase, a need or opportunity is identified, a project manager is chosen, a general plan is structured, and team members are chosen.
- **Planning.** Detail work is done on the Project Plan. Activities and tasks are assigned, money is budgeted, and time is scheduled.
- **Execution.** The work is performed by the team, and guided and monitored by the project manager.
- **Close out.** Deliverables are delivered, accepted, and utilized by the stakeholders. Project reports are prepared in order to assess the efficiency of the process and identify areas for improvement.

## The Project Manager

A **project manager** is the person who is in charge of running the project. His or her responsibilities include everything involved in the project, including liaison with the organization(s) from which the project originated; coordination and communication with suppliers, partners, and other stakeholders; and leadership of the team members who were chosen to work on the project.

This can be a challenging task. Project managers must be able to act in good faith, while staying true to their personal beliefs and representing the interests of many parties who are directly and indirectly involved with the project.

Here are some of the personal traits of a good project manager.

- Accessible and personable
- Honest, open-minded, and fair
- Decisive
- Empathetic and understanding
- Inspiring, positive, and enthusiastic
- Able to live with uncertainty and doubt
- Cool under pressure
- Comfortable with change

In addition to these personal traits, a project manager must have certain professional skills in order to be effective, including:

- **An understanding of project management techniques.** A project manager should understand process management, and be familiar with such project management tools and techniques as schedules, diagrams, charts, and project management software. He or she should also know how to prepare a scope, a **requirements document**, project and action plans, and accurate timelines and budgets.
- **Leadership skills.** Project managers usually have to rely on others to aid in getting things done. Therefore, leading, motivating, negotiating, delegating, and communicating are very useful skills to have when running a project.
- **Technological abilities.** Often, a project requires use or knowledge of certain technologies (e.g., software development, marketing, Web design, energy efficiency, or construction). The project manager should have a good working knowledge of the technologies at the core of a project, or the ability to develop it on the job.

The managers and workers who will ultimately use the product that results from a project are looking for certainty in assumptions, projections, and results. Since real life is full of uncertainty, it's the project manager's responsibility to expected the unexpected, manage risk, and adapt when necessary to get the job done.

It's the project manager's responsibility to expected the unexpected, manage risk, and adapt when necessary to get the job done

Even the best project managers can run into all kinds of difficulties. Some of the most common problems include unrealistic targets, inflexible time constraints, uncooperative team members, confusion over authority and responsibility, communication breakdowns, and difficulty in managing their normal "day job" and the project at the same time. It takes an unusual person to keep all these elements under control.

### Team Building

The project manager's front-end work relates to **initiating** a project. The **planning** phase starts when the various team members are chosen and officially come on board.

Team-building skills are of particular importance for project managers. A team builder is someone of strength and substance who can bring people together to achieve a common goal.

First, a team leader must understand who should be chosen to form the team. Determining which employees and interested parties outside the company have the right combination of technical skills and personal talents is the first step in any team-building exercise. Once formed, the team must be led and motivated, so leadership skills are critical to any successful project management venture.

How and when should you choose a team? First, the project must be sufficiently fleshed out. You need to know the general direction in which you're headed, and have enough details to define who will do what. You can't lead a team effectively when goals are vague or poorly defined.

At the same time, too much detail will discourage buy-in from new members. Achieving the ideal level of detail is a balancing act that usually gets easier with practice.

In most organizations, project managers also look at a particular individual's skill set and time commitment (i.e., money budgeted for their time on the project), and weigh this against their department's relevance to, and impact on, the end result of the project. This assessment of financial involvement and expected contribution should also be part of the selection process.

Last, issues of compatibility are very important. Finding team members who will be fully committed to the goals of the project, and not solely to their own interests, is ideal. How do you find them? Here are some questions to consider when screening prospective team members.

- Do the candidates have the technical skills you're looking for?
- Are their interpersonal skills adequate for the job?
- Ask them to describe their problem-solving methods.
- Do candidates have the right personal traits for the job?
- Are they committed to the project goals?
- Do they have time to work on the project?
- Have they worked on a similar project before? What was the outcome?
- Why do they want to work on this particular project?

### Leadership

A project manager's major contribution to any project is the ability to lead team members towards a stated goal

A project manager's major contribution to any project is the ability to lead team members towards a stated goal. From the start, project managers must have a clear vision of where a given project should go.

They must also have the ability to articulate this vision to team members. Good communication and motivational skills allow a leader to empower team members, and aid them in envisioning what their individual contributions will mean to themselves, the team, and the company.

For more on this topic, review Chapter 22 *Team Building and Leadership*.

### Duties

Project managers have a variety of duties, many of which are specific to an individual project. Here is a basic summary of job expectations that apply to most situations.

- Develop the scope of the project
- Outline a best-guess timeline for the work
- Screen and select team members
- Develop work processes and performance expectations
- Facilitate project meetings
- Manage conflict and motivate team members
- Communicate milestones and information to team members and stakeholders
- Protect the team from disruptive outside pressures
- Keep team on scope, on schedule, and on budget
- Reward high achievement and remove unproductive team members
- Close out the project and prepare the final report
- Coordinate roll-out of project results when needed

Project managers should keep in mind that team members will naturally look to their leader for direction. Furthermore, all team members are not created equal, so each should be managed in a way that will maximize their talents and participation. It's best to outline duties and expectations very clearly early on in the project, and then do everything in your power to help your team members achieve their individual and project goals.

It's best to outline duties and expectations very clearly early on in the project

*When John returned from his second trip to Dubai, and explained his idea to Bill and Samir, they were very interested. Both of them were looking for something new, and both of them had experience that could be very valuable to the sort of business John was contemplating.*

*Bill had been in the furnishings business for over twenty years. There wasn't much he hadn't worked with. Carpet, drapes, kitchen outfitting...you name it, he had done it.*

*Samir, who had been born in Lebanon and spoke fluent Arabic, was a purchasing and contract manager for a company that worked with hotels, restaurants, commercial laundries, and office parks. This firm specialized in everything from design to installation, and Samir had a good general knowledge of these issues, as well as an understanding of the cultural issues that tend to arise when doing business in the Middle East.*

*In short, both of them had a bit of international business experience, and a lot of knowledge about their respective fields. And both of them felt that they could really contribute to John's business idea.*

*After a couple of meetings where they fleshed out the details of the business, they decided that before quitting their jobs and starting an export company, they'd take some vacation time and travel to the Middle East to do a market survey. They were so excited the day they got on the plane, it felt like they were flying 10,000 feet higher than the aircraft!*

## The Process of Project Management

Each project is unique, and has its own appropriate goals, team members, and tools. However, there is a basic logic to the process by which most projects are managed:

- Prioritize feasible projects
- Define the scope and outline major deliverables
- Break the project down into specific tasks
- Recruit and lead team
- Organize the Project Plan
- Develop a timeframe from inception to completion
- Communicate goals and objectives
- Delegate responsibility for tasks, tied to specific timeframes
- Account for and document time and money
- Adjust to changing conditions
- Check, measure, and reward performance
- Close out the project

The skills required to accomplish these tasks include organizing, communicating, accounting, team building, and motivating. (Before proceeding, take a moment to honestly assess your own skills. Is there anything you need to learn or practice?)

At the outset, the project team, utilizing the project manager's initial outline of the project, must agree to and prepare a **project template** that specifies the following details.

1. Clearly defined scope, purpose, deliverables, benchmarks, and goals
2. An outline of project parameters (e.g., budgets, timeframes, authority, job descriptions, and—if appropriate—project management software selection)
3. Guidelines for how the team will collaborate, make decisions, and meet
4. Clearly defined data-gathering, measurement, and reporting standards
5. A list of potential project risks and problems, plans for dealing with them, and a system that will keep the project on track and within budget
6. Basic protocols for communication, giving and receiving instructions, lodging and resolving complaints, resolving conflicts, and solving problems

By working together to complete a detailed project template—including goals, principles, and operating procedures—the entire team starts out on the same page.

### Preparing a Detailed Project Plan

The hardest part of this process tends to be the preparation of the Project Plan. Three difficulties come to the fore at this point in the project. First, solidifying the end goals of the project usually takes a very thorough and painstaking examination of what you really want to accomplish.

Second, the identification and sequencing of necessary tasks also takes a great deal of thought, not least because the tasks may be interdependent in complicated and overlapping ways. Last, estimating the time each task will take to complete is never easy.

Regardless, all of these steps must be taken. Many projects are doomed from the start because the project manager and the team are not thorough enough in addressing these issues at the outset.

For some projects—such as the preparation of a requirements document for software development—this front-end work can take as long as the actual project. Still, smart project managers do not rush this part of the process. Taking time to do things right on the front end always pays off with a more successful project at the back end.

Taking time to do things right on the front end always pays off with a more successful project at the back end

#### How to Define a Need or Opportunity

- Create a description of the problem or the opportunity
- Survey end users, and get their input
- Assess the impact of the problem or opportunity on your company
- Specify what will occur if the problem or opportunity is ignored
- Define the desired outcome and subsequent benefits
- Describe how the outcome fits the company's goals
- Define risks, uncertainties, and limitations
- Detail assumptions, and back them up with facts

*Scope of work*

Broadly speaking, defining the **scope of work** means identifying exactly what the project is intended to accomplish. A good definition of the scope of work would be a description of the project goals, combined with the time and money budgeted to achieve it.

The next step is to define each of the activities that must be performed in order to reach those goals. Having done so, you should break each activity down into the tasks that are necessary to complete it. This list of activities and tasks will form the basis for your project deliverables. Along with a careful estimate of the time and money required to complete the project, these elements will help to define and communicate the project's goals, size, and requirements.

Of course, these preliminary activities also take time and cost money. Therefore, as you drill down from the major activities to the smaller tasks necessary to accomplish them, you must assign timeframes and dollar amounts to the work. (Remember: if the scope changes, the time and money must change as well!)

As you work through your assessment of the scope, and the time and money it requires, you can assign the appropriate team members, equipment, and materials to each activity and task. In this way, you will logically fill out a complete work plan for the project, based on the crucial project management parameters of **work breakdown**, work assignment, scheduling, and budgeting.

*Work assignment*

This is one of the primary responsibilities of a project manager. If you're in charge of a project, it's your job to outline a body of work and match each task with the skill set and technical capabilities that would best accomplish the job. Finding the right people for each task can be difficult, but it's critical to your project's success.

Even a good project manager sometimes picks the wrong person. When this happens, it's usually best for the team member, the team, and the project to find a replacement, if at all possible. Very few people enjoy working in a job they are not qualified for. If replacing the team member is not possible, the project manager will usually have to carry some of the load and help that team member complete his or her work.

Time management is an essential skill for a project manager

Time management is another essential skill for a project manager. In order to compute milestones for individual activities and tasks, assign team members, and prepare a timeline, the project manager must have a system along the following lines:

1. Using a work breakdown, prepare a list of all activities and tasks
2. Develop a list of activities that must be finished before others are started
3. Develop a list of activities can be done simultaneously
4. Prepare a time estimate for each item listed above
5. Prepare a project calendar of activities and times (excluding holidays)
6. List available resources and other limitations on the above calendar
7. Reevaluate the project calendar, accounting for resources and limitations
8. Recalculate the project calendar, comparing the project required date to the actual date
9. Make adjustments to resources or limitations where possible
10. Prepare a final project calendar, with adjusted completion date

*John couldn't believe how fast things had happened. Their very first call on a prospective client resulted in an invitation to bid on a small construction camp job in Dubai. The project manager loved the case goods that John's current employer sold. In fact, back home he had just bought a new bedroom set for his wife's birthday. John assured him he would bid the manager's housing project with the very same line of furniture.*

*And so it went. By the time John, Bill, and Samir headed home, they had five prospective projects to bid on, even though they didn't really have a company yet!*

*In that first year, things were so hectic that they didn't really have time to set up proper management systems to bid and run all the jobs they were involved with. Although they were winning more than their share of the bids, managing a dozen employees, and making more money than they'd ever thought possible, things were starting to go wrong.*

*Some mistakes were minor, and easily fixed. But some were downright embarrassing, and others cost them a lot of money to remedy. For instance, they would occasionally mix up line items from different bids, resulting in disqualification for that tender. Or their pricing and delivery terms would get mixed up from one project to the next. But the straw that broke the camel's back was when they accidentally shipped three containers of materials that were destined for a contract in Egypt to Kuwait.*

*Fixing that problem cost them all the profit that was in the deal, and then some. And the client expressed his displeasure by pointedly not inviting to bid on the next job.*

*Clearly, something had to change! It was time for John, Bill, and Samir to take a step back, and have a serious look at Exports Unlimited's business processes.*

### What's Next?

After completing the planning phase, it's time to publish the Project Plan and scope of work. It's also wise to hold an operations kick-off meeting to set the stage for the **execution** phase.

