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Small Business Management

Theory and Practice

Fourth Edition

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1 The Role of the Small Business Within the Economy

1.1 Introduction

> Our own research and observations do show that the owner-managers of small businesses see themselves as making a very special contribution to the economy in a qualitative sense. (Bolton Report, 1971 p. 23).

This chapter examines the role of small business within the economy as well as government policy toward the small business sector. It provides an overview of the small business sector while considering the specific nature of management within a small firm and the policy responses available to governments. Small businesses typically make up the majority of firms within most economies. While the concept of a 'typical' small business may be difficult to define, most have few, if any, employees and are owned and operated by owner-managers who usually provide all the risk capital associated with the firm. Despite their numbers and relative importance to the economy, the level of attention and general understanding of the small business sector remains low. Academic research into small business management is less developed than for larger organisations. Government policy relating to small business can often be fragmented and problematic due to the lack of adequate understanding of the sector and its needs.

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1.2 Small Firms in an International Context

To gain an international perspective on small business, attention can be given to the work of the Organisation for Economic Cooperation and Development (OECD), and the Asia-Pacific Economic Cooperation (APEC) forum. The OECD has a membership of 35 countries spread throughout Europe, North America, Asia and Australasia, while APEC is comprised of 21 countries from within the Asia Pacific region. Both regional groupings maintain statistics on SMEs and provide a good comparison of small firms at an international level. In addition, the World Bank's International Finance Corporation (IFC), has collected data on micro, small and medium enterprises (MSMEs) across 132 countries to develop their MSME country indicators (MSME-CI) (IFC, 2016).

Within the countries of the APEC region, SMEs comprise over 97% of all enterprises within each country, and more than 99% of all enterprises in 13 (62%) of the APEC member states. SMEs also create more jobs across the region than do large firms. For example, firms with between 5 and 250 employees account for 67% of total formal employment, and contribute 85% of employment growth (Zhang, 2013). In the EU, SMEs comprise 99.8% of all enterprises, employ 67% of the workforce and contribute 58% of gross value added (GVA)[1] (Wymenga et al., 2011).

This pattern of SME distribution is similar to the OECD where 99% of all business enterprises, approximately two-thirds of all employment, and over half of all value added are provided by small firms (OECD, 2010a). The majority (70–95%) of these firms are micro-enterprises with less than 10 employees, and most of these firms have only the owner-manager working within the business (OECD, 2016).

According to the IFC there are around 125 million formally registered, micro, small and medium sized enterprises (MSMEs) operating across 132 countries, with 89 million MSMEs operating in developing economies (Kushnir, Mirmulstein, & Ramalho, 2010). In developing economies, more than 90% of non-agricultural businesses are MSMEs and a high proportion of these firms operate in the informal economy (Edinburgh Group, 2013).[2] For example, in India it is estimated that around 94.2% of all micro, small and medium enterprises (MSMEs) are informal (Kushnir et al., 2010).

An examination of 39 economically developed countries from across the Asia-Pacific, Europe and North and South America found that SMEs (firms with <250 employees) comprised an average of 98.9% of all firms in the manufacturing sector, and 98.8% of all firms in the construction and services sectors of those economies (OECD, 2016). Within developing economies, the growth rate of MSMEs was three-times greater over the period 2000–2009 than in the developed economies, while the overall growth rate for all MSMEs over that time period was around 6% (Kushnir et al., 2010).

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[1] GVA is defined as the value of outputs less the value of intermediate consumption and is an important factor in Gross Domestic Product (GDP).

[2] Operating in the informal economy means that they are not formally registered for taxation.

1.3 Defining the Small Firm

One of the biggest challenges facing any academic study of small firms is to get an accurate definition of the term 'small business', or 'small to medium enterprise' (SME) (Headd & Saade, 2008). Many definitions exist around the world, with different countries adopting differing measures (Kushnir et al., 2010). There is no single, universally accepted definition of a small business (Storey, 1994; Tonge, 2001). However, definitions are important to researchers trying to understand the behaviour of small businesses. Without good definitions, it is difficult to understand what is being observed. Imagine a biologist studying frogs (of which there are 4800 known species) who did not have a clear definition of what a frog is and how it might differ from a snake or a dog?

Lacking good definitions of what makes a frog a frog, or how one type of frog differs from other types, would make any research scientifically unsound. However, a review of 217 peer reviewed journal articles from 20 specialist small business and entrepreneurship journals found no consistent approach to the definition of small business or small to medium enterprise (SME). In fact, 31% of the papers provided no definition at all, including many of the most highly ranked academic journals (Reboud, Mazzarol, Clark, & Mamouni Limnios, 2014).

Good definition is not only important for academic research, it also has significant impacts on government policy, particularly how SMEs are dealt with in relation to regulation, taxation and support (Keefe, Gates, & Talley, 2005). This is a problem throughout the world where a small business is defined differently by different government agencies with differing impacts in relation to regulation.

As illustrated in Table 1.1 in Australia the definition of a small business varies across government statutes and agencies, with quite significant variations and types of measure. In addition to the various definitions listed in Table 1.1. the Australian Securities & Investments Commission (ASIC) defines a small business as one that has less than $25 million in annual turnover, fewer than 50 employees, and consolidated gross assets of less than $12.5 million (ASIC, 2015).

This complexity and diversity in the definition of a small business is also found in the United States where federal and state statutes define a small business in a range of ways using turnover, employment and assets. This has direct influence on workplace relations, environmental and economic regulations and programs that offer support to SMEs (Keefe et al., 2005).

Academics seeking to define small to medium enterprises (SMEs) when undertaking research tend to rely on official classification systems used by governments (Al-Qrim, 2005; Audretsch, 2002). The most usual criteria for such definitions include the number of employees, annual turnover or assets under management (APEC, 2002; OECD, 2004). A review of how SMEs are defined across 75 countries within the Asia-Pacific region found that there were 60 different definitions used (Zhang, 2013). For example, in Australia the classification of an SME is a firm with fewer than 200 employees (ABS, 2002a). By contrast, in the United States (US) an SME is any firm with fewer than 500 employees if it is in manufacturing, and less than US$5 million in annual sales revenue if it is not. Singapore defines an

Table 1.1 Differing definitions of small business in Australian legislation

Measure	Threshold	Legislation/agency	Purpose
Employees	<15	Fair Work Australia	Unfair dismissal & redundancy laws
	<20	Australian Bureau of Statistics	Statistical reporting
	<20	Reserve Bank of Australia	Business liaison
	<100	Workplace Gender Equality Act, 2012	Equal opportunity laws
Turnover	<$2 million	Australian Taxation	Taxation
	<$3 million	Privacy Act 1988	Privacy laws
Assets	<$50 million	Australian Prudential Regulation Authority	Prudential supervision
Loan size	<$1 million	Australian Prudential Regulation Authority	Prudential supervision
	<$2 million	Reserve Bank of Australia	Analysis of financial conditions
Legal structure	Unincorporated	Reserve Bank of Australia	Analysis of financial conditions
Transaction	<$3 million	Australian Competition & Consumer Commission	Collective bargaining
Wages	Varies by state	Payroll Tax	Taxation
Gaming machines	<15	AUSTRAC	Anti-money laundering & counter terrorism financing rules

Source: Productivity Commission (2013)

SME as a firm that has fewer than 200 employees and less than SIN$100 million in assets (Zhang, 2013).

Many different definitions exist for SMEs depending on whether they are used for statistical, legal or administrative definitions. Distinctions are also made in some countries on the basis of whether a business is engaged in manufacturing, services and retailing. Whether the firm is independently owned and managed may also form part of a country's definition of an SME, as well as the level of investment.

For example, in Japan the SME sector is defined in terms of both the number of people that are employed and the amount of capital assets that the firm may hold. It also categorises SMEs by industry. As a result, a small firm in Japan can be one with up to 300 employees and ¥300 million in assets if it is manufacturing, construction or transportation. However, if it is in the services sector it can be a firm with up to 100 employees and ¥50 million assets, or up to 100 employees and ¥100 in assets if it is in the wholesale trade. By contrast, Japanese retail firms can be defined as small if they have fewer than 50 employees and ¥50 million in assets (OECD, 2004).