During this meeting, all team members receive their final work assignments, and the template under which the job will be run is unveiled. Good project managers also use this meeting to energize their teammates, outline meeting agendas and frequency, and detail the processes by which communication and collaboration will proceed.

The execution of the plan is where the rubber meets the road, and the managerial and leadership talents of the project manager become vitally important. Above all, the skills and technical capabilities of team members must be guided and encouraged in order to drive the team's tactics and activities towards meeting project goals.

At this stage, one of the project manager's key activities is to monitor the work of team members, and be available to answer questions. You may also need to aid in collaborative problem-solving and conflict resolution, or sourcing additional resources.

How the project manager handles problems has a lot to do with the final outcome of the project

Most projects will encounter problems. How the project manager handles them has a lot to do with the final outcome of the project. Encouraging early reporting of problems, questions from team members, and open communications is always a good policy.

Even if the results aren't favorable, rewarding team members who follow the process is another way to keep things on track.

You and your team members should practice and promote positive reinforcement

By demonstrating personal and professional integrity, the project manager ensures that the team will do the same. Talking behind a team member's back, gossiping, and criticizing one team member in front of another are all destructive practices that your team would do well to avoid. Instead, you and your team members should practice and promote positive reinforcement.

## NxLEVEL® GREEN TIP

ENVIRONMENTAL BUSINESS RESOURCES

As green projects become more common, there's a growing interest in **green project management (GreenPM)**. Simply put, this means taking environmental issues into account during each phase of the project management process.

Typical GreenPM goals include specifying green materials or vendors, using networking technology to reduce paperwork and commute time, and minimizing environmental impact as much as possible at every decision point.

At a minimum, whatever green practices and goals your business pursues must be incorporated into your Project Plan. A more ambitious goal would be to follow **ISO 14000**, an internationally recognized management tool that enables businesses to:

- Identify and control the environmental impact of their activities
- Continually improve their environmental performance
- Maintain a systematic approach to setting, achieving, and communicating green objectives

Note that ISO 14000 does not specify specific environmental targets. Instead, it establishes "a common reference for communicating about environmental management issues between organizations and their customers, regulators, the public and other stakeholders." For more information, visit **www.iso.org/iso/iso_14000_essentials**.

### Project Control

When most people hear the word "control," they associate it with power and authority. In the project management world, this term has more to do with guidance, shepherding, and influence. The project manager's job during the execution phase is to keep the project on track by continually examining where the project is in relation to its scope and benchmarks, and guiding team members back on course when things start to drift.

Project managers do this by comparing where the team is to where it should be, according to these elements of the Project Plan:

- **Budget.** Are project costs on track?
- **Timeline.** Is the project on schedule?
- **Deliverables.** Do they meet the required specifications?

The goal here is to identify **variances** (e.g., the difference between planned and actual results at any given time). In order to do this, you must determine what data you need to gather, and then perform the following steps.

- Develop a starting point for your data
- Have a standard method for data gathering
- Ensure that the data are reliable
- Have tools in place to measure performance and identify variances
- If necessary, take steps to realign the Project Plan

As you'll recall from our discussion of accounting, the phrase "garbage in, garbage out" explains why you must pay careful attention to the reliability of your data. Almost all projects require some sort of data-gathering during the execution phase, so data quality is extremely important.

Almost all projects require some sort of data-gathering during the execution phase, so data quality is extremely important

Sometimes, projects managers discover problems during the execution phase that can't be managed within the framework of the Project Plan. Unrealistic deadlines and budgeting, under-staffing, and unfeasible deliverables are good examples of problems that call for project changes.

When this occurs, the project manager must make certain decisions, most of which will address one or more of the following problems:

- **Project delays.** Too little time for too much work results in deadline renegotiation.
- **Budget shortfalls.** Too little money for scope of the project results in renegotiated budgets.
- **Overly broad scope.** A scope that's too broad—either because of poor initial planning, or unmanaged "creep" during the execution phase—usually results in reduced deliverables or increased budgets.

Usually, these issues come to the fore after a frustrating ordeal, as team members try to make the project work under the unrealistic conditions of the original project scope. If this happens in your project, it's best to recognize these problems as intractable under the current Project Plan, and take corrective action as detailed above.

A risk management program is a necessary part of an intelligent Project Plan

### Risk and Uncertainty

In any project you undertake, you will face risks and uncertainties. A risk management program is a necessary part of an intelligent Project Plan.

**Project risks** can be simply defined as "unknowns." These can be positive (opportunities) or negative (threats). Project managers should happily accept and benefit from opportunities, and take steps to avoid or minimize threats.

Here is a proven method for anticipating and managing risks that can derail projects:

1. Have all the team members make a list of likely risks, and consolidate these lists into a master list.
2. Prioritize each risk by its probability and the seriousness of its negative outcome.
3. Assign each risk to the most appropriate team member, and have that person track and report on it.
4. Prepare a list of reasonable preventative actions should the risk in question arise.
5. Take appropriate action when necessary to keep the project on track.

### Project Management Tools

Many projects undertaken by small entrepreneurial businesses can be managed with relatively simple tools. Examples include moving your office, purchasing a new telephone system, or writing a NxLeveL® Business Plan (see the NxLeveL® Action Log in Session 2 of your Workbook).

More complex projects require more complex tools. There's often a correlation between the size of the budget and a project's complexity, so this is one method of determining what type of tools you'll need. Other pertinent factors include:

- The number of deliverables and team members
- The length of time budgeted for project completion
- The interconnectedness of all the elements in the project
- Risks and risk management strategies
- The financial impact on the company

*John, Bill, and Samir decided they needed to bring on another partner—one who had a lot more experience in international business than they did, and knew something about project management.*

*Enter Tim McCarty. Tim had an MBA in international business, and had worked overseas for most of his career. He came to them from a big construction company that was a former client of theirs. Most important, Tim knew a lot about project management.*

*Tim spent the first few weeks just observing the way things worked—or didn't—at Export International, and taking copious notes. After that, the four partners held a conference, away from the office and all the other employees, to go over Tim's findings about their business operations.*

*"Tim laid it all out for us in sort of a 'tough love' session," John recalls. "To an extent, he told us what we already knew, which is that we didn't have any project management systems. What was harder to hear was that we never should've started a business of this type and complexity without them, and to a large extent the fact that we weren't already out of business was just dumb luck. He was actually pretty amazed that we hadn't had more and worse disasters."*

*It was a sobering meeting. But Samir found one bright side: "At least we can start out from scratch and build things the right way. We won't have to overhaul an inefficient system, because we don't have any system at all!"*

### NxLeveL® Action Plan

The **NxLeveL® Action Plan**, which you'll find in your Workbook, is a simple but effective project management tool. It allows you to enter and track the following data:

The NxLeveL® Action Plan is a simple but effective project management tool

1. Project (describe the task)
2. Team (choose a team leader and team)
3. Resources (identify necessary equipment, materials, technology, and people)
4. Budget (what will these resources cost?)
5. Budget variance (were actual costs higher or lower than budgeted costs?)
6. Success indicators (define your benchmarks)
7. Next steps (what must you do to move forward, and who is responsible?)
8. Schedule (estimate the timeline in weeks)
9. Schedule variance (was the actual time more or less than the estimated time?)

One way to prepare such a plan is to utilize the **work back schedule**. You do this by starting from the date on which the project should be finished, and outlining deliverables, activities, and tasks in reverse order, with due dates for each. Then, you can develop team assignments and budgets. Finally, you can develop an appropriate timetable by plotting the important milestones and timeframes on a timeline.

### Other Tools

There are many other tools available for project management. The following pages will discuss some of the more important ones.

### *Logic network*

This tool is developed by sequencing tasks and activities, and plotting them across a timeline. This is a good way to determine which activity should proceed or follow another, and it's often used to chart a critical path of a project and identify important milestones.

### *Gantt charts*

Gantt charts can help you plan tasks, determine when they must be carried out, and allocate resources

Gantt charts are used to plan and analyze more complex projects. They delineate the timing of activities and tasks as they occur. Gantt charts can help you plan tasks, determine when they must be carried out, allocate resources, and work out the critical path from inception to completion.

In order to complete a Gantt chart, follow these steps:

1. List all activities and tasks, and provide a time estimate to completion (including whether they must be undertaken sequentially or in parallel to each other).
2. Develop a graph with a header measured in days, weeks, or months.
3. Plot activities and tasks on the chart, and place them sequentially so that they follow one another as they should.
4. Redraw the chart to show how activities link together, demonstrating a critical path and outlining costs.

Here is a sample Gantt chart for the introduction of a new product, with a three-month timeframe that has been broken down into week-long blocks.

| Tasks | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | Cost |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Perform market analysis | ■ | | | | | | | | | | | | $ 400 |
| Design product | ■ | ■ | | | | | | | | | | | 250 |
| Choose and test materials | | ■ | ■ | | | | | | | | | | 300 |
| Find suppliers | | | | ■ | ■ | | | | | | | | 25 |
| Develop marketing plan | | | | ■ | ■ | ■ | ■ | | | | | | 1,800 |
| Secure funding | | | | | | | ■ | ■ | | | | | 200 |
| Create prototype | | | | | | | | | ■ | | | | 750 |
| Manufacture product | | | | | | | | | | ■ | ■ | | 2,700 |
| Advertise product | | | | | | | | | | ■ | ■ | ■ | 1,400 |
| Introduce product | | | | | | | | | | | | ■ | 400 |

### *Critical Path Analysis (CPA) and PERT charts*

CPA is a means of plotting out and managing project activities that must be completed on time, if the overall project is to be completed within the budgeted timeframe. It's often used to calculate the minimum time necessary to complete a complex project. CPA is also a very useful tool for schedule and resource planning.

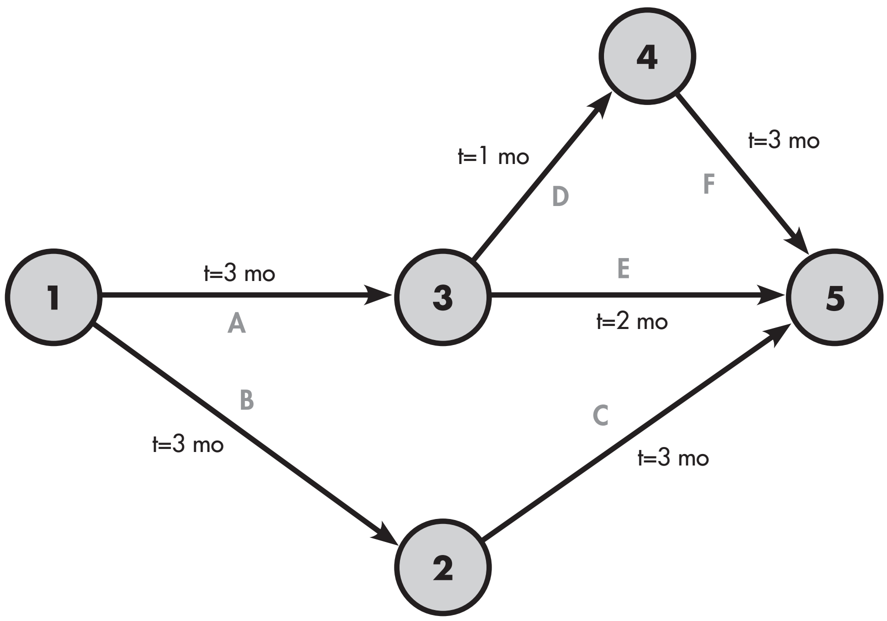
"PERT" stands for *Program Evaluation and Review Technique*. This is a method of analyzing the elements—especially time—that are needed to complete a project.

The basic premise of CPA is that you cannot start certain activities until others are finished. The process for using this tool is as follows:

1. List all activities and milestones in the Project Plan, showing start date, time to completion, and whether it must be done in sequence or in parallel.
2. Use sequentially numbered circles for milestones, and arrows for each task that must be completed in order to reach each milestone. Write the necessary task on one side of the arrow, and the amount of time the task will take on the other.
3. Link activities in sequence where one must be completed before the other.
4. Chart sequenced activities that must be run in parallel.
5. Make adjustments when the critical path is not on schedule.

Project management software simplifies this process greatly, by converting tables of task and sequence data into a **network diagram**. This diagram is a visual representation of the critical path of the project, and demonstrates problems that must be corrected to stay on schedule.

Here is a simplified PERT chart.




Again, the circles represent project milestones, with numbers to indicate sequential order. The arrows represent the tasks that must be done between one milestone and the next. They are labeled with letters. An associated key would normally be used to identify each task by name (e.g., "A = perform competitive analysis"). The notation opposite the letters is the estimated timeframe for each task. In this example, "t=3 mo" means that it will take an estimated three months to get from Milestone 1 to Milestone 2.

Keeping track of projects is much easier if you choose the right project management software!

### Project Management Software

Keeping track of projects can be much easier if you choose the right project management software. There are hundreds of these programs on the market, ranging from systems that allow complex collaboration among virtual teams with hundreds of members all over the world, to a simple system for a couple of team members working in one location.

The more sophisticated the project is, the more sophisticated (and costly) the project management software must be. Luckily, there are a number of free software packages available, which may be adequate for your needs. It pays to do your research before using any software, to make sure it matches your needs. Of course, the NxLeveL® Action Plan is always available for your simpler tasks.

## NxLEVEL® TECH TIP

BUSINESS RESOURCES AND THE WEB

**Project Management Software**

Popular programs include **Microsoft Project**, **Intellisys Project**, **Open Mind**, **Project Kickstart**, **Rational Plan Multi-Project**, and **Minuteman**. Their prices range from $50 to $500.

Another option is to use Web-hosted project-management software services, like **@task** (www.attask.com), **Clarizen** (www.clarizen.com), **Daptiv** (www.daptiv.com), **Mariner PPM** (www.serena.com), **Basecamp** (www.basecamphq.com), and **QuickBase** (quickbase.intuit.com).

If you don't want to spend that kind of money, or simply wish to experiment first, you can try free, open-source software like **GanttProject** (www.ganttproject.biz), **iTeamWork** (www.iteamwork.com), and **Task Juggler** (www.taskjuggler.org).

You can also check **www.freewarefiles.com** for more free project management software.

*After the meeting, the first thing Tim did was install project management software and set up teams to work on different projects that were currently in process.*

*Each team was set up as a one-time project team, and created specifically to respond to the contractual requirements in that tender. The project manager would choose people who had the right skills for that particular project.*

*Going forward, each tender for bid Export International received would create a separate project team, and each project team would have a single project manager assigned to oversee that job.*

*The team would track benchmarks, deliverables, and critical path with the project management software, which Tim had selected for its intuitive interface and seamless integration of communications, bidding, purchasing, shipping, installation, and project close-out functions.*

*When Exports Unlimited won a bid, a new team was created—and a new project manager was assigned—to ensure that they performed to the highest standards of contract management, and each and every deliverable was met on time and on budget. This newly created "award team" used the same project management software and files that were initiated and utilized during the bidding phase to manage the project during the execution phase. Prizes were awarded to teams that performed in an exemplary way, and everybody enjoyed the friendly, competitive relationship between the various project teams.*

*Bill thought this system was great. "I'd been wondering if there wasn't some way to handle the tender document from initial receipt all the way through to installation and project close-out, while measuring progress along the way. And of course, there was. It's just that we'd done things the hard way by default, because we didn't know any better."*

*Exports Unlimited has grown by leaps and bounds, and is currently looking at expanding into several Asian markets. As John says, "None of this would have been possible if we hadn't made the decision to bring on Tim, and take to his advice on how to run projects. We did a lot wrong early on, but we did one thing right, and that made all the difference."*

## Closing Out a Project

Projects come to a close in many different ways. Some are successful in meeting deadlines and deliverables. Others, during the course of the project, are terminated prior to completion because the team discovers that the project will not be beneficial to the company, costs too much money, or will have to be completely restructured and restarted.

Many people see the early termination of a project as a failure, and sometimes it is. On other occasions, the project *should* be terminated, because total completion is not in the best interests of the business. This is a good thing, as it usually saves time and money that could be used to better effect in other areas of the company.

How do you close out a successful project? There are certain steps that will help you no matter what kind of project you are working on.

First and foremost, you must ensure that the project will deliver what was promised. There are normally some sticking points that must be resolved towards the end of a project. And at this stage, many of these items are the ones that proved to be the most difficult to accomplish. Good project managers must make every effort to push these

You must ensure that the project will deliver what was promised troublesome elements through to completion, which often requires spending extra time working with the team members who are responsible for them.

The project manager should always acknowledge the contributions of team members

The project manager must also ensure that there's a consensus that all the elements of the project have been completed to the best of everyone's ability. At the same time, preparations must be made for delivering the project and receiving sign-off from those who will take the results of the project and use them. The project manager should always acknowledge (and reward, when appropriate) the contributions of all team members.

The last step in the close-out process is to prepare a final report to all stakeholders in the project, and prepare the project file for storage.

At this stage, most effective project managers will take some time to see what actually happened during this process. Questions to ask include, "What did I learn by doing this? What went wrong? What went right? What could I do better next time?"

These questions may seem simple, but nothing is better suited to prepare you for the next successful project.

## Conclusion

Good project managers are made, not born. You can learn to use these tools, and you'll find that doing so will not only pay financial dividends when managing projects, but also help you to improve the everyday management of your business. There are many common problems entrepreneurs face that are best resolved through a disciplined approach based on project management skills.

Team building and leadership are critical to completing a successful project. Finding the right people to lead and work on a team is not easy, but it will pay huge rewards.

Along with the right people, you need the right tools to run a project. These tools should be selected to match the sophistication and cost of the job in mind, and used consistently.

As these habits and skills become second nature to you and your team, your business will be well positioned for profitable growth.

# PART XII
# CONCLUSION

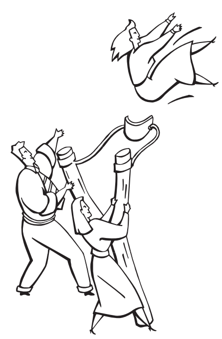
## Chapter 48
## CONGRATULATIONS!

*About This Chapter:*
- *Understanding entrepreneurship*
- *The value of the business plan*
- *The tools of your trade*
- *Ethical issues*

### Introduction

As an entrepreneur, you're one of America's folk heroes. You create jobs, launch innovative products, improve on existing ideas, and spark economic growth in your community. You turn risks into opportunities, overturn the conventional wisdom, and make the lives of your fellow citizens easier and more pleasant.

Having completed this course, you've done something that merits considerable respect and praise. You've examined your business concept, confronted and overcome challenges, and planned for future growth. You've developed your skills and knowledge, and joined thousands of other entrepreneurs whose dynamic leadership leads to national economic growth and community vitality.



### Understanding Entrepreneurship

Entrepreneurs are free from the traditional limits of standard pay for standard work. They invent their work, their product, and the way they do business. But all the same, entrepreneurs are bound by the laws of profitability, which state that a business must generate more money than it spends.

Entrepreneurs are bound by the laws of profitability

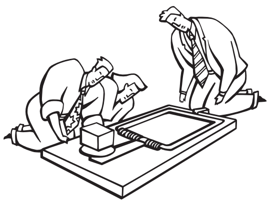
Cash left after all expenses have been paid is profit, which can be allocated to the owner, or reinvested to help grow the business.

Your business earnings must compensate you for the risks you've taken, and for your time, energy, and personal savings. But such compensation is not the only reward of being an entrepreneur. Independence, creative freedom, and the fun of growing a business offset the long hours, risks, and uncertainties that entrepreneurs face.

#### Customer Orientation

The profit your business generates comes from satisfying your customers' needs. How much will people pay for a product that meets their needs? That depends on the product's perceived value, and perceived value depends in turn on your quality, positioning, branding, reliability, ethics, environmental benefits, and customer service.

To satisfy your customers, you need to understand them thoroughly. At the same time, you must carefully manage your brand identity, and work to keep the promises that it makes to your customers. Your goal is to make sure that your customers recognize and value the things that make your business special. Remember that every decision you make—from sourcing, to packaging, to shipping—communicates a strong message about your values and your abilities. Anything that affects your customer affects your business, and no detail is too small to overlook.



We believe that a consistent, compelling, and creative brand identity, backed up by customer-centered service and strong ethics, is the key to building an unbeatable competitive advantage.

### Learning and Entrepreneurship Go Hand in Hand

Entrepreneurship is a continuous cycle of questioning, analyzing, and learning

Success doesn't come simply from knowing what your personal strengths are. It also comes from understanding and overcoming your weaknesses. Entrepreneurship is a continuous cycle of questioning, analyzing, and learning. Did you achieve your objectives last time around? What could you have done better? Whose help do you need? What will you do next time to improve?

You don't have to become an expert in every area of business management, but you do need to understand enough about each element of your business that you can ask the right questions, and ensure that business tasks are being done properly.

Don't ignore areas of your business that intimidate or confuse you. No part of your business should be off limits to careful scrutiny. Each aspect of your business can be more easily managed if you break it down into smaller steps, and take the time to ask questions and seek help. Once you've done this, you can make smart choices about allocating responsibility and resources, and if necessary, engaging the services of experts.

## The Value of the Business Plan

At the risk of repeating ourselves, researching and writing a thorough NxLeveL® Business Plan is the most valuable thing an entrepreneur can do.

A business plan should be compelling, easy to read, and informative for anyone interested in financing, supplying, or working with your business. The ideal business plan is both an inspirational narrative, and a blueprint for success.

### Many Paths to Follow

We hope that in the process of preparing your business plan, you've found some answers to your most pressing questions. Have you achieved your original objectives? Have your goals changed? Has your target market changed? Have you found ways to make your product more attractive, sustainable, or innovative?

There are many paths you might take from this point. We hope that participating in NxLeveL® has given you a better understanding of the basics of marketing, financing, producing, and planning for growth.

**Why Business Plans Succeed**

Here are some things that you should bear in mind when writing your plan.

- **Always provide evidence for your assumptions.** Most readers of business plans are looking for a solid factual foundation, with well thought out reasons for the business to exist. Too many business plan writers fail to do their homework, and this usually results in a plan that doesn't offer enough evidence to give readers faith in the success of the venture.
- **Always acknowledge the challenges you face.** Failing to produce an honest account of obstacles to success is a common mistake among novice writers. It's better to describe challenges with complete candor, and then offer credible solutions.
- **Always stay focused on market needs.** Many technology-oriented companies in particular dwell on the art and science of their innovation, without regard to a market need. Though they may be entertaining reading for other technologists, these plans tend to fail because they do not tie the technology to the market in a compelling way.
- **Highlight past performance.** Although it's important to tout the credentials of your team, investors and bankers want to know if your group has ever faced similar challenges and succeeded. Describing where they worked isn't enough. Instead, demonstrate that they have a history of innovating, solving problems, and reaching goals.

## The Tools of Your Trade

Simply by starting your business at this time in history, you have a huge technological advantage over generations of previous entrepreneurs. Countless pre-packaged and hosted software applications for communications, word processing, database management, graphics, presentation, and networking can help you solve your business problems, and keep things running smoothly.

Use new and emerging technologies to your advantage!

The convergence of these technologies gives you the ability to track and control multiple functions of your business at once, even while you're traveling. If you have not yet availed yourself of these powerful business tools, now is the time to start!

That said, remember that the old tools are as useful as ever. The basics of financial management, and the ratios and equations that help you to chart the course of your business, are still vitally important. Even if you use accounting software to calculate them, you still need to understand what you're calculating, and why.

## NxLEVEL® GREEN TIP

ENVIRONMENTAL BUSINESS RESOURCES

Here are some sites that will help you to keep your business green and profitable.

**The US Department of Energy's Energy Efficiency and Renewable Energy** site (www.eere.energy.gov) offers valuable hints and incentives for increasing the energy efficiency of your business.

**Clean Edge** (www.cleanedge.com) is "the world's first research and publishing firm devoted to the clean-tech sector." It's a good place to track the latest developments in clean energy, transportation, and materials.