South Korea also defines an SME differently across sectors. For example, within manufacturing an SME is a firm with fewer than 300 employees and less than US $8 million assets. However, in mining, construction and transportation an SME has fewer than 300 employees, but less than US $3 million in assets. Retailing, tourism

Table 1.2 OECD and EU definition of small firms

	Employees	Annual Turnover	Assets
Micro-enterprise	1–9	<€2 million	<€2 million
Small enterprise	10–49	<€10 million	<€10 million
Medium-sized enterprise	50–249	<€50 million	<€43 million
Large enterprise	>250	>€50 million	>€43 million

Source: OECD (2004)

Table 1.3 IFC definition of small firms

	Employees	Annual Turnover	Assets
Micro-enterprise	1–9	<US $100,000	<US $100,000
Small enterprise	10–49	<US $3 million	<US $3 million
Medium-sized enterprise	50–299	<US $15 million	<US $15 million
Large enterprise	>300	>US $15 million	>US $15 million

Source: IFC (2012)

and information and communications technologies (ICT) firms are SMEs if they have fewer than 200 employees and less than US $30 million in annual turnover. Other sectors have further differences in definition (Zhang, 2013).

In the Russian Federation, an SME is defined as one that is independent with no more than 25% of its share capital held by public sector organisations, charities or other firms, and that has fewer than 250 employees and an annual turnover below RUB 1 billion. However, Russia also classifies firms into 'small' (<100 employees and < RUB 400 m turnover), and 'micro' (<16 employees and < RUB 60 m turnover). While China, which once had a complex definition encompassing state-owned, collectively-owned, rural, household and privately-owned enterprises, has two categories: (i) small business (<300 employees and <RMB 20 m turnover), and (ii) medium business (<1000 and <RMB 400 m turnover) (Zhang, 2013).

This plethora of definitions is unsatisfactory when attempting to study SMEs or develop international comparisons. To address this problem, the European Union (EU) undertook a program of developing a standardised definition for SMEs for use across the EU group of countries. This was first issued in 2003, and is outlined in Table 1.2. This has been adopted by the OECD in their definition of small firms (OECD, 2004, 2010a).

The OECD/EU definition of an SME is now the most commonly used definition, and a study of 132 economies found that around a third of all countries used the figure of 250 employees as a cut-off for differentiating SMEs from large firms (Kushnir et al., 2010). Nevertheless, the OECD/EU definition has recently been challenged by the International Finance Corporation (IFC) with an alternative definition outlined in Table 1.3.

Table 1.4 lists 15 countries from the Asia-Pacific Economic Cooperation (APEC) forum and the various definitions used by them in 2014 to define SMEs. It can be seen that many differences exist, thereby making research and benchmarking of small firms problematic.

Table 1.4 Official definitions of SMEs in selected countries

Country	Micro	Small	Medium
Australia	<5 employees	5–19 employees	20–200 employees
Brunei	1–5 employees	6–50 employees	51–100 employees
Canada	1–4 employees	5–99 employees (manufacturing)	100–499 employees (manufacturing)
		5–49 employees (services)	50–499 employees (services)
China	N/A	<300 employees + <RMB 2 m turnover	<300–1000 employees + RMB 2 m–400 m turnover
Hong Kong	N/A	<50 employees (services)	N/A
		<100 employees (goods)	
Indonesia	1–4 employees + <IDR 300 m turnover + <IDR 50 m assets	5–19 employees + <IDR 2.5bn turnover + <IDR 500 m assets	20–99 employees + <IDR 50bn turnover + <IDR 10bn assets
Malaysia	<5 employees + <MYR 300,000 turnover	5–75 employees + MYR 300,000-15 m turnover (manufacturing)	75–200 employees + MYR 15 m–50 m turnover (manufacturing)
		5–30 employees + MYR 300,000-3 m turnover (services)	30–75 employees + MYR 3 m–20 m turnover (services)
Philippines	1–9 employees + <PHP 3 m turnover	10–99 employees + PHP 3 m–15 m turnover	100–199 employees + PHP 15 m–100 m turnover
Singapore	N/A	N/A	<200 employees + <$100 m turnover
Chinese Taipei (Taiwan)	<5 employees	N/A	<200 employees + <$100 m turnover
Thailand	N/A	<51 employees + < THB 50 m turnover	51–200 employees + THB 50 m–200 m turnover
United States	N/A	N/A	<500 employees
Vietnam	<11 employees	<11–200 employees + <VN $20bn	201–300 employees + <VN $20bn-$100bn
Russia	1–15 employees + <RUB 60 m turnover	16–100 employees + RUB 61 m–400 m turnover	101–250 employees + RUB 401 m-1bn turnover
New Zealand		<19 employees	20–50 employees

Source: APEC (2002), OECD (2010a), Zhang (2013)

Despite these attempts to provide a common measure for small firms, there remains a lack of standard definitions around the world. How small firms are defined varies depending on the purpose for which the data is being collected. The most common methods of classification are based on the size of the firm's employment, which is often used by national statistical agencies as it is a useful means of examining workforce distribution.

1.4 Small Business Contribution to Employment

The contribution small firms make to overall employment statistics within most economies makes them of particular interest to governments. For example, formally registered (e.g. for taxation compliance) MSMEs employ more than one third of the world's labour force with the largest concentrations of MSME employment as a proportion of total employment found in China (80%) and the Asia-Pacific (IFC, 2016).

In times of economic downturn, such as the Global Financial Crisis of 2007–2009, it is often the small business sector that is worst affected. Such firms find it difficult to downsize as they are already small and any additional loss of employees can significantly reduce their capacity to operate. They are also less solvent and have fewer options to raise additional finance (OECD, 2009).

An examination of MSMEs contribution to employment across 34 OECD economies found that such firms comprised an average of 99.6% of all registered businesses in these countries, and employed an average of 68.5% of the workforce. Micro-enterprises (including the non-employing nano-firms) contributed an average of 28.5% of all employment, followed by small businesses with 17.3%, and medium-enterprises, with 14.9% (IFC, 2016; OECD, 2010a, 2016).

What these statistics show is the significant role played by small firms throughout the world's economies. Some nations are very heavily reliant on SMEs to generate employment, and it is for this reason that governments place such a strong emphasis on policies to help boost their small business sectors. SMEs comprise the majority of all firms and more than half of all employment within most economies. It is this contribution to the level of employment that most official definitions of SME are related to the number of employees the firm has.

1.4.1 The Job Generation Process and Gazelles

Government interest in the small business sector as a source of job creation can be traced back to the publication in 1979 of the report *The Job Generation Process*, by David Birch, from the Massachusetts Institute of Technology (MIT) (Birch, 1979). This longitudinal study drew on a database of 5.6 million American firms supplied by Dunn & Bradstreet, that covered the period 1969–1976. The key finding was that job generation was not being driven by large corporations, but small, independent and volatile firms.

This report came at a time when the US economy, like many nations at the time, was experiencing significant economic readjustment, declining economic growth and rising unemployment (Irvin, 2011). It recommended a focus on job replacement through start-ups and self-employment rather than attempting to stem the rate of job loss within large established firms or via reducing immigration. Rather than slowing migration, the report suggested targeted programs designed to stimulate new business creation and growth in regions with attention given to SMEs (Birch, 1979).

Birch's report has been subsequently criticised for lacking a strong theoretical foundation and suffering flaws in its methodology (Davis, Haltiwanger, & Schuh, 1994; Tuerck, 1990). However, at the time of its release it captured the attention of the media and politicians eager to find solutions to stagnating economic growth and high unemployment (Landström, 2005). Birch later published further research indicating that firms with fewer than 20 employees generated approximately 88% of all employment growth in the US over the period 1981–1985 (Birch, 1987). This highlighted the key role in job creation played by young, high-growth firms he termed "*Gazelles*".

The role of SMEs in job generation has continued to be a major area for government policy and has stimulated the interest in entrepreneurship as a source of economic growth and employment creation. Additional research into the job generating role of SMEs has supported the view that small firms create more jobs than their larger counterparts (Neumark, Wall, & Zhang, 2011).