**GreenBlue** (www.greenblue.org) is "a nonprofit institute that stimulates the creative redesign of industry by focusing the expertise of professional communities to create practical solutions, resources, and opportunities for implementing sustainability."

**Green Economy Network** (www.greeneconomynetwork.org) is a green business advocacy site "driven by the deep desire to provide our country with a sustainable economic base that can employ all of our people, foster the bold innovation that exemplifies American entrepreneurialism, and revere our precious environment that sustains us all."

### Finding Partners, Creating Teams

Collaboration is an essential ingredient of creativity and efficiency

Committing yourself to acquiring new skills doesn't mean that you have to do everything yourself. Collaboration is an essential ingredient of creativity and efficiency, and new technologies like social networking media and videoconferencing make it easier than ever before.

When you feel overwhelmed by the challenges you face, the insight and support of others will inspire you to strive onward and upward. Surrounding yourself with people who have complementary skills and different points of view will save time, increase the credibility of your business, and improve the decisions you make.

In short, by creating a pool of talent your business can draw on (through formal partnerships, team building, or informal mentoring arrangements), you increase the likelihood that your business will succeed.

When faced with business tasks that are beyond your core competencies, the use of outsourcing and independent contractors lets you focus on what you do best, and leave laborious, complex tasks to experts. Knowing when, what, and how to delegate is crucial to your business.

### Leadership Skills

A boss instructs and disciplines employees, sets goals and expectations, and limits the ways in which people can achieve their tasks.

By contrast, a leader generates an emotional connection with people, attracting and inspiring them towards a common goal. A successful leader has learned the art of managing through influence, communication, and inspiration. When employees are given the opportunity to identify their own goals, and the freedom to select the best way to achieve them, their performance improves dramatically.

### Greening Your Business

Societal values are changing, and green standards and practices are being accepted at every level of the business world. If you haven't yet aligned your business with these values, it's time to give it serious thought. Businesses that fail to meet the growing consumer and legislative demand for efficiency, transparency, and good citizenship are likely to be at a competitive disadvantage in years to come.

You should approach greening your business the way you'd approach any other business task. You need to identify problems, weigh the costs and benefits of solutions, and prioritize your activities based on cost, payback, and timeframe. By creating a Green Action Plan to guide your business towards appropriate, affordable, and attainable goals, you'll be able to build on your successes, and work logically towards a competitive, customer-centered business that is environmentally and financially sustainable. Communicating these goals, and the benefits of achieving them, should be a consistent focus of your business plan.

### An Open Mind

Shrewd entrepreneurs are careful to avoid tunnel vision and wishful thinking. They try not to let political, social, or philosophical prejudices impede their understanding of trends and market conditions, nor do they limit their intake of information to the things they want to hear.

Shrewd entrepreneurs are careful to avoid tunnel vision and wishful thinking

Instead, they consistently challenge their assumptions, invite feedback and constructive criticism from others, and adapt to changing conditions. They listen to many different points of view, and assess them as objectively as possible, while working to create the kind of world in which they can succeed and thrive.

### A Culture of Innovation

The role that innovation plays in attracting and keeping customers cannot be overemphasized, and is likely to increase in years to come. Maintaining a culture of innovation at your business is a vital strategy for success, and it requires a sincere commitment from you. If your employees feel that you don't value new ideas, they won't bother to think innovatively. But if you are emotionally and intellectually ready to innovate, your employees will follow your lead.

#### Profitable Growth

From a business perspective, the only meaningful growth is *profitable* growth. Other types of growth—like market share, number of employees, and sales volume—increase costs, not net worth.

In order to achieve and maintain profitable growth, you must manage and operate your business in a way that will ensure a cost-effective accumulation of profit. Always bear these points in mind:

- Customer orientation is essential in a growth company.
- Time spent on things that don't maximize profit will slow your growth.
- Growth strategies require your personal commitment and vocal leadership.
- All employees and stakeholders must pull together to be successful. Team-building and communication are absolute musts.
- Employees are your most important resource. People matter more than data.
- To be successful, make others successful!

### Ethical Issues

Ethical business decisions will earn the loyalty and respect of your customers, employees, and suppliers

Business ethics involve principles of right and wrong that go beyond questions of mere legality. Great entrepreneurs are respectful of their obligations to customers, employees, suppliers, investors, their community, and future generations.

This sense of integrity and honesty must inform the day-to-day operation of your business. The reasons are simple: Ethical business decisions earn the loyalty and respect of your customers, employees, and suppliers; they protect you from potentially disastrous legal problems; and they give you an enormous competitive advantage!

#### Community Involvement

No business operates in a vacuum. You are part of the community in which you work. Your current and future customers, suppliers, employers, and investors are also part of your community. When you give something back to your community, you gain the economic and personal benefits such actions produce, and your community reaps the benefits that only entrepreneurs can bring to the table.

### Welcome to the NxLeveL® Training Network

The NxLeveL® Program for Entrepreneurs is a broad, national network of kindred spirits and fellow innovators. To date, thousands of people have emerged from NxLeveL® Programs. Like you, these entrepreneurs completed business plans and took the next step in growing their businesses.

The most valuable asset NxLeveL® gives its participants is access to other people who have participated in and taught programs; their combined business and life experiences are a golden resource. By sharing ideas, entrepreneurs learn from each others' mistakes and explore new ways to achieve their goals. They also enjoy the comfort of knowing that others have experienced similar challenges, risks, and rewards.

You can participate in this network by visiting our Website, and by building on the relationships you formed with fellow participants. Furthermore, local trade associations, community colleges, Chambers of Commerce, and Small Business Development Centers sponsor many events for small businesses. Attend them, contribute to them, and benefit from them!

We are happy to welcome you into the NxLeveL® network, and look forward to your contribution to our success stories and innovative entrepreneurial solutions.

## NxLEVEL® TECH TIP

### BUSINESS RESOURCES AND THE WEB

Whether you want to learn about new theories of management, keep up on the latest trends and technology, contact your elected representatives, or connect with other entrepreneurs like yourself, the Internet can help you. The Tech Tips in this book don't even scratch the surface of the resources available to you online.

The Internet is a tool that previous generations could only dream of, and it will be a primary force in shaping the business world of tomorrow. Take advantage of it, and make continuous, lifelong learning your goal!

**NxLeveL® Education Foundation** (NxLeveL®.org) is our Website. Stay in touch with us...we want to hear all about your successes!

**Small Business and Self-Employed One-Stop Resource** (www.irs.gov/businesses/small) is a useful site compiled by the Internal Revenue Service. Be sure to pick up a copy of their Small Business Resource Guide CD-ROM.

**Cofoundr** (www.cofoundr.com) is "a private community for entrepreneurs—programmers, designers, investors, and other individuals deeply involved with starting new ventures. Members use the site to find co-founders, build teams, and get advice."

**Fast Pitch** (www.fastpitchnetworking.com) is a fast-growing social network for business professionals across the world. It bills itself as "a one-stop shop for business professionals to network and market their business."

**TwiTip** (www.twitip.com) is a blog dedicated to helping businesses and individuals improve their use of Twitter. If you've been doubting that Twitter can really do good things for your business and your customers, this site is very likely to change your mind!

## The Journey Ahead

You are embarking on a journey into the world of entrepreneurship, where opportunities and rewards are as numerous as the risks and challenges you'll encounter. On this journey, initiative, creativity, and ingenuity triumph. Being a successful entrepreneur begins with finding your unique strengths and interests. Once you've done this, you must use them to your best advantage, by building your business around them. When you love what you do, you work harder, with more creativity and drive. This gives you a powerful competitive advantage.

Having taken the time and expended the energy to study the basics of entrepreneurship, you now have more tools with which to build your business and ensure the chances of its success and profitability.

The entrepreneurial vision is a powerful force. It can transform the quality of your life, the goals you achieve, and the legacy you leave your family and community. When you combine this vision with your expanding knowledge of business, your entrepreneurial journey becomes fun, fulfilling, and profitable!

# Part XIII
# Appendix

## GLOSSARY OF TERMS

*This section makes it easy to look up common business terms, and defines acronyms frequently used in business.*

**acceptance**. An agreement to purchase goods at a stated price and under stated terms.

**accounts payable**. Money owed for inventory, supplies, and other expenses.

**accounts receivable**. Money owed to a business by customers.

**accrual basis**. A method of accounting in which revenues are recorded when earned and expenses are recorded when incurred, no matter when the cash changes hands.

**active investment**. An investment in which one is actively involved in earning money, such as owning and operating a business.

**ad hoc research**. A form of market research conducted to satisfy situational information needs.

**adware**. Ad delivery systems that are integrated into software applications. Adware will usually continue to generate advertising (e.g., pop-up ads) even when the user is not running the original program.

**affective conflict**. Unhealthy conflict between team members on the basis of personality and ego. *See also cognitive conflict.*

**agent**. A representative who normally has authority to make commitments on behalf of the firm he or she represents.

**aging report**. A list of accounts receivable according to the length of time the unpaid balance has been owed.

**amortization**. The process of liquidating a cost over a long period of time (e.g., a home mortgage) by periodically making a payment that reduces the principal amount.

**appropriate technology**. Technology that is suited to the environmental, ethical, cultural, social, and economic situation of a specific community or region (usually, but not always, in the developing world). It's generally a simple, non-polluting or sustainable technology, using local materials and skills.

**arbitration**. A system administered by the court system to resolve disputes; it is increasingly used instead of litigation.

**arbitration clause**. A clause in a sales contract outlining the method under which disputes will be settled. *See also arbitration.*

**articles of incorporation**. A document filed with a state's Department of Commerce stating why a corporation is being formed and what type of business it will conduct, and serving to register the corporate name.

**asset valuation**. A method of business valuation that calculates the total assets of the business (building, property, machinery, etc.) to arrive at a value for the business.

**assets**. Any items of value owned by a business, including cash, accounts receivable, notes receivable, property, and property rights.

**assumed business name**. The name under which a business operates. Most states provide for registration of assumed business names, which protects the name from misuse by others.

**authentication certificate**. A digital "ID card" that establishes one's identity when doing business or other transactions on the Web.

**balance sheet**. An itemized report listing assets, liabilities, and owner's equity at a given point in time.

**bankruptcy**. The inability of a business to pay its debts.

**behavioral segmentation**. A form of market segmentation based on observations of consumer browsing and buying patterns, and the effect of marketing on those patterns.

**benchmark**. A point of reference set to determine progress towards a goal.

**bid pricing**. Pricing used by organizational buyers in which requests for proposals invite interested sellers to bid on a set of specifications.

**bill of lading**. A shipping contract that outlines the terms of a shipping agreement and the means by which goods will be shipped.

**blog**. An online journal that is frequently updated, and offered for general public consumption. Short for *Weblog*.

**blue sky law**. A law regulating the sale of securities, real estate, etc., especially designed to prevent the promotion of fraudulent stocks.

**board of directors**. Individuals elected by shareholders to oversee the management of a corporation. The members of a board of directors are paid in cash and/or stock, meet several times each year, and assume legal responsibility for corporate activities.

**boilerplate**. The detailed standard wording of a contract. Also known as "fine print."

**bonded warehouse**. A secure area within a customs territory, where foreign merchandise can be stored without duties being assessed.

**botnet.** A network of personal computers infected with malicious code, usually under the control of a criminal individual or organization. Some experts believe that botnets account for about 90 percent of all spam.

**brand**. A name or symbol that represents a product.

**brand identity**. The image a business tries to project to customers, communicated by a product's design, benefits, packaging, advertising, and the services delivered along with it.

**brand image**. The customer's impression of a brand.

**branding**. Telling the "story" of your business and your product in a compelling and colorful way—one that will give people reasons to buy your product instead of someone else's.

**brand management**. Management activities related to the development, maintenance, and promotion of a brand.

**breakdown forecasting**. Looking at one's largest population of customers, then breaking that group down by qualifying criteria such as age, income, and preferences to define the level of sales expected from target customers.

**break-even analysis**. Identifies the point at which total revenue equals total costs and profits are zero.

**break-even point**. The sales level at which neither a profit is earned nor a loss incurred. The basic break-even formula is: S (break-even level of sales) = FC (fixed costs) + VC (variable costs). Analyzing the break-even point helps to predict the effects of changing costs or sales levels on income.

**broadband**. A communications medium capable of simultaneously transmitting a large amount of voice, data, and video signals.

**brokers**. Professional intermediaries who bring buyers and sellers together. Brokers do not have formal or lasting relationships with either party, and are often used by businesses that need not maintain a full-time sales force.