However, as noted by Birch (1987), the major contributors to net new job creation are the small proportion of *gazelles*, which are young firms, aged less than 5 years, that have an annualised average growth rate of more than 20% per annum over a consecutive three-year period. Such firms typically comprise fewer than 1% of all firms by employment, and 2% by annual turnover (OECD, 2010a).

Multi-country studies suggest that *gazelle* firms generate a disproportionate amount of net-new jobs within the economy (Clayton, Sadeghi, Spletzer, & Talan, 2013; EDSE, 2016; OECD, 2002). These *gazelle* firms are not just high-tech, and can be found in almost all industry sectors (Hendrickson, Bucifal, Balaguer, & Hansell, 2015). However, they are typically export focused, innovative, good at exploiting their intellectual property assets, well-networked and able secure access to financial resources (OECD, 2010b).

Australian research supports the view that most of the net new job creation is caused by high-growth firms, particularly *gazelles*. An examination of job creation by business over the ten-year period from 2001–2011 found that young SMEs aged less than 5 years contributed around 40% of all new net employment. However, only 3% of all start-ups were *gazelles*, which contributed the majority of this job creation (Hendrickson et al., 2015).

1.4.2 The Importance of Non-employing 'Nano-Enterprises'

The vast majority of 'ordinary' SMEs are not focused on rapid growth, have only modest levels of innovation and employ few people other than the owners. Most are micro-enterprises with fewer than 5–10 employees, or the nano-enterprises that have only one employee, the owner-manager. The non-employing nano-enterprises are the most common type of small firm in most economies (McKeown & Phillips, 2014). These businesses comprise a variety of types including self-employed trades people, independent contractors, the independent professional (iPros), sole traders, *life stylers* and freelancers (McKeown, 2015). Many of them work in what is now called the *gig economy* (McKeown et al., 2018).

It is difficult to assess the total number of such firms due to the absence of reliable data collection. Many countries don't even separately record these businesses, just including them into the micro-enterprise group. However, one estimate has suggested that within the EU the number of iPros alone is around 9 million and has been increasing rapidly (EDSE, 2016; Leighton & Brown, 2013). In Australia nano-enterprises comprise 61% of all registered businesses (ASBFEO, 2017). In the United States, this *gig economy* was estimated in 2016 to comprise between 600,000 to more than 1.9 million people (Brinkley, 2016). Although in some industries it represented around 34% of the workforce (Bracha, Burke, & Khachiyan, 2015). This is a pattern found in other nations where most firms are micro-enterprises, and the majority of these are non-employing nano-enterprises (OECD, 2016).

These owner-managers are typically not interested in employing staff and their decision to do so is likely to be determined by several factors. These include their level of education, and previous experience with self-employment. Also, they may have concerns over economic downturns that could make employing others a risk to the business. In some countries, regulations that make it difficult for employers to dismiss workers may serve as a barrier to hiring (Millán, Millán, Román, & van Stel, 2015). These individuals value autonomy, flexibility and the relative freedom that comes from not having to maintain a workforce, or even fixed places of employment (McKeown, 2015). Many, but not all, work in high-skilled jobs in professional services, computer programming, engineering and the creative arts. They typically work from other people's premises where they may be sub-contracted, or co-working spaces and 'professional hubs' (Leighton & Brown, 2013).

In an industry study of job creation in the United States over the period 1985–2010 the growth in nano-firms, or '*solopreneur'* increased at a much faster rate than employing SMEs. Further, within the employing SMEs there was a growing preference for hiring sub-contractor or temporary 'gig' workers rather than full-time staff. The key factors motivating this trend were: (i) the need to find specialist skills; (ii) not needing full-time workers; (iii) lacking the cash flow to employ full-time staff; (iv) the desire to avoid paying on-costs such as health care insurance; and (v) lower cost of sub-contractors or casual workers (SCORE, 2017).

1.5 The Working Lives of Small Business Owners

Let us now take a look at the challenges facing small business owners. Small businesses are characterised not only by the size of their payrolls but also by their managerial structure and environment. For example, small firms usually have an independent ownership structure and operations that involve close control by owner-managers. Such people typically contribute the majority – and in some cases perhaps all – of the working capital required by the business, and are responsible for making most – if not all – of the decisions relating to the firm's operations.

In a study of small business owners in the United Kingdom, Hankinson (2000) interviewed 90 owners and investigated their characteristics and management behaviour. Although this was a British study, the profiles of these owner-managers are relevant for SME owners throughout the world.

The picture that emerged from this research was of a predominately middle-aged male group of owners who worked between 47 and 65 h a week – often over 7 days. Despite these heavy working hours, these owners mostly viewed their workload as ‘manageable’. During their working day, approximately 93% of their time was spent working inside the firm, with approximately 55% spent in meetings and 38% on the telephone. These owner-managers spent little time in self-reflection or engaged in strategic planning or analysis of their firm’s performance.

The heavy workload of these small business owners meant that few could afford to take more than 2–3 weeks’ holiday per year, and while most felt that they had a stable family life, they devoted more time to their business than to their family. Most of these owners played no sport due to their either being ‘too busy’ or ‘too tired’. However, many were active members of local business associations and chambers of commerce. Most read only two or three books a year, visited the cinema or theatre once or twice, and took their news from one newspaper and listening to the radio while driving or from the television in the evenings. Some subscribed to a weekly or monthly magazine.

In terms of their skills and capabilities, the small business owners interviewed by Hankinson (2000) were predominately technical experts with limited expertise in areas such as marketing, general management, finance, leadership, languages and human resources management. They generally felt their management skills to be adequate while their other managerial skills were deficient, but they had taken little action to build up these skills. The most common approach to the management of their firms was for them to be the centre of action surrounded by their staff with little or no delegation or structure. However, all had some form of deputy manager who usually had technical skills rather than sales or management skills. Little or no use was made of external consultants.

Characteristics of Small Business Owners

A survey of 90 small business owners in the United Kingdom found the following characteristics common to such people:

- mostly males aged in their mid-50s, married with children.
- predominately educated with only high school diplomas and technical certificates.
- work between 47 and 65 h per week over 5–6 days.
- time management remains a key problem, with 93% of time spent inside their firm, 55% of this spent in having meetings with staff, 38% spent on the telephone and 7% spent travelling.
- limited time spent with family or playing sport.
- read two to three books per year, listened to approximately 4 h of radio per week (while driving), and 7–8 h of TV per week – about half of which was

(continued)

news and current events (also read one daily newspaper, one weekly and one monthly magazine).
- active members of chambers of commerce, Lions & Rotary clubs.
- lacked skills in marketing, finance, HR and leadership.
- made little use of outside consultants.
- weak on delegation, with at least one key frontline manager who was predominately a technical specialist not a general manger or sales manager.

Source: Hankinson (2000).

What motivated these owner-managers was a desire for independence and, perhaps, social status and financial rewards. They did not view their role as contributing to the national economy or creating jobs. When asked about their future plans, most felt that their business was already large enough but that it could be more profitable. Few had any desire to grow their businesses, even if they could do so. There seemed to be a desire to avoid the risk and uncertainty that a growth strategy might create. For example, a survival mentality prevailed as opposed to a positive futuristic outgoing approach (Hankinson, 2000, p. 97).

Most had a heavy dependence on a few large firms as customers who comprised up to 50% of all turnover. Net profitability for these firms ranged from 4% up to 10% before tax, which most of the owners considered to be 'too low for comfortable survival'. According to Hankinson (2000), many of the firms were 'merely breaking even or worse'.

These interviews were undertaken in the period 1997–2000, but it can be argued that the general picture that emerges from them could describe the majority of SMEs across many countries at any period of recent history. This ad hoc, nonstrategic approach to management, with a highly personal approach to the development of systems, long working hours and reliance of one or two key staff – usually a frontline manager – and a handful of key customers, are the characteristics of the typical small business manager.

1.6 Problems Facing Small Businesses

In 1971, the Bolton Committee of Inquiry on Small Firms in the United Kingdom (UK) identified clearly that the management of a small firm was substantially different from that of its larger counterparts (Bolton, 1971; Creedy & Johnson, 1983). The report found that small business owner-managers face particular problems in at least five important areas:

1. *Financial* – particularly raising and using finance, costing and control information.
2. *Marketing* – identifying and developing new markets and products.