**browser**. A software program that allows users to view and interact with pages displayed on the World Wide Web. The most popular browsers, such as Netscape Navigator and Microsoft Internet Explorer, are graphical browsers; these allow users to view text and graphics.

**buildup forecasting**. Estimating the size of each market segment, then adding them together to arrive at a sales forecast.

**business continuity planning**. *See continuity planning.*

**buy/sell agreement**. A contract that sets forth the terms and conditions by which associates in a business can buy out other associates.

**bylaws**. Corporate rules that set forth provisions for the annual meeting, size and manner of election of the board of directors, number and duties of the officers, voting requirements for merger, and similar matters.

**cable modem**. A modem designed to operate over cable TV lines. Because the coaxial cable used by cable TV provides much greater bandwidth than telephone lines, a cable modem can be used to achieve extremely fast access to the World Wide Web.

**capital**. Cash and/or material assets (e.g., tools, property, and equipment) owned by or used in a business.

**carbon-neutral business**. A business that has limited and offset its carbon emissions to the extent that total carbon emissions are zero.

**carrying costs**. The cost of tying up money by holding inventory, plus additional costs like taxes and insurance on inventory.

**case study**. An in-depth investigation of how target populations do things that are of interest to researchers. A case study usually focuses on a representative of the larger population (e.g., a person, household, company, or community that is thought to be "typical"). A form of market research.

**cash basis**. A method of recording income and expenses in which each item is entered when received or paid.

**cash discount**. A discount given to buyers who pay bills within a specified time.

**cash flow**. The movement of cash into and out of a business.

**cash flow cycle**. The cash flow cycle represents the length of time that cash is tied up in business operations. If the cycle can be shortened, cash will be freed to begin the cycle again, or to invest in other projects.

**cash flow projections**. The information in your cash flow projection comes from your other budgets, but it is organized so that cash is highlighted. Preparing cash flow projections helps you anticipate cash shortages, or plan for using excess cash.

**cash in advance**. A method of payment for goods in which the buyer pays the seller in advance of the shipment of the goods. Usually employed when the goods are built to order.

**cash receipts**. Cash generated from sales, accounts receivable, and loans.

**causal research**. A form of market research that examines the impact of independent variables (e.g., the incidence of smoking) on dependent variables (e.g, the mortality rate from lung cancer).

**certificate of origin**. A document certifying the country of origin for goods, used in foreign commerce.

**certified public accountant (CPA)**. An accountant certified by a state examining board as having fulfilled the requirements of state law to be a public accountant.

**CET**. *See common external tariff.*

**CFR**. *See Code of Federal Regulations.*

**change management**. The process of planning and implementing a smooth transition from one organizational structure or business process to another.

**channel of distribution**. *See distribution channel.*

**channel partners**. Businesses that act as intermediaries to help other businesses buy, sell, assemble, store, and display products.

**chargebacks**. A refund given by a credit card company to a cardholder. When a customer disputes a credit card bill, the credit card gives the customer the money back, and then "charges back" the merchant, often adding a fine to the refunded amount.

**civil law**. The body of laws regulating ordinary private matters, as distinct from laws regulating criminal, political, or military matters.

**cleantech**. Technology that creates cleaner, safer, more efficient products and processes, in order to reduce or reverse human impacts on the environment

**closely held business**. A business owned by a small number of persons (usually under 25) whose interests in the business are not publicly traded.

**CMI.** *See customer managed inventory.*

**cloud computing.** Using Web-hosted infrastructure or software on an as-needed basis, instead of purchasing the necessary hardware and software for one's own office. See also *software as a service* and *infrastructure as a service.*

**code of federal regulations (CFR)**. The general and permanent rules of the federal government, as published in the Federal Register.

**COGS**. *See cost of goods sold.*

**cognitive conflict**. Productive, healthy debate between team members that ideally leads to a group solution transcending individual capabilities. *See also affective conflict.*

**collateral**. Assets pledged to a lender to secure or support a loan.

**collection payment method**. A bank is the middle party between the buyer and the seller. The bank pays the seller for the goods; in order to obtain them, the buyer must pay the bank for them. The goods serve as collateral for the bank if the buyer defaults on the deal.

**common external tariff (CET)**. A common tariff that members of a customs union, common market, or economic union impose on nonmembers.

**common law**. Law created through judicial application of precedent.

**common market**. This type of trading bloc is similar to a customs union, with the important difference that it permits unrestricted movement of labor and capital between its member countries.

**competitive analysis**. Assessing your prospective market's overall attractiveness. A competitive analysis has three components: industry analysis, competitor analysis, and SWOT analysis.

**competitor analysis**. Analysis of your competitors' strengths and weaknesses, both actual and potential.

**compound interest**. Interest earned on the principal and on previously accumulated interest.

**conservation ethics**. A theory of environmental ethics arguing for the protection of the environment on the basis that it's necessary for the welfare of human beings, now and in the future. *See also intergenerational equity.*

**consideration**. An exchange of value that passes between the parties to a legal contract.

**consequential damages**. Damages awarded for expenses incurred as a direct result of a breached contract.

**consumer orientation**. A policy of adapting the processes and products of one's business to the wishes or needs of customers. *See also product orientation.*

**consumer promotions**. Short-term sales promotions to consumers.

**contingency planning**. Considering possibilities for disruption of your usual business activities, and developing a means of continuing your business should those disruptions actually occur.

**continuity planning**. Planning intended to help businesses recover quickly from the effects of disasters and extended disruptions.

**continuous budget**. A budgeting technique in which twelve months are always shown, with a new month added constantly.

**contract management**. Practices that keep a contractual relationship running smoothly, such as scheduling meetings with partners, setting performance checkpoints, creating a stable operating environment, and establishing a method of achieving goals despite the uncertainties of the market.

**convergence**. An accelerating process of integration and interoperability between communication and networking devices. *See also unified communications.*

**cooperative advertising**. Advertising in which manufacturers and retailers pool their resources to promote both the product and the store. The manufacturer offers retailers an allowance to advertise the manufacturer's product, allowing retailers to include the name of their store.

**copyright**. The exclusive right to reproduce, sell, publish, or distribute literary or artistic work (i.e., works of authors, composers, and other artists). *See also intellectual property.*

**corporate shield**. Protection against personal liability offered by a corporation.

**corporation**. A group of persons authorized by the state to function as a separate legal entity, with privileges and liabilities distinct from those of its individual members.

**cost of goods sold (COGS)**. Costs associated with the sale of a product or service, which may include materials, freight, direct labor, and overhead.

**cost-plus pricing**. A basic pricing method in which a business determines its costs, then adds a percentage to achieve a desired profit margin.

**country risk analysis (CRA)**. Analysis of the financial risks that may arise from the political, economic, or social instability of a country.

**CPA**. *See certified public accountant.*

**CPS**. *See current population survey.*

**CRA**. *See country risk analysis.*

**cradle to cradle design**. A highly efficient form of design in which end-of-life products are reutilized as inputs for new products, resulting in minimal use of energy and production of waste. *See also zero-waste business.*

**credit risk insurance**. A form of insurance that protects the seller against loss due to default on the part of the buyer.

**criminal law.** Concerns the rights of society versus the actions of individuals.

**crowd financing.** The process of raising business capital by getting small amounts of money from numerous individuals, usually by means of social networking media and online communities.

**crowdsourcing.** The process of outsourcing a business function like ad design to a group of individuals (e.g., current and prospective customers).

**culture**. The beliefs, norms, values, and customs that define a business or a country.

**current liabilities**. Monetary obligations due to be paid within one year (e.g., accounts payable, wages payable, taxes payable, current portion of long-term debt, interest, and dividends payable).

**current ratio**. Current assets divided by current liabilities, indicative of whether or not a business has sufficient current assets to meet its current debts. The higher the ratio, the more likely it is that a business will be able to meet its current obligations.

**customer orientation**. A primary focus on the needs of customers. *See also product orientation.*

**custom marketing strategy**. Segmentation of a target market down to the individual.

**customs**. A government authority that regulates the flow of commercial goods into and out of a country, and collects duties levied upon imports and exports.

**customs broker**. A person or firm licensed by the Treasury Department to enter and clear goods through customs.

**customs union**. A group of countries among which goods pass free of trade barriers, but which impose a common external tariff on countries outside the union.

**debt financing**. Business financing that normally requires periodic interest payments, and repayment of the principal within a specified time.

**debt to equity ratio**. The relationship of creditors' money to owners' money in a business, indicating the extent to which a business is dependent upon borrowed funds.

**demand-driven manufacturing**. Manufacturing in which production levels fluctuate in real time according to consumer demand, allowing a reduction in inventory costs.

**demographic data**. Marketing data that describe the specific characteristics of an individual, such as age, level of education, occupation, income, marital status, and address. *See also psychographic data.*

**demographic segmentation**. Market segmentation based on demographic data.

**deposits in transit**. Deposits that have not yet been posted by the bank.

**depreciation**. The portion of the cost of tangible operating assets (such as buildings or equipment) recorded as expense for the accounting period; results from spreading out the cost of long-lived assets over several years.

**digital subscriber line (DSL)**. Digital subscriber lines carry data at high speeds over standard copper telephone wires. With DSL, data can be delivered about 30 times faster than through a standard modem. Also, DSL users can receive voice and data simultaneously, so small offices can leave computers plugged into the Net without interrupting phone connections.

**direct exporting**. Sale by an exporter directly to a buyer located in a foreign country.

**direct labor**. For a manufacturer, labor costs that can be directly traced to the products.

**direct loans**. Loans made by the Small Business Administration directly to a small business.

**direct mail**. Presenting a product or service to the customer via mail, without the use of middlemen.

**direct marketing**. Presenting promotional information to prospective consumers via door-to-door selling, telemarketing, direct mail, catalog, or the Internet; any presentation of a product or service directly to the consumer, without the use of a middleman.

**direct materials**. For a manufacturer, those materials that become an integral part of a finished product.

**direct writer**. A type of insurance agent who represents only one insurance company.

**discretionary income**. Amount of spendable or savable income available after providing for basic necessities such as shelter, food, clothes.

**distributor**. An agent who sells directly for a manufacturer and maintains an inventory on hand.

**distribution channel**. An organized system of interrelated marketing institutions that promotes the physical flow of goods and services from the producer to the consumer or end-user.

**dividend**. A share of profits paid to stockholders of a corporation.

**doctrine of primary actor responsibility**. States that a person is always responsible for his or her own actions, regardless of whether they occur in the context of a corporation or sole proprietorship.

**documents against payment (D/P)**. A type of payment for goods in which the documents transferring title to the goods are not given to the buyer until he has paid the value of a draft issued against him.

**domain name**. A name that locates the Website of an organization or other entity on the Internet (e.g., www.nxlevel.org).

**double taxation**. Taxation of both corporate net income and stockholder dividends.

**duties**. Taxes levied by a government on the import, export, or use and consumption of goods. Duties are based on a given country's preset tariff rate.

**dynamic pricing.** A pricing scheme in which the seller offers identical goods at prices that are tailored to individual customers or customer segments.

**e-commerce**. The buying or selling of products, information, or services over the Internet.

**economies of scale**. A mass production concept: the more goods are produced with the same machinery and overhead, the lower the per-unit cost of the goods.

**eco-labeling**. A label certifying to consumers that a product meets certain environmental standards, according to a third-party certification process.

**eco-tourism**. Tourism to areas where there are natural attractions (e.g., a bird population), undertaken in ways that minimize the negative effects of conventional tourism on the environment.

**EDI**. *See electronic data interchange.*

**electronic data interchange (EDI)**. In a similar way to e-mail, EDI allows users to exchange business documents—such as invoices, delivery notes, orders, and receipts—over the telephone.

**EIN**. *See Employer Identification Number.*

**e-mail client**. A software application that runs on a personal computer, enabling the user to send, receive, and organize e-mail.

**EMC**. *See export management company.*

**EMS**. *See environmental management system.*

**employer identification number (EIN)**. An identifying number of a business entity, obtained from the IRS by filing application form SS-4.

**environmental management system (EMS)**. A management structure that supports development, implementation, achievement, review, and improvement of environmental policies.

**environmental scanning**. A form of country risk analysis in which analysts scan cultural, political, legal, and economic environments for business opportunities or threats.