3. *Production* – particularly scheduling and purchase controls.
4. *Human resources* – particularly organisation and delegation, and personnel management.
5. *Physical resources* – particularly management of technological change, and the implementation and use of information systems.

Despite the passage of time since this inquiry took place, the same problems continue to face the majority of small business owner-managers. Further, as a business grows and its operations become more complex, the challenges facing the owner-manager in each of these key areas also increase. Small business owner-managers have little opportunity to specialise into specific management roles. They are required to manage their business in a 'holistic' manner – usually with limited formal education or training in business management. It is, therefore, highly important that they receive timely and effective support from outside parties as well as management development education.

The *Sensis Business Index* – which commenced in 1993 – regularly surveys 1800 small firms in Australia to examine attitudes toward a range of factors. For the past 18 years, the top ten 'prime concerns' facing these small businesses have consistently been:

1. A lack of sales or work;
2. The difficulties in finding and keeping good staff;
3. Competition from large firms;
4. Cash flow, bad debts and profitability;
5. Paperwork and bureaucracy, and
6. The economic climate;
7. Costs and overheads;
8. Environment and natural disasters;
9. The impact of technology, and
10. Employment costs (Sensis, 1995–2018).

The relative priority of these issues varies from year to year, but concern over lack of work or sales and cash flow management are usually the top two issues, with the challenges of finding and keeping good employees as a third constant. This data tends to support the findings from the Bolton Committee and suggests that, despite the passage of 40 years, the plight of the majority of small business owners remains constant.

1.7 Myths About Small Firms

It is common to hear it said that starting and running a small business is a highly risky activity. According to this view, small business owners struggle alone to succeed, burdened down with excessive government regulations, starved of capital and motivated only by the desire to make money. While many small businesses may experience some or all of these problems in their lifetime, much of this 'doom and gloom' view is based on well-cultivated myths. The failure rates of small firms are frequently quoted as being very high. For example, according to one popular view of ten start-ups, five will 'go bust', four will struggle in the 'land of the living dead', and the tenth will succeed.

Although the mortality rate of small business from start-up is high, the nature of its failure is frequently overstated. Within the US, business bankruptcy rates fell from an average of 6.8% to 2.3% over the period 1986–2003 (Lawless & Warren, 2005). In Australia, only 3–3.5% of small firms actually experience bankruptcy with many small business owners closing down their firms for others reasons such as 'to avoid further losses', 'did not make a go of it', retirement, ill health or, more commonly, to sell out and recover some of their investment (Everett & Watson, 1998).

The high 'failure' rate of small firms in most economies is explained less by the financial collapse of the business and more by the decision of the owner-manager to abandon the operation. This is usually a conscious decision due to the owner finding the lifestyle of a self-employed person too difficult in comparison with that of an employee. However, it should be noted that during times of economic downturn the number of bankruptcies and insolvencies within the small business sector increases. For example, during the Global Financial Crisis (GFC), the number of bankruptcies in Europe increased by over 50% in the first 2 months of 2009 compared to the previous year, and insolvencies increased by 11% over the period from 2007 to 2008 (OECD, 2009).

Another myth is the lack of capital or finance available for small firms. While it is true that fast growing SMEs can find it difficult to secure sufficient finance from banks or private venture capital, there is generally a strong willingness to lend or invest by such groups. Most business banks are highly competitive with each other, and do actively seek SME clients. However, the cost of securing capital is often as much as seven times higher than the cost for larger companies. The reason for this is that financial institutions see SMEs as posing a greater risk and therefore demand a premium for their capital.

What Really Is a Small Business?

Small and medium-sized enterprise ownership means a greater emphasis is placed on:

- standing alone;
- operating with limited resources;
- high levels of uncertainty;
- high levels of external dependency;
- coping with 'total' responsibility;
- being closer to the customer;
- managing a wider range of tasks;
- greater scope for individual dominance;
- greater individual responsibility;

(continued)

- a wide scope for change and flexibility;
- managing networks with suppliers, customers, accountants, lawyers, bankers, etc.;
- culture rather than systems pull the business together; and
- strategic awareness (continuous) but little formal strategic planning process.

The GFC squeezed the small business sector in relation to financing. According to OECD (2009) research, many SMEs found it more difficult to secure bank financing. About half of all Australian firms indicated this, while more than 80% of small firms in Spain reported problems in accessing finance during that global crisis. Cash flow was also squeezed, but small business owners were also found to have been reluctant to take out more debt faced with falling sales and late payments by their customers.

Small businesses are also frequently quoted as complaining about the heavy burdens of government-imposed compliance costs (Gome, 2005). Federal, state and local government agencies frequently impose a range of regulations upon business that can impact negatively on SMEs. For example, they may be required to complete additional paperwork. However, well-organised small firms will generally experience few serious problems dealing with such compliance or 'red tape' issues. Further, many of these government-related compliance issues (e.g. VAT/GST, income tax, workers compensation, occupational health and safety) are administrative issues that a small firm should be able to monitor. For example, in Australia, the introduction of the Goods and Services Tax (GST) compliance in 2000, despite adding additional compliance costs, had the positive effect of requiring the small business owner-manager to keep a close eye on his/her cash flow and pricing policies.

The willingness of the small business owner-manager to seek assistance and undertake education or training is frequently viewed as low. Major reasons for this are the lack of time to engage in such training, the preference for more informal 'on-the-job' learning, a disinterest in formal qualifications and assessment, and cost (Lee & McGuiggan, 2009; Mitchell, 2007). This reflects less on the owner-manager's willingness to train and more on the nature of the training offered. Many courses are designed without adequately addressing the needs of the small business (Coetzer, Battisti, Jurado, & Massey, 2011; Dawe & Nguyen, 2007).

A final myth is that the main factor motivating small business owner-managers is money. While financial return for effort is a highly important issue for the owner-manager, their motivation is not solely money. The desire to achieve a better lifestyle, follow a dream, or create new opportunities is frequently more important (Mazzarol, Volery, Doss, & Thein, 2001).

The motivations of small business owners in going into business in the first place are highly complex and tied up with broader entrepreneurial characteristics. Of importance is the need to understand the small business from a holistic perspective.

Most small businesses are personal or family affairs and often require a social rather than purely economic interpretation.

1.8 The Growth Cycle of Small Firms

Interest in the growth cycles of small firms has traditionally taken second place to the study of the growth cycles of larger firms. However, since the 1960s several theoretical models of small business growth have been proposed (Churchill & Lewis, 1983; Barnes & Hershon, 1976; Scott & Bruce, 1987; Steinmetz, 1969).

Research into the growth cycle of small firms has indicated a series of 'stage-models' in which the business moves through a number of defined stages as it grows. Churchill and Lewis (1983), Scott and Bruce (1987) have identified at least five separate stages. In the first stage, the business is conceived and established. During this period, it is entirely the creation of its entrepreneur founder(s). All attention is given to finding customers and maintaining adequate cash flows to survive. The owner is the most important asset of the business, providing all its managerial skill, direction and capital.

If it survives, the business will pass into a second stage known as survival. During this period, the business is financially viable and may even hire additional staff. The owner-manager usually remains in control of the business and usually undertakes only minimal formal planning (Churchill & Lewis, 1983). Many small firms continue to operate in this stage for long periods of time, with a single or limited product line and any growth being driven by natural market expansion (Scott & Bruce, 1987).

From the perspective of growth, it is the third stage that may be most critical. Churchill and Lewis (1983) identify two sub-stages in this growth or success period. The first of these is the success-disengagement sub-phase, and the second is success-growth sub-phase.

In the success-disengagement sub-phase, the business is economically strong and has sufficient size and product market penetration enabling it to sustain its current position. Its size is such that is requires professional managers. In this sub-stage the owner-manager makes a decision to either grow or not. The business is usually profitable and ca n continue in its present form or is even sold at a profit (Scott & Bruce, 1987). Figure 1.1 illustrates this process.

If the owner-manager decides to opt for growth, the business then enters the success-growth sub-stage. During this stage, the owner-manager frequently places the business under risk to finance its growth. The need for professional managers may also increase along with the need for systems and enhanced planning. As noted by Scott and Bruce (1987), the most likely crises facing the business during its growth are the threats posed by larger competitors, and the demands placed on its resources as it seeks to develop new products or markets.