**equity**. The amount of the owner's investment in the business; what remains after total liabilities are subtracted from total assets. Also called "net worth."

**equity financing**. An investment received in exchange for partial business ownership. The investor's financial return comes from dividend payments, and from growth in the net worth of a business.

**estoppel**. A rule of law requiring that a party who leads another party into believing that a contract exists between them must perform as per the terms of that contract.

**ETC**. *See export trading company.*

**exit limits**. A predetermined point at which a businessperson will decide to get out of a business. Exit limits act as a safety net against personal and professional loss.

**expediting**. Moving orders quickly and efficiently by ensuring the supplier's commitment to a scheduled shipping date.

**expenses**. Assets spent in order to operate a business; expenses are subtracted from total revenues to determine net income.

**exploratory research**. A type of market research that tries to reveal what consumers really think about a given product. Its methods include customer interviews, case studies, focus groups, and unobtrusive observation.

**export controls**. Regulations that restrict the release of certain goods, technologies, equipment, and information to foreign agents or residents.

**export declaration**. A formal statement made to the director of customs, describing goods being exported.

**exporting**. Sending goods to a foreign country.

**export license**. A permit required in order to export certain commodities to certain destinations.

**export management company (EMC)**. An organization which, for a commission, acts as a purchase agent for either a buyer or seller.

**export management system**. A program designed to ensure compliance with Export Administration Regulations, thus reducing the risk of inadvertently exporting to an unauthorized party or for an unauthorized end use.

**export merchant**. A producer or merchant who sells directly to a foreign purchaser without going through an intermediary such as an export broker.

**export trading company (ETC)**. An ETC facilitates the export of US goods and services. Like an EMC, an ETC can either act as an export department for producers, or take title to the product and export for its own benefit. Most frequently, ETCs take title to the goods and pay the exporter directly.

**express contract**. A contract whose terms are in words or writing.

**extended producer responsibility (EPR)**. A program under which the producers of hazardous materials or waste products are required to take back, reuse, or recycle goods that would otherwise pose a disposal problem for municipalities. The cost of EPR policies to producers are generally passed on to the consumer, reflecting a more accurate cost of production. (In states without EPR programs, consumers usually pay for disposal costs through taxation that funds municipal waste programs and pollution clean-up.)

**external cost.** Very simply put, a negative effect of business activities, the costs of which are imposed on society instead of on the business or industry responsible for them.

**factoring**. A method of financing in which a business sells its accounts receivable at a discount for cash.

**FDD**. *See franchise disclosure document.*

**feasibility study**. Research and analysis intended to determine whether a business opportunity is worth pursuing.

**Federal Insurance Contributions Act (FICA)**. Legislation under which taxes are levied for the support of Social Security.

**FICA**. *See Federal Insurance Contributions Act.*

**financial intermediary**. A financial institution that acts as the intermediary between borrowers and lenders. Banks, savings and loan associations, finance companies, and venture capital companies are major financial intermediaries in the United States.

**financial statements**. Accounting reports that generally include a Balance Sheet, an Income Statement (also called a profit & loss statement), a Statement of Owners' Equity, and a Statement of Cash Flows.

**financing proposal**. A document prepared in order to educate prospective lenders and investors about a business. It communicates the business's financial position, the quality of its management, and the degree of risk it offers.

**fixed costs**. Costs that do not vary significantly with the volume of output or sales (i.e., utilities, rent, depreciation, interest, administrative salaries). Also, costs that are constant regardless of quantity of products or services sold. *See also variable costs.*

**fixed-price contract**. A contract that provides for a specified price (or, in some cases, an adjustable price) for supplies or services, usually within a stipulated contract period. Such a contract places maximum risk and responsibility upon the contractor.

**fixed rate**. An interest rate that does not change during the life of the loan.

**flexible budget**. A budget that includes a range of activity levels, used to compare with a budget that reflects actual sales volume.

**focus group**. A group of 6-12 people interviewed by a professional who asks open-ended questions for the purpose of gathering data about their preferences, opinions, beliefs, and experiences. Also, a group of prospective consumers who participate in a structured discussion of a product or service.

**follow-the-leader pricing**. A pricing policy based on what industry leaders charge for a given product.

**forbearance**. The giving up of a right under a contractual agreement. A form of consideration.

**foreign sales agent**. An agent residing in a foreign country who acts as a salesman for a domestic manufacturer.

**form postponement operations**. A process in which a manufacturer creates the component parts of a product, but the parts are not assembled until later (e.g., when a customer orders the final product, customized to his or her specifications).

**Four Ps**. Product, Price, Placement, and Promotion. These are the elements that must be appropriately balanced in the marketing mix.

**formula retail**. Branded "chain" businesses and franchises that usually have standardized design elements, business methods, products, and practices.

**franchise disclosure document (FDD)**. An informational document that must be provided by a franchisor to a prospective franchisee at least 14 calendar days before any agreement of sale is finalized.

**free trade**. A situation in which there are no regulatory barriers to trade.

**free trade area**. A type of trading bloc in which member countries trade freely and equally amongst themselves, while maintaining trade barriers with outside countries.

**freight forwarder**. A corporation that carries on the business of forwarding, but is neither a shipper nor a consignee. The foreign freight forwarder receives compensation from the shipper for preparing documents and arranging transactions related to the international distribution of goods.

**full cost accounting**. An accounting method that attempts to quantify the "full cost" of business decisions, by considering hidden and external costs, especially as they relate to environmental and social health. See also *triple bottom line.*

**full-time workers**. Generally, workers who work more than 35 hours per week.

**general ledgers**. A business record that includes details of all accounts.

**general partnership**. Two or more persons who jointly own a business. General partners participate fully in management of the business, and their liability is personal and unlimited.

**geographic segmentation**. A form of market segmentation based on such factors as population density, climate, landscape (e.g., beach versus mountains), and weather.

**geotargeting.** Aiming promotional messages at target customers based on their location, usually on the basis of Internet Protocol addresses or geolocation software.

**globalization**. The homogenization of activity and process in global channels of communications, culture, economics, politics, and technology.

**goodwill**. Intangible assets of a business, generally referring to the difference between the business's market value, and the market value of its net tangible (appraisable) assets.

**green premium**. The amount of extra money that a consumer may be willing to pay for an environmentally preferable product.

**greenwashing.** Representing a business or product as green by downplaying or hiding its negative environmental effects.

**gross profit**. Net sales (gross sales less returned merchandise, discounts, or other allowances) minus cost of goods sold; also referred to as "gross margin."

**groupthink**. A tendency towards reactionary, consensus thinking that limits the ability of a group to investigate or appreciate issues and alternatives.

**guaranteed loan**. A loan made by a financial institution to a small business with a partial guarantee given by the Small Business Association.

**historical cost principle**. An accounting principle stating that all costs must be recorded at the exchange price of the transaction at the time it occurred.

**IGO**. *See intergovernmental organization.*

**implied contract**. A contract whose terms are implied by conduct.

**income distribution**. The level of personal income found in various segments of a target market.

**income statement**. A financial report showing revenues earned, expenses incurred in earning the revenues, and the resulting net income or net loss; also referred to as a profit and loss statement.

**incoterms**. International commercial terms. The purpose of incoterms is to provide a worldwide standard for the interpretation of terms used in international trade.

**indemnification clause**. A contractual clause that transfers the risk of damages or loss from one party to another.

**independent agent**. An insurance agent who offers policies from a variety of companies.

**independent contractor**. A self-employed individual who has his or her own business; has many occasions to do freelance work for others; and is responsible for his or her own acts, contracts, and tax withholdings.

**indirect exporting**. Selling a product to a US-based intermediary, who then sells it abroad.

**indirect forecasting**. Gathering of data relating to a target market, in the absence of specific information about that market.

**industry analysis**. Research that identifies how attractive your industry is, and helps you compete more effectively if you decide to enter a given market.

**industry profile**. Pertinent information about a specific industry, such as its size, trends, growth potential, and history.

**infrastructure as a service.** The delivery of storage, hardware, servers, and networking on an on-demand basis. It allows users to have extremely powerful computing capabilities without buying, installing, and maintaining the necessary infrastructure. *See also cloud computing.*

**infringement**. A breach of a law, right, or obligation.

**initial public offering (IPO)**. The first offering of stock in a company to public investors.

**intangible assets**. Those assets that literally cannot be touched. These include a business's goodwill and patents.

**intellectual property**. Ownership or exclusive rights to processes or other products of intelligent thought, such as trade secrets, copyrights, patents, or trademarks.

**intensive distribution**. Distributing a product through many retail outlets. Usually used for low-cost "convenience" products.

**intergenerational equity**. The attempt to establish a code of fair dealing between generations, particularly as it applies to resource use. The goal is to ensure that the resource consumption of current generations leaves adequate resources for the needs of the next generations.

**intergovernmental organizations (IGOs)**. Organizations sponsored by several governments that seek to coordinate their efforts. Some are regional (e.g., the Council of Europe); some are alliances (e.g., NATO); and some are dedicated to a specific purpose (e.g., the UN Centre for Human Rights, UNESCO).

**intermediaries**. Businesses or individuals who help a product move through the distribution channel from the manufacturer to the customer.

**intermediate-term loans**. Loans for three to seven years, which are used for permanent expansion of working capital or to acquire equipment. These loans are generally at a fixed interest rate, and may include a penalty for early repayment of the principal.

**internal controls**. The policies and procedures a business establishes to assure reliability of its accounting records, to safeguard its assets, and to promote its objectives.

**Internet**. A global network of linked computers that share information using agreed-upon communication standards.

**Internet service provider (ISP)**. Commercial companies that provide access to the World Wide Web, often for a monthly fee.

**interruption marketing**. Marketing methods that require the subject to interrupt an activity or experience in order to view an advertising message. See also permission marketing.

**intranet.** A private computer network, the use of which is restricted to members of a business or other organization.

**inventory**. The raw materials, work-in-process, and finished goods (including merchandise purchased for resale) intended for internal consumption or sale; an asset listed on a business's balance sheet.

**inventory turnover ratio**. This tells you the average number of times inventory is sold during the year.

**investment bankers**. Bankers who arrange long-term financial transactions for their clients, often guaranteeing the sale of securities within a certain amount of time and at a specific price.

**IPO**. *See initial public offering.*

**ISP**. *See Internet service provider.*

**JIT**. *See just-in-time delivery.*

**joint liability**. Where one debtor has the right to insist that a co-debtor be joined in the liability. The liability is required to be apportioned among the debtors.

**joint venture**. A business entity comprising two or more active business partners. Also known as "strategic alliances" or "partnering agreements."

**just-in-time delivery (JIT)**. The practice of producing the exact amount of products needed by customers and delivering them at the exact time they are needed. Businesses that buy from JIT suppliers minimize inventory holding costs and decrease their turnaround time.

**key-person insurance**. Life insurance taken out by a business on an essential or very important employee, with the company as beneficiary.

**LAN**. *See local-area network.*

**L/C**. *See letter of credit.*

**leasehold improvement**. Any improvement made to leased property. Such improvements become the property of the lessor at the end of the lease, and are categorized as an intangible asset to the lessee.

**letter of credit (L/C)**. A method of payment for goods in which the buyer establishes credit with a local bank, clearly describing the goods to be purchased, the price, the documentation required and a limit for completion of the transaction. Upon receipt of documentation, the bank is either paid by the buyer, or takes title to the goods itself and proceeds to transfer funds to the seller.

**liabilities**. A business's short- and long-term debts.

**liability**. Legal responsibility for injury or damage to a person or property.

**liability insurance**. Insurance covering losses arising from injury or damage to another person or property.

**licensing agreement**. A legal contract in which a licenser grants the use of specific property rights to a licensee in return for royalty payments.

**life cycle assessment.** The process of assessing the environmental and social impact of a product from "cradle to grave." *See also product stewardship.*

**limited liability company (LLC)**. A business entity that is a hybrid between a partnership and a corporation. They are highly flexible, provide limited liability to their members, and are not subject to double taxation.

**limited partnership**. A partnership that allows for general and limited partners. Limited partners are usually liable for debts only to the extent of their investment, and have limited or no control over management.

**line of credit**. Short-term financing (usually from a bank) that is available for a business to borrow against as needed, and must be repaid within a specific time.

**liquidated damages**. Consequences of breaching the terms of a contract, as set out in that contract.

**liquidity**. The readiness and ease with which assets can be converted to cash without a loss; generally describes the degree of solvency of a business.