A successful growth strategy will take the business into the fourth stage, known as take-off or expansion. This stage can also be identified as involving a process of team building and delegation. The owner-manager must develop a management

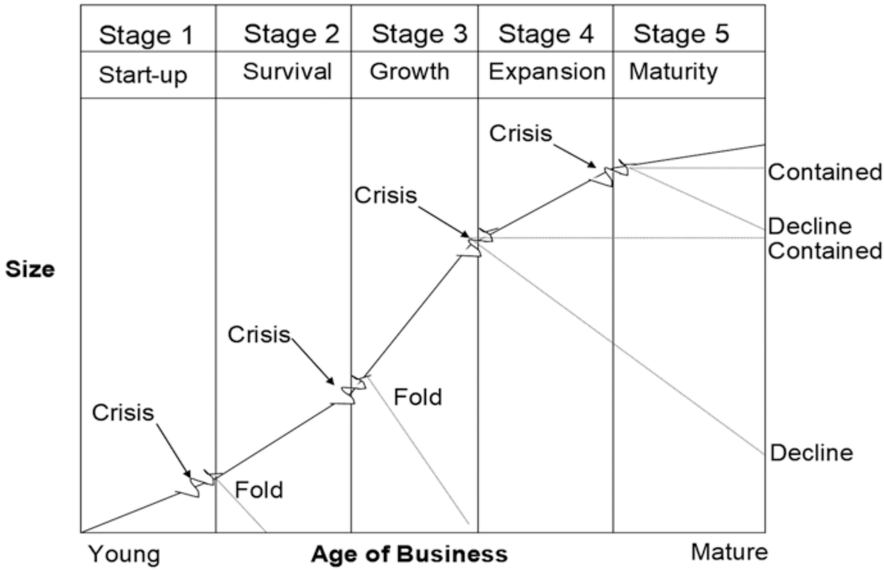

Fig. 1.1 The stage-model of small business growth
Source: Scott and Bruce (1987)

team capable of taking over the increasingly complex tasks associated with running the business. If they cannot learn to delegate their responsibilities, they will have trouble achieving effective growth. Furthermore, as the business moves into the fifth stage, i.e. the resource maturity stage, it will require greater team-based development. Failure to achieve effective management team effort in the fourth stage will impede its efficiency later.

In this critical fourth stage, the business will succeed and develop into a larger business, or not. As it grows, the business will become more formalised in its accounting, management and other systems. The needs for greater quantities of capital are likely to lead the business towards equity finance. This may pose new difficulties as the business seeks to secure long-term debt against its assets. Major crises facing the business during this stage are frequently those associated with the distancing of the original entrepreneur owner from the day-to-day running of the firm. Expansion requires the introduction of more professional managers:

> They will not have the commitment to the business that those who were with the business from the early stages had and are unlikely to be prepared to make the same sacrifices 'for the sake of the businesses. This situation is potentially dangerous and can cause a crisis (Scott & Bruce, 1987, pp. 50–51).

The fifth and final stage is one of maturity or resource maturity. This stage sees the business with sufficient resources to conduct formal strategic planning. Its management structure is likely to be decentralised and there is a greater separation between the owner and the business in terms of financial and operational matters. Large-scale investment in marketing and production facilities during this stage may result in additional equity financing. Many entrepreneurs have trouble at this stage with pressures from shareholders over strategic directions.

1.9 The Dynamics of a Healthy SME Sector

In seeking to assist small firms, government policy makers need to recognise that an SME faces different challenges at different stages of the life cycle. Further, how well a small firm operates is usually contingent on the managerial capacity of the owner-manager. Particularly in its early stages of growth, the small firm is usually closely associated with its owner who effectively 'is the business'. To help classify small businesses, a three-part taxonomy may be useful. This identifies 'Lions', 'Mules' and 'Turkeys' within the small business sector. Figure 1.2 illustrates this concept.

Lion firms are those that usually perform well. Their owners are growth focused, dynamic and innovative. They generally seek productive partnerships, new markets, and new ways to value add to their products or services. Such firms are not price driven and don't compete on price if they can offer value-added products. At any given time, usually around 10% of the small business community profiles as Lions.

Mule firms are usually successful and profitable, but are not as dynamic as their Lion counterparts. Mules are generally satisfied with slow, steady progress and their owners do not embrace change willingly. In a stable economic environment or industry, the Mule firm can usually operate successfully and profitably. However, the owner-managers of such firms frequently plateau at a certain point of growth and do not attempt to move beyond this. They usually retire with the business

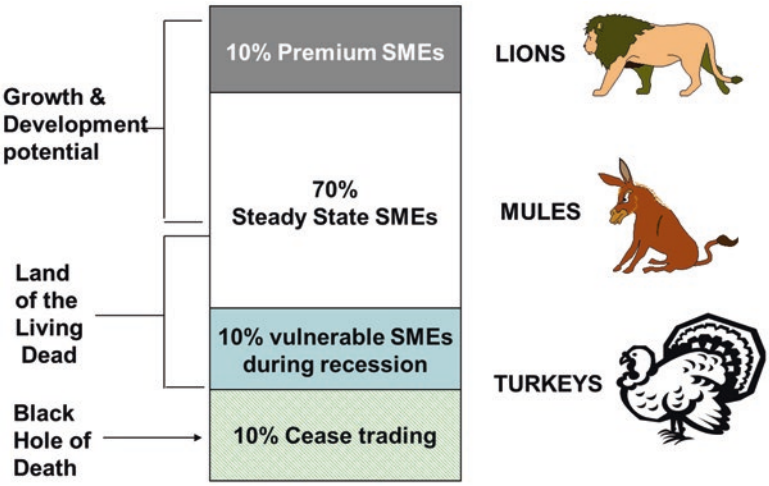

Fig. 1.2 The dynamics of a healthy SME sector

having achieved limited progress after an initial brief period of expansion. The majority of small firms are Mules. This category may include as many as 70%. The owners of such firms frequently 'die in harness', so to speak.

Turkey firms are the least successful of small businesses. Their owner-managers generally lack a clear focus as to where they wish to take their enterprise. They are also usually highly price-driven, seeking to compete on price which frequently results in them suffering lower profitability. Turkey firms generally display little interest in new ideas or the external environment. They are prone to isolation and rarely seek help unless they face a crisis. These firms usually have only a short life span. Turkeys often comprise approximately 20% of the small business sector. There may be approximately 5–10% at any given time that will fail and a similar number that are vulnerable to failure.

For banks, accountants or other professionals seeking to develop a portfolio of small firms, the most valuable clients are likely to be those in the Lion and Mule categories. The owner-managers of such firms are usually receptive to outside assistance and are prepared to seek partnerships with external parties who might help them. Providing assistance to Turkey firms is not to be discouraged, however it must be realised that the owner-managers of such firms are frequently unwilling to take advice and often seek to shift the blame for their problems onto third parties. The Lion and Mule firms are also more likely to grow and develop and have been identified in the US as entrepreneurial growth companies (EGCs) (NOCE, , 2001).

1.10 Causes of Small Business Failure

The failure of a small business is a complex issue. Failure is usually identified as a halt in the firm's operations. Williams (1987) found that newly-founded small businesses have around an 82% chance of surviving beyond the first 6-months. After approximately 2 years, this survival rate falls to around 52%. The probability of survival beyond 3 years is as low as 39%.

The issue of bankruptcy is a major fear of many small business owners who must typically put their personal assets – often their home – at risk to secure financing for their venture. However, while bankruptcy is devastating, it is likely to affect no more than 6–7% of small firms (Bradley & Cowdery, 2004). In most cases, the owner-manager simply decides to discontinue trading before they fail.

If a firm is to fail financially, it is most likely to do so during the first 3 years following start up. Financial failure in the form of bankruptcy is more common in some industries than others. For example, volatility is much higher among service firms than manufacturers. The reason for this is unclear but it is likely that the higher entry barriers, e.g. start-up costs, associated with manufacturing assist in reducing volatility since entrepreneurs seeking to establish manufacturing operations will probably plan their new ventures more carefully given the substantial costs associated with establishing such operations (Table 1.5).

Table 1.5 Major causes of small business bankruptcy

Under capitalisation	Loss of a key person
Lack of planning	Growing pains – over trading
Lack of trade credit	Lack of technology
Tax burdens and regulations	Poor business location
Personal issues by owner-manager	Natural disaster
Unrealistic expectations	Poor record keeping
Poor cash flow	Failure to use professional advice

Source: Bradley and Cowdery (2004)

It is important for professional advisors and those seeking to assist small business owners to be able to identify vulnerable firms and identify the principal causes of failure among start-up firms. Vulnerable small businesses are commonly found to have some or all of the following characteristics:

- *Low profit margins* – the firm's products or services are sold at a price that does not allow sufficient profit margin to ensure profitability. Such a business may quick experience cash flow problems and eventually financial difficulties.
- *External competition* – the firm is likely to operate in a crowded market that competes principally on price. Unless the firm has some means of securing a competitive edge based on non-price factors – or unless it can match the industry price without loss of profitability – it may experience problems.
- *Price-sensitive markets* – the industry or market in which the firm operates is characterised by high levels of price elasticity. This means that small increases or decreases in price will result in large fluctuations in customer demand. In such markets, price-based competition is risky if the business has low margins.
- *Local markets* – the market or markets into which the firm trades are likely to be local and offer limited growth potential. By restricting itself to a small local market, the firm is unable to benchmark itself against best practice in its industry. Further, it may be adversely affected if aggressive competitors enter this local market.
- *Low wage* – the business activity the owner and their staff commit themselves to must return a good financial benefit to sustain motivation. If the wages or *economic rents*[3] the owner-managers derive from the business are too low, they will most likely abandon the firm over time.
- *Poor management* – perhaps the most common cause of business failure in small firms is poor management practices by the owners. Dunn and Bradstreet estimate as many as 90 percent of small business failures are due to this cause (Bradley & Cowdery, 2004).

[3] An economic rent is the returns payed to an owner or factor of production in excess of the costs needed to bring that factor into production.

1.11 Small Business vs. Large Business

The process of growth requires the small firm to move its culture and processes towards that of the large corporation. On one hand, the small firm is defined by informality, loose job definition and open communication flows. On the other hand, the large company is usually more rigid and formal with structured communication systems.

An example of the difference between large and small firms can be seen in marketing. Large corporations have substantial resources to devote to marketing and frequently have many levels of marketing management with responsibilities for national and regional operations, or for different product lines (Webster, 1992). A feature of the large corporation is its use of formal planning processes to guide its marketing activities (McColl-Kennedy, Yau, & Kiel, 1990). By contrast, most small business proprietors find the marketing of their businesses a complex and difficult task. Unlike larger firms, the small business typically lacks both resources and expertise (DITR, 1987; Productivity Commission, 2015).

While the large business can afford a dedicated team of trained marketing specialists, the small business owner-manager is forced carry the burden of being responsible for sales, marketing, personnel, publicity, production and financial matters. In most cases, these duties are performed by an owner-manager lacking any formal training. Marketing knowledge and skill among small business proprietors is generally low, and many consider marketing to be little more than selling or advertising (Gold, 1993).

Small firms also lack the same systems to allow strategic planning, human resource management, and financial control to take place in the same way as large firms. SMEs are therefore characterised by informality and lack of systems. They can be highly flexible in the face of external environmental challenges or opportunities; however, they remain dependent to a much greater degree on their owner-managers to provide leadership.

1.12 Enhancing the Capacity of Small Business

Small firms face common problems that impair both their performance and survival rate. These problems include: lack of managerial competence, under capitalisation, disadvantages of scale, and failure to update market knowledge or adapt to new technologies. However, there is also a tremendous diversity among SMEs, which is important to consider given the support they require. For example, the size of the business, in addition to whether the business is innovative and rapidly growing, or in a mature market, will impact on the business in terms of required funds from outside sources, skill levels and training needs of staff, plus the likelihood of it exporting (Lattimore, Madge, Martin, & Mills, 1998). Therefore, it is important that policy makers do not view the small business sector as a coherent group.

Given the importance of this sector, the Australian government and most other OECD countries have developed support mechanisms to assist small businesses (OECD, 2010a). In general, governments have two broad mechanisms to assist businesses:

- *Macroeconomic policies*, which include interest rates, regulations, taxation, the legal environment, and national infrastructure; and
- *Direct intervention,* by designing policy and programs that directly assist businesses to achieve set policy objectives.

Government policy designed to assist small firms to grow and prosper requires a dual-track approach that focuses simultaneously on two ends of a continuum. At one end is the individual owner-manager or entrepreneur; at the other is the industry within which this individual is seeking to operate their business. The first, needs to be addressed in a *laissez faire* manner allowing the individual owner-manager and their small business pursue their own idiosyncratic objectives. The second, requires a more 'hands-on' approach to the way in which regulations, taxation and other external factors are managed so as to ensure that the small business sector can compete on a fair and equitable level against larger firms.

Direct government intervention or assistance to small businesses has tended to focus on: start-up programs including training and financial assistance, business incubators which aim to foster successful business operations, and advisory or counselling services (Blackburn & Schaper, 2012). However, the proportion of SMEs that make use of government advisory services is often low (Jay & Schaper, 2003). In addition, government-supported advisory services may not always be adequately matched to the actual needs of small firms (Breen & Bergin-Seers, 2002).

According to the OECD (2010c), government support for high growth *Gazelle* firms should focus on enhancing the business environment by removing bureaucratic and regulatory obstacles and improving the access of such firms to external debt and equity financing. There should also be support and encouragement of entrepreneurs plus training and support in management skills as well as the facilitation of international market access.

1.13 Developing Small Business Policies

When seeking to develop policies to support the small business sector, attention should be given to the personal values and orientation of the individual owner-manager and not of their firm. From the perspective of employment generation, the important questions are whether the owner-manager is prepared to expand their firm, and whether they can they manage growth (Kotey & Meredith, 1997). While these are issues over which governments can have little direct impact, it should be recognised that the owner-manager is a more important point of focus than the firm itself.

In seeking to understand the importance of this issue, government policy should acknowledge that entrepreneurs come in several varieties, and each type is likely to

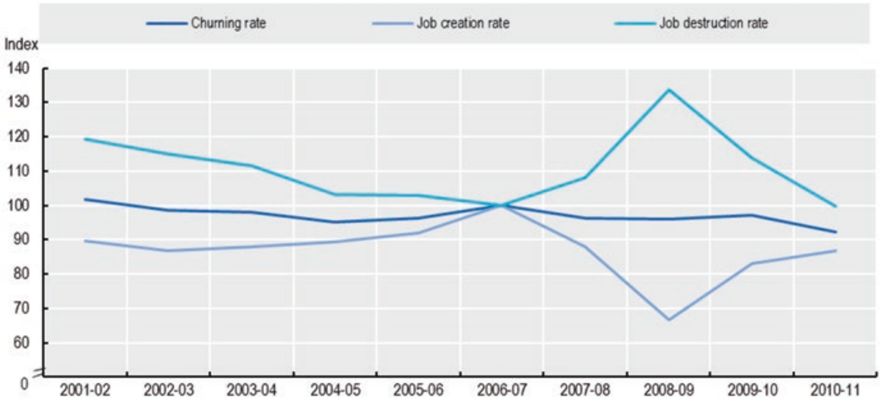

Fig. 1.3 Job creation, job destruction and churning rate, 2001–2011 across 16 OECD countries
Source: OECD (2015)

require different policy responses. The first consideration in this taxonomy is whether the entrepreneur is driven by opportunity or necessity. The first, those driven by opportunity, are the owner-managers who launch a business venture in order to take advantage of a perceived opportunity for growth or self-fulfilment. Such individuals are typically among those that develop sustainable, growth-focused businesses with the potential to employ. The second, those driven by necessity, are the owner-managers that enter self-employment due to a lack of alternatives. Such individuals are frequently undercapitalised and lack strong market or product development capability. Less business growth and employment generation are likely from the latter type of small business owner.