**list price**. The price that appears on a product line sheet or a catalog, or is quoted by a salesperson. This is a business's official price before any discounts. This is also known as the final selling price.

**LLC**. *See limited liability company.*

**local area network (LAN)**. A computer network that spans a relatively small area (e.g., a building or group of buildings).

**localized searching**. The ability to search the Internet by geographical location.

**localization**. The process of adapting a Website, marketing effort, or product to the cultural, linguistic, and political environment of another country.

**log files**. Files that list actions taken by visitors to a Website. They reveal where visitors are coming from, how often they return, and how they navigate through the site. **long-term debt**. Loans scheduled to be paid back over a period longer than one year.

**long-term liabilities**. Debt that will not mature within the next year.

**long-term loans**. These loans are for ten or more years, and are usually for real estate transactions or equipment purchases.

**loss leader**. Merchandise or services sold at a loss to increase customers, sales of related items, or customer awareness.

**machine-to-machine communication (M2M)**. A system in which machines communicate via wireless sensors, in order to regulate their operations.

**MACRS**. *See modified accelerated cost recovery system.*

**malware**. A generic term for any form of malicious software that damages computers or computer files (e.g., viruses, Trojan Horses, and worms).

**manufacturer's export agent**. A firm that acts as an export sales agent for several noncompeting manufacturers. Business is transacted under the name of the agent firm.

**manufacturer's representatives**. These are independent salespeople who operate as free agents, representing a large assortment of similar or complementary products.

**market**. A population segment comprising actual or prospective buyers of a particular product or service.

**market analysis**. Gathering of data that tell how attractive a given market is for a business.

**marketing**. All activities meant to influence the sale of goods and services to consumers.

**marketing mix**. The balance of product, price, placement, and promotion that a business uses to achieve a competitive advantage and sell to a target customer. See also Four Ps.

**marketing plan**. A document describing how a business will market its products or services; contains information on target markets, product positioning, competitive advantage, and the marketing mix.

**market intelligence**. Any information that refers specifically to a business's external environment, and affects the demand for old or new products.

**market research**. The process of gathering information needed in order to make strategic business decisions.

**market segment**. A unique, homogenous submarket of a larger market, comprising groups of customers with similar needs and characteristics.

**market segmentation**. Examining the target market in order to find the market segment that is most likely to generate profitable sales.

**market share**. The percentage of a market's total sales (in units or dollars) that a business receives.

**mark-up**. The percentage by which a product's price is increased to achieve a desired profit margin. This is used with cost-plus pricing, and is expressed as a percentage of the price of the product.

**mass merchandisers**. Stores that sell at lower prices than department stores and specialty boutiques, and offer a broad assortment of products.

**materials exchange.** A network (usually online) that finds users for waste materials and products discarded by others.

**materials substitution**. Sourcing alternative raw materials in order to reduce one's use of hazardous, toxic, polluting, or nonsustainable compounds.

**MBDC**. *See Minority Business Development Centers.*

**mediation**. A nonbinding means of settling a contractual dispute through mediated negotiation.

**merchandising**. The planning and promotion of sales by presenting a product to the right market at the right time.

**merchantability**. An implied warranty stating that goods are fit for normal use and are of the same quality as similar items produced by others.

**merger**. A combination of two or more businesses into one.

**merger clause**. A contractual clause that nullifies any and all existing agreements between the parties to a contract, and affirms that the contract itself is the only valid description of the agreement.

**metatags**. HTML (hypertext markup language) descriptions of the contents of pages on the World Wide Web. Their purpose is to assist search engines in locating the pages when keywords are entered.

**minority business development centers (MBDC)**. Established to increase the number of minority-owned businesses, help existing firms expand, and minimize business failures.

**minority-owned business**. For the purposes of the Bureau of the Census's 1987 Characteristics of Business Owners (CBO) survey, businesses owned by Blacks, Hispanics, Asians, American Indians, Alaska natives, and other minority groups.

**mission statement**. A written statement broadly describing what a business hopes to achieve.

**MNCs**. *See multinational corporations.*

**modem**. A modem (MOdulator-DEModulator) is a device that allows computers to communicate using telephone lines. Computer information is stored digitally, but information is transmitted over telephone lines in the form of analog waves. A modem converts digital signals to analog signals.

**modified accelerated cost recovery system (MACRS)**. The system of calculating depreciation used for income tax reporting.

**multinational corporations (MNCs)**. Multinational corporations are large companies that conduct their business operations in several countries. Although transnational corporations (TNCs) are commonly thought to be synonymous with MNCs, they are in fact different in several regards. The primary difference is that TNCs tend to keep their financial headquarters offshore to protect them from taxes. Thus, they lack financial accountability to the states in which they conduct their primary operations.

**net present value**. A calculation of what future dollars are worth today.

**net profit**. Sales minus variable costs and fixed costs. Net profit is used as a starting point to measure return on investment for specific products or businesses.

**networking**. Making contact with a variety of people in related fields to foster communication with additional contacts, or to provide information that goes beyond the reason for the initial contact.

**net worth**. The total assets of a business minus its total liabilities.

**NGOs**. See nongovernmental organizations.

**niche market**. A special segment of a market, often defined in terms of particular buyer characteristics, which a given business is particularly well suited to target.

**noncompetition agreement**. A contract that restricts an employee or owner from competing against a former business or employer. These contracts are permitted if they are limited in time and geographical area.

**nondisclosure agreement**. A contract whereby a person or company agrees not to disclose trade secrets.

**nongovernmental organizations (NGOs)**. International organizations that take a position of advocacy on social, economic, or political issues.

**objectives**. The goals a business wishes to achieve.

**Occupational Safety and Health Administration (OSHA)**. A federal agency under the Department of Labor that issues standards and rules for safe working conditions, tools, equipment, facilities, and processes; and conducts compliance inspections.

**Office Of Small and Disadvantaged Business Utilization (OSDBU)**. Located within nearly every federal department to assist minority-owned businesses with selling to the government.

**offshoring**. Outsourcing to workers or suppliers in a foreign country.

**open book management**. A management technique that provides employees with detailed accounting information, in the belief that doing so will benefit the company by enhancing the employees' commitment, trust, and decision-making skills.

**operating agreement**. An agreement among the members of a limited liability company, or parties to a partnership, that serves much the same function as a corporation's bylaws.

**operating expenses budget**. A budget that estimates the amount of capital required to operate a business over a specified period of time.

**operating lease**. A lease that usually provides for maintenance service, is cancelable, and lasts less than the expected economic life of the asset.

**operational planning**. A planning process focused on short-term actions (usually one year).

**opportunity costs**. The cost of an activity in terms of foregone or sacrificed alternative uses of one's assets. This concept can most easily be formulated as "amount of product B one must give up to produce a unit of product A."

**ordinances**. Local regulations that cover zoning and building codes, requirements for business licenses, road restrictions within the municipal territory, signage regulations, and so forth.

**organizational chart**. A chart diagramming the managerial structure of a business, designating specific areas of responsibility.

**OSHA**. *See Occupational Safety and Health Administration.*

**OSDBU**. *See Office of Small and Disadvantaged Business Utilization.*

**outsourcing**. The hiring of independent contractors to assist with business operations. *See also offshoring.*

**overhead**. The regular ongoing operating expenses of a business, including rent, utilities, upkeep, taxes, administrative salaries; costs not directly associated with the product/service.

**owner's equity**. The amount owed by a business to its owner.

**part-time workers**. Employees working fewer than 35 hours per week.

**passive investment**. An investment in which one is not actively involved in generating money, such as a savings account or the stock market.

**patent**. Governmental granting of exclusive rights for a specified period of time to the inventor of an invention or process.

**peer-to-peer funding**. A form of financing that connects borrowers with lenders—usually over the Internet—without the mediation of a financial institution.

**penetration pricing**. A pricing policy that sets an attractively low price in order to enter a new market, or gain market share.

**performance reports**. Reports to management that compare actual results to budgeted amounts and indicate variances.

**permission marketing**. A form of advertising in which the subject consents to view an advertising message in return for a tangible or intangible reward. See also interruption marketing.

**personal financial statements**. Financial documents of an individual, often requested by financial institutions from the borrower or guarantor of a loan; generally includes a balance sheet and tax returns from the prior three years.

**personal guaranty**. A contract where the individual acts as a surety or guarantees the obligations of another. Most often used by lenders dealing with a closely held corporation, where principal shareholders must sign personally.

**PEST analysis**. Analysis of how the political, economic, social, and technological environments affect business.

**pharming**. An illegal practice in which malicious code is installed on a personal computer or server, in order to direct users to fraudulent Web sites that harvest credit-card data or other personal information.

**phishing**. A form of cybercrime that lures victims into revealing credit card or other financial information by sending counterfeit e-mails that purport to be from a legitimate, well-known business.

**piggyback marketing**. An arrangement in which one manufacturer or service firm, typically a large one, distributes the product or service of a second firm, typically a smaller one.

**point-of-purchase displays.** Promotional displays in stores (e.g., window displays, display racks, and banners).

**point-of-sale data**. Marketing data obtained from cash register scanners.

**political risk analysis**. A form of country risk analysis that usually focuses on such political issues as governmental stability, the likelihood that a business will be nationalized, new tax policies and their likely impact on foreign businesses, and so forth.

**polluter pays principle (PPP)**. A concept stating that industries must pay for clean-up and disposal of their own wastes, rather than passing the task and its associated costs onto municipalities. The cost of clean-up or disposal is added to the price of the product and passed onto the consumer, thereby reflecting a more accurate cost of industrial production.

**pollution prevention (P2)**. A program businesses can implement to reduce or eliminate generation of hazardous and nonhazardous wastes.

**preferred stock**. A special class of stock, often non-voting, which is given priority over common stock as to dividends.

**premium pricing**. Pricing above market value in order to evoke perceptions of quality and prestige.

**price elasticity**. The extent to which changes in price affect consumer demand. When demand is affected by a price change, demand is elastic. When demand stays the same despite a price change, demand is inelastic.

**price promotions**. Short-term discounts offered by manufacturers or retailers to encourage customers to try a product.

**price transparency.** A situation in which consumers and sellers have access to a wide variety of price data, as is often the case when buying and selling on the Internet.

**primary data**. These are data collected directly by a market researcher for the purpose of answering questions about customers or markets. This may involve observing customer behavior, or designing questionnaires and surveys to learn more about a representative customer population. See also secondary data.

**principal**. The dollar amount originally borrowed or financed, on which interest is paid. Also referred to as the "face amount" of a loan.

**product**. All of the tangible and intangible features and benefits offered by a business. This can be a physical product or a service.

**product diversification**. Producing new products in order to compete in new markets.

**production budget**. A budget that estimates the amount of capital and labor needed to produce a specified amount of goods over a specified amount of time.

**product life cycle**. The phases a product or service goes through as a result of changes in consumer demand and competition. Phases include introduction, growth, maturity, and decline. These affect the marketing strategy a business uses.

**product line**. The collection of products or services that a business offers.

**product orientation**. A focus on product or production methods instead of customer needs. This can lead to producing products that customers reject. *See also consumer orientation.*

**product positioning**. The way a product is priced, promoted, and placed in the market. Businesses use positioning strategies to maximize their competitive advantage and differentiate their offerings from those of competitors. Products are frequently "repositioned" to highlight a new feature, or to target a new market niche.

**product stewardship.** The process of identifying, managing, and minimizing health and environmental risks throughout all stages of a product's life cycle, from cradle to grave. *See also life cycle assessment.*

**profit**. Total revenue, minus total costs.

**profit margin**. The amount of each sales dollar that represents net income, usually stated as a percentage; net income divided by sales.

**promotional allowance**. Price discounts offered by a manufacturer to retailers in exchange for advertising the manufacturer's products. *See also cooperative advertising.*

**promotional mix**. The strategies and tactics a company uses to communicate the benefits of its products or services to target customers. These include advertising, personal selling, public relations, networking, sales promotions, and direct mail.

**psychographic data**. Data dealing with the activities, interests, and opinions of a target population. In marketing, such data are valuable in understanding target consumers' buying decisions. *See also demographic data.*

**publicly held corporation**. A corporation whose stock is traded publicly, and is therefore registered with the Securities and Exchange Commission.