Also, of importance is how experienced the owner-manager is in terms of business management. Too often government assistance programs are targeted at people within limited experience of self-employment with an aim to encourage more small business start-ups. However, the high 'churn over' rate[4] among small firms means that such new venture creation may have limited sustainable impact. For example, an examination of business 'churn over' within the Australian economy found that the majority of firms entering and exiting the economy over the five-year period 2011–2015 was pretty even, with the average percentage change around minus 0.1%. This churn rate was found to be consistent across most industries and fairly consistent over time. The chances of a new start-up business surviving beyond 3-years was around 50/50 (Mazzarol, 2017). This 'churn over' rate is roughly three-times greater for small firms than large ones (Productivity Commission, 2015).

This is a pattern that can be found across most countries. For example, Fig. 1.3 shows the results from 16 developed economy countries within the OECD in relation to job creation, destruction and churn over during the period 2001–2011. As

[4] Churn over rate refers to the relationship between the number of new businesses entering the economy as compared to the number of existing business that exit.

can be seen, the overall churning rate remains constant with an even balance between new jobs created and existing jobs lost. The gross job creation and destruction rates are the sum of all positive or negative unit-level job variations found within the period. The churn rate is the sum of the job creation rate and job destruction rate. This is a measure not only of the rate of job destruction and replacement, but also the ebb and flow of businesses that enter and exit the economy, or that expand and contract. It can also be seen that the GFC seriously disrupted this balance, which took several years to correct.

In addition to assisting start-ups and early stage firms, government policy should be directed toward experienced small business owners and habitual entrepreneurs, and particularly those who own and manage multiple business ventures, i.e. portfolio entrepreneurs. Research evidence suggests that such individuals are likely to be the most significant generators of employment and wealth within a region (Westhead & Wright, 1999).

Attention should be given to policies that encourage and reward successful, experienced small business owner-managers to network with other like-minded owners both within their local region and nationally. Government agencies should encourage collaborative networking among successful business owners in order to foster innovation and competitive benchmarking. Small business growth can be enhanced by offering targeted assistance for owner-managers seeking to overcome critical bottlenecks in their business development, and could include: providing management expertise; facilitating business planning support; and facilitating financing for product research and development (R&D) and new market development.

At the other end of the continuum, government policy should concentrate on establishing focused industry programs to encourage the growth of existing industries and the enhancement of innovation and international competitiveness. Assistance should be provided to all industries, not just favourites, with the understanding that while there may be uncompetitive *firms*, there should be no such thing as an uncompetitive *industry*. Enhancing industry competitiveness requires attention to be given to the structure of industry supply chain relationships as well as to the interactions among firms within the industry and across industries.

Greater attention should be given to mapping industry value chains and industry clustering behaviour. Small firms are generally lacking in resources and need to collaborate or network in order to secure access to capital, labour, expertise, materials or markets that they cannot afford to acquire or develop alone. As the complexity of business activities increases – perhaps through the application of new technologies or the development of new products or markets – the ability of a firm to network is likely to assist its capacity to manage such increased complexity. By networking and clustering, small firms within industries or across industries can create sufficient demand to sustain categories of skilled employment that might otherwise be unsustainable (Baptista, 1998).

Figure 1.4 illustrates the *SME Policy Framework* proposed by Mazzarol and Clark (2016) in their review of the evolution of small business policy in Australia and New Zealand. This draws from the work of Bennett, who proposed a conceptual framework for understanding entrepreneurship and small business policy.

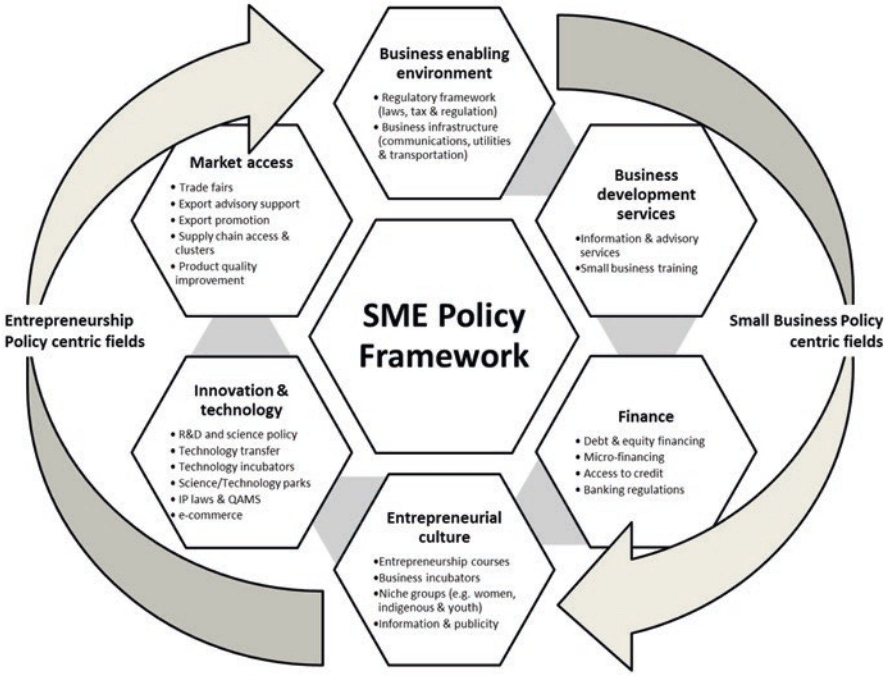

Fig. 1.4 The SME policy framework
Source: Mazzarol and Clark (2016)

As shown in Fig. 1.4 there are six elements that comprise the framework. The first three are *small business policy centric fields*, that relate to the government regulatory environment (i.e. laws, taxation) that impact small businesses, as well as the public good infrastructure (i.e. roads, communication services, utilities). These all impact the overall cost of doing business and need to be designed to make it easy for SMEs to start-up and grow. The business development services that provide SME owner-managers with advice, training and support are also important. Also important is the ability of SMEs to access financing and credit and the cost of this.

The next three elements in the framework are more focused on *entrepreneurship policy centric fields*. These include the fostering of an entrepreneurial culture, (e.g. via courses, information and publicity, start-up and growth incubators), as well as a range of government policy areas associated with science, R&D support, the creation of science or technology parks, incubators and intellectual property rights laws. Another important aspect of fostering entrepreneurship and the growth of SMEs is the development of policies that enhance these firms' access to global markets. Here governments can assist via trade fairs, export assistance, connections to global supply chains and maintenance of "best practice" and quality assurance.

It should be noted that small business policy is widely recognised around the world with most countries having a Minister for Small Business, and even government agencies dedicated to small business support. The Small Business Administration (SBA) in the United States is a good example. Established under the Small Business Act, 1953, the SBA has continued to provide support to SMEs at the national level (Bean, 2000). By contrast entrepreneurship policy is not generally recognised as a specific area within government. It has been suggested that small business policy should focus on established firms (i.e. those older than 3 years) which have fewer than 250 employees, while entrepreneurship policy should focus on start-up and younger firms (Lundström et al., 2014).

The distinction between small business and entrepreneurship policy remains fuzzy and might be explained simply by noting the suggestion of Mason and Brown (2014), who point to small business policy being primarily about "transactional" issues (i.e. taxation, subsidies, regulation), while entrepreneurship policy is focused more on "relational" issues (e.g. networking, mentoring). Either way the size of the SME sector across most countries ensures that governments will be required to develop policies designed to help the start-up, sustainability and growth of small firms.

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Entrepreneurs vs. Owner-Managers

2

2.1 Introduction

> Although there is considerable overlap between small business and entrepreneurship, the concepts are not the same. All new ventures are not entrepreneurial in nature. Entrepreneurial firms may begin at any size level, but key on growth over time. Some new small firms may grow, but many will remain small businesses for their organizational lifetimes (Carland, Hoy, Boulton, & Carland, 1984 p. 357).

This chapter examines the differences between small business owner-managers and entrepreneurs. It also looks at the different types of small firms and at the small business start-up process. Entrepreneurship and small business management are *not* the same event. In this chapter these distinctions will be explored further. In addition, the new venture creation process will be examined. Reference will be made to a variety of models relating to the new venture creation process.