**pull strategy**. A marketing strategy in which consumer demand "pulls" the product through distribution channels.

**push money**. A cash premium, prize, or commission offered for increasing sales of a particular item or type of merchandise.

**push strategy**. A marketing strategy in which manufacturers "push" a product through distribution channels, towards the end user.

**qualitative data**. Marketing data that cannot be quantified or counted, such as political beliefs, preferences, and experiences.

**quantitative data**. Marketing data that can be measured and subjected to statistical analysis (e.g., monthly earnings, number of children, amount of rent paid).

**quick ratio**. "Quick assets" (cash and other assets immediately convertible to cash) divided by current liabilities. Lenders use this ratio to measure the ability of a business to meet current debt obligations.

**quote**. An offer to sell goods at a stated price and under stated terms.

**rebound effect.** An increase in overall consumption that offsets the savings achieved by an increase in efficiency. For instance, energy-efficient lightbulbs may cause consumers to leave the lights on longer, which reduces actual energy savings by a certain percentage.

**responsibility accounting**. A method of accounting that associates business activities and costs with the individual responsible for those costs.

**radio frequency identification (RFID)**. A method of wireless identification and tracking using small integrated circuits ("tags") connected to an antenna, which can respond to an interrogating radio signal. Among other things, RFID tags can be used to locate or track merchandise, materials, packages, and documents.

**raw materials**. All the materials used in the manufacture of a product for resale.

**receivables turnover**. This ratio indicates the average number of times receivables turn (are collected) during the year.

**responsible design.** Product and process design that attempts to prevent or solve social and environmental problems.

**retained earnings**. A corporation's accumulated, undistributed earnings.

**revenue**. The money generated by such earning activities as selling a product, charging rent, or receiving interest on a loan.

**RFID**. *See radio frequency identification.*

**rule of entry**. A formal policy by which a family member must have gained a certain amount of work experience with other companies before he or she may join the family business.

**SaaS**. *See software as a service.*

**sale and leaseback**. An arrangement in which a business sells an asset while simultaneously leasing the asset back from the purchaser.

**sales agents**. Extensions of a manufacturer's sales force. These intermediaries have more authority to set prices and terms of sale than manufacturer's agents, and may even take over a manufacturer's entire marketing effort. Sales agents specialize in specific types of products, and operate primarily in industrial goods markets.

**sales forecast**. Predicts how much of a product will be sold over a period of time.

**sales representative**. Sales representatives use the company's product literature and samples to present the product to prospective buyers. A representative usually handles many complementary lines that do not compete. He or she usually works on a commission basis, assumes no risk or responsibility, and is under contract for a definite period of time.

**SBA**. *See Small Business Administration.*

**SBDC**. *See Small Business Development Centers.*

**SBIC**. *See Small Business Investment Company.*

**SBIR**. *See Small Business Innovation Research Program.*

**SCOR**. *See Small Corporate Offering Registration.*

**secondary data**. These data comprise information that has already been gathered and published by someone other than the market researcher. This information might come from academic research studies; articles in magazines, trade journals, or newsletters; census reports; or contact with distributors, middlemen, customers, competitors, or other knowledgeable people in the industry. *See also primary data.*

**secured loan**. A loan for which the borrower has pledged assets as collateral to the lender.

**secure socket layer (SSL)**. A standard that encrypts all data between a Web browser and a Web server. This enables consumers to submit credit card data and other private information to an Internet business, without fear of the information being intercepted and misused by a third party.

**seed capital**. Funding required in the early or growth stages of a business to finance market research, strategic planning, technical research, and product development.

**selective distribution**. The practice of distributing goods or services through a limited number of intermediaries and outlets. This enables manufacturers to have greater control over the way their products are sold.

**settlement range**. In negotiations, a range of acceptable possibilities between the best-case scenario, and a minimally acceptable outcome.

**shareholder**. One who owns shares of stock in a corporation. Along with this ownership comes a right to vote on certain company matters, including election of the board of directors.

**short-term debt**. Loans that are due within one year.

**short-term interest rates**. Interest rates for short-term borrowing, usually for a term of one year or less.

**SIC Code**. *See Standard Industrial Classification Code.*

**sight draft**. A draft that is payable upon presentation to the drawee.

**simple interest**. Interest paid on the principal of a loan only, rather than on the principal plus accrued interest.

**single-source data**. These market research data are integrated from multiple sources to monitor the effect of marketing efforts on a particular customer group over time.

**situation analysis**. A preliminary look at the market data available, which tells one whether additional information is needed.

**skimming**. Entering a market with a high price until one satisfies demand or attracts competitors, then gradually lowering the price.

**slotting fee**. A fee required by a retailer for stocking an item.

**Small Business Administration (SBA)**. A federal agency established to provide prospective and existing small businesses with advocacy, financial assistance, management counseling, and training.

**Small Business Development Centers (SBDC)**. Established by Congress in 1980 to join federal, state, and local governments; the educational community; and the private sector in making management assistance and counseling available to existing and prospective small business owners.

**Small Business Innovation Research Program (SBIR)**. A grant program for small businesses that are working to meet the research and development needs of the federal government.

**Small Business Investment Company (SBIC)**. A federal venture capital program that uses private venture capital firms and SBA-guaranteed financing.

**Small Corporate Offering Registration (SCOR)**. A program in which security offerings that are exempt from registration with the Securities Exchange Commission can meet state registration requirements with a minimum of cost and regulation.

**socially responsible business**. A business venture that attempts to advance the welfare and interests of regional, national, or global society, and protect the environment.

**social networking media.** Online sites and services that help people to connect and communicate, based on their shared interests, views, or activities.

**software as a service (SaaS).** A system in which computer software is provided to the end user on demand, via the Internet, instead of being purchased and installed on a home or office computer. *See also cloud computing.*

**sole proprietorship**. An unincorporated one-owner business, farm, or professional practice.

**spam**. Unwanted e-mails sent by mass marketers; the digital equivalent of junk mail.

**specification buying**. Buying products customized to one's own specifications, rather than selecting from a manufacturer's existing product line.

**spyware**. Computer software that gathers information about Internet users' online activities without their knowledge.

**squeeze-out**. Techniques employed by one or more owners of a business to remove another owner.

**standard industrial classification code (SIC code)**. A numerical code that identifies a business based on its type of business or trade activity.

**strategic partnerships**. These are much like alliances, but are characterized by more informal arrangements. There is no legal contract between the partners, although an implied contract may exist.

**strategies**. Plans devised in order to achieve objectives.

**stream of earnings**. A method of business valuation that derives a company's value from its profit, earnings, or cash flow (or their multiples or present values).

**subcontract**. A contract between a prime contractor and a subcontractor, or between subcontractors, to furnish supplies or services for performance of a prime contract or a subcontract.

**succession**. The passing of legal authority over a business to new leadership (which usually—but not necessarily—consists of family members in the next generation), along with the transfer of ownership interest (equity) in the business.

**succession plan**. A plan, preferably formal, whereby the controlling owners arrange to pass on authority and assets in the family business to the next generation, or to non-family buyers of the business.

**supply chain**. Comprises all the interdependent business processes and activities involved in the flow of goods from the producer to the consumer, from sourcing of raw materials to distribution of the product.

**surety bond**. Bonds providing security from claims filed against a business.

**sustainable.** A term referring to businesses that seek to meet present needs without reducing the ability of future generations to meet their own needs.

**SWOT analysis**. A process of examining your business's strengths, weaknesses, opportunities, and threats, and comparing them to those of your competitors.

**tactics**. Specific actions that support strategies.

**tangible assets**. Those assets that can literally be touched (e.g., equipment, buildings, inventory).

**target market**. The market segment whose needs a business tries to anticipate and satisfy.

**target return**. An established level of financial return on an investment, usually expressed as a percentage of total costs. This guides price setting.

**tariffs**. Taxes on imported or exported goods.

**term loan**. A loan having a due date for repayment of longer than one year; most commonly used for equipment, real estate, or other fixed asset purchases.

**terms**. Conditions or provisions specified for repaying loans or paying invoices; terms usually include the time limit, amount to be paid, and any discount.

**test marketing**. A way to experiment with a new product or marketing strategy before attempting to act on a larger scale. Test marketing is used for short periods of time.

**tort**. A wrongful act causing injury to a person, for which a civil action may be brought to recover damages.

**total cost analysis**. A decision-making approach that aims at minimization of total costs, and recognizes the interrelationship between such variables as transportation, warehousing, inventory, and customer service.

**total revenue**. Unit price, multiplied by the number of units sold.

**trade associations**. Organizations formed by members of an industry to advance and protect their interests.

**trade discounts**. Discounts offered to wholesalers or retailers who perform certain marketing functions on behalf of the manufacturer.

**trade dress.** The unique characteristics of a product or its packaging that signify the source of the product to consumers. Can include everything from colors and sounds to the architectural design of a building.

**trade promotions**. Incentives that businesses offer to retailers and wholesalers for stocking their product.

**trademark**. A symbol, letter, device, or word that identifies a product; it is officially registered, and grants exclusive legal use to its owner or manufacturer.

**trading blocs**. Regional agreements that allow for less restrictive trade between member nations, which are usually contiguous (or at least geographically close).

**triple bottom line.** An accounting method that attempts to quantify the financial, social, and environmental costs and benefits of business decisions. Often defined as "people, planet, profit." *See also full cost accounting.*

**true cost accounting.** *See full cost accounting.*

**unified communications.** The integration and interoperability of multiple forms of communication, in order to streamline information delivery and increase the availability of communication partners. *See also convergence.*

**uniform resource locator (URL)**. The addressing scheme used to link resources on the Web.

**unsecured loan**. An uncollateralized loan backed only by the borrower's signature.

**upcycling**. A process in which waste materials are used as inputs for new products of greater use or value. *See also cradle to cradle design.*

**URL**. *See uniform resource locator.*

**user-generated content.** The production of online media content or advertising by the general public rather than by traditional media producers.

**value-based pricing**. Setting a price based on the perceived value of the product to the customer.

**value in use**. The overall savings and other benefits a product delivers, which may justify paying a higher price than one would for a similar product without those benefits.

**variable rate**. An interest rate that changes during the term of the loan.

**variable costs**. Costs that change significantly in direct proportion to the volume of output or sales. *See also fixed costs.*

**venture capital**. Money used to finance new or unusual business undertakings.

**vertical integration**. The strategy of controlling many or all of the sourcing, manufacturing, and distribution tasks required by a business.

**viral marketing**. A form of online marketing in which an offer or incentive is so attractive that Internet users spread it to one another, usually through social networking media.

**virtual assistant**. An entrepreneur who provides professional administrative, technical, or consulting assistance to other business owners, usually from a home office.

**virtual organization**. Structure in which organization members in different locations work together using e-mail, phone, videoconferencing, and other communication methods.

**virtual team**. A group of employees and/or independent contractors who use communications technologies to collaborate from different work bases.

**VoIP**. *See voice over Internet protocol.*

**voice over Internet protocol**. A technology allowing voice communications over the Internet.

**warranty**. A promise or representation made about goods that becomes part of the deal, and creates an expectation that the goods will conform to that promise.

**Web**. *See World Wide Web.*

**Weblog**. *See blog.*

**win-win negotiations**. A style of negotiation in which one or both parties seek an outcome that will maximize the benefit to each party. *See also zero-sum negotiations.*

**work done for hire**. A doctrine stating that ideas created while employed or commissioned are owned by the employer or commissioner.

**working capital**. Resources available to cover short-term expenses, as determined by subtracting current liabilities from current assets.

**work-in-process**. Materials that are in the process of being made into a finished product.

**World Wide Web**. A user-friendly portion of the Internet that allows the use of "pages" featuring graphic displays, fonts, colors, animation, audio, and the like; and permits users to jump instantly from one page to another.

**zero-sum negotiations**. An adversarial type of negotiations in which one party seeks a total victory at the expense of the other. The term comes from game theory, and is based on the formula 1 + -1 = 0. In other words, one party's gain (+) is canceled out by the other's loss (-). *See also win-win negotiations.*

**zero-waste business.** A form of sustainable business that attempts to emulate ecological process by reducing waste to the bare minimum, and using discarded and waste materials as inputs for new products or processes. *See also sustainable.*

**zoning**. The division of an area into zones that restrict the number and types of buildings and their uses.

# index

## symbols



### a



### b

## c

## d



## e

## f

## g



## h



## i

## q



## r

## S

**x**



**y**



**z**