2.2 The Enterprise Environment: Entrepreneurial Ecosystems

The entrepreneurial ecosystems (EE) framework provides a new approach for understanding the many complex and dynamic factors involved in economic growth and social development. Aligned with the broader view of entrepreneurship as a social process embedded in context (Cope, 2011), this EE approach has become popular with entrepreneurial leaders and policy makers from around the world (Stam & Spigel, 2016). Although still discussed and debated by academics, the EE framework as outlined by Isenberg (2010, 2011, 2014, 2015), from global studies of

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how to foster entrepreneurship in countries and regions, has been adopted, adapted and applied by policy makers and researchers in many countries. In addition, the EE framework has been recognised and utilised by leading international agencies including the World Economic Forum (WEF), the OECD, the World Bank, and the European Commission (EU).

A comprehensive definition of an entrepreneurial ecosystem was provided by Mason and Brown (2014) from their study for the OECD of growth-oriented entrepreneurship as follows. An entrepreneurial ecosystem is,

> "…a set of interconnected entrepreneurial actors (both potential and existing), entrepreneurial organisations (e.g. firms, venture capitalists, business angels, banks), institutions (universities, public sector agencies, financial bodies) and entrepreneurial processes (…) which formally and informally coalesce to connect, mediate and govern the performance within the local entrepreneurial environment" (Mason & Brown, 2014, p. 5).

This definition captures the complexity of these ecosystems, which are dynamic and co-evolving communities of diverse actors who create and capture value through increasingly sophisticated models of both collaboration and competition (Kastalli, Van Looy & Neely, 2013). In this type of dynamic context, new and existing firms have better opportunities to grow and create employment than in traditional industry silos, thereby fostering innovation (Williamson & De Meyer, 2012). The key players in an EE are not just entrepreneurs and small high growth potential firms, but also the organisations and institutions that contribute to shaping the context, as well as large firms that may provide opportunities to access markets, technologies or expertise. The quality of the links between the components, as well as the supportive mindset of the different actors involved can make a difference.

Isenberg (2010, 2011, 2014) proposed that an EE should comprise at least six core elements. A further, three additional elements were added by the WEF (2013). The overall EE framework, shown in Fig. 2.1 provides a structure for understanding and evaluating the enabling environment in which entrepreneurial firms can grow. As each ecosystem is unique, shaped by the local assets and conditions, and evolving, a holistic approach is required to ensure the inter-related components are mutually reinforcing to stimulate self-sustaining venture creation (Isenberg, 2010, 2011). Each of these nine elements are discussed in the following sub-sections.

2.2.1 Government Policy

The role of government is to facilitate and foster a vibrant environment for entrepreneurial ventures to be successful and sustainable, rather than providing direct investment schemes (Isenberg, 2011). Policies may be specific to encourage and support growth of small and entrepreneurial business developments, as well as general policies and regulations for taxation, financial services, telecommunications, transportation, labour markets, immigration, education and health (Mazzarol, 2014b). Policy makers are advised to target four aspects of the EE including: (i) entrepreneurial

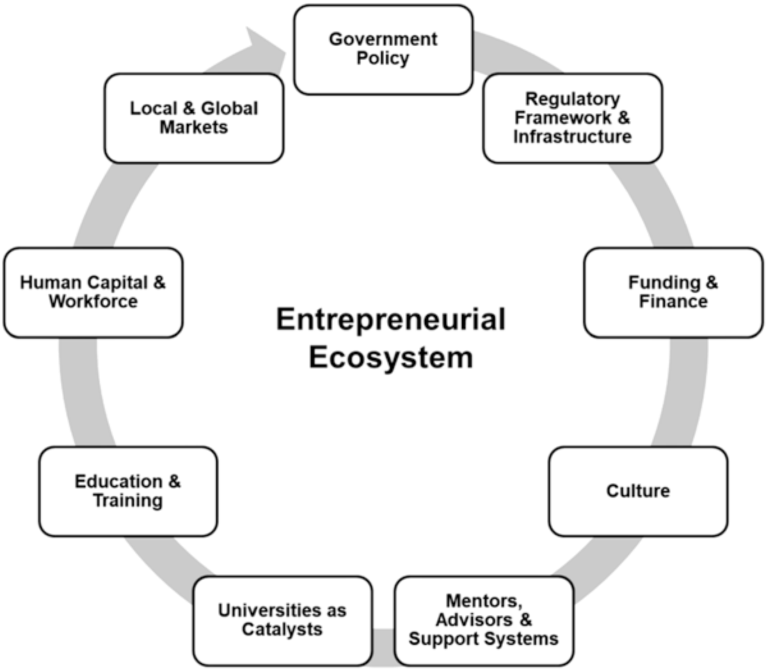

Fig. 2.1 Entrepreneurial ecosystem conceptual framework: nine core components
Source: Mazzarol (2014b) – adapted from Isenberg (2010) and World Economic Forum (2013)

actors; (ii) entrepreneurial resource providers; (iii) entrepreneurial connectors, and (iv) entrepreneurial orientation (Brown & Mason, 2017; Mason & Brown, 2014).

2.2.2 Regulatory Framework and Infrastructure

Regulation and infrastructure act as potential enablers or inhibitors of small business creation and growth (Foster et al., 2013; Mazzarol, 2014a). The ease of 'doing business' is reviewed and reported each year by the World Bank focusing on eleven areas of business regulation in 189 countries (World Bank, 2016). This analysis, which includes the complexity and cost of regulatory processes and the strength of legal institutions, provides rankings and detailed summaries including notes on key areas of improvement. Access to basic infrastructure, including utilities, telecommunications and transportation, which are essential for business operations also need to be considered within the EE context.

2.2.3 Funding and Finance

Access to funding and finance is another fundamental requirement for new and growing businesses. Research on entrepreneurs, microbusinesses and SMEs shows personal resources and informal loans from friends and family are often the preferred source of funds for many new and small businesses. However, to fund significant growth external debt is generally preferred to external equity (Clark & Douglas, 2012; Vos and Roulston, 2008). The status of the financial sector can be evaluated using a set of indicators provided by ANDE (2013) for banks, venture capital, angel investors, private equity, public stock markets and philanthropic activity. Access to credit is measured in the World Bank's *Doing Business* study by considering the sharing of credit information and the legal rights of borrowers and lenders with respect to secured transactions (through collateral laws and bankruptcy laws (World Bank, 2016). New sources of funding from online sources or crowdfunding platforms are providing alternative sources of funds for entrepreneurs with new business ideas (Mazzarol, 2014b).

Culture

Developing a culture in which entrepreneurship is highly valued can be assisted by communications strategies to profile entrepreneurial business growth, education programs to increase knowledge and awareness, and celebrations of awards to recognise innovations (WEF, 2013). Culture is one of the key intangibles impacting on entrepreneurial activities, as shared values and norms influence attitudes and patterns of behaviour (Barney, 1986).

Society's tolerance for risk, mistakes and failure is one of the specific cultural attributes that is relevant for EE (Isenberg, 2011; WEF, 2013). Attitudes towards innovation, creativity and experimentation are also key cultural factors which impact on the acceptance of new ideas and willingness to engage in entrepreneurial business practices (Isenberg, 2011).

The social status accorded to entrepreneurs is also relevant as this may act to either encourage or inhibit people from establishing and growing entrepreneurial enterprises (Isenberg, 2011). Similarly, if there is a preference for self-employment vs working as an employee within the culture, this can increase the numbers of small and entrepreneurial businesses (WEF, 2013). In addition, societal norms for personal drive, ambition and wealth creation can play a major role in the cultural dimension of the ecosystem (Isenberg, 2010).

The culture surrounding the entrepreneur at the family, community and national level needs to be supportive and tolerant of risk taking, diversity and failure (NCOE, 2000). It has been suggested that education for enterprise should commence as early as possible and involve children and nascent entrepreneurs participating in opportunities to experience and practice enterprise. These opportunities could involve interacting with entrepreneurial role models while receiving formal skills and knowledge transfer, and developing personal networks able to facilitate future business endeavours (Gibb, 1987).

Social networks have also been recognised as important in facilitating new venture creation (Johannisson, 1988), as has the level of social support and acceptance given to nascent entrepreneurs by their community (Bull & Winter, 1991). According to Gibb (1988), the key components of a healthy enterprise culture include five things:

1. *Positive role models.* There is a need for abundant positive role-images of successful entrepreneurs to inspire future entrepreneurs.
2. *Opportunity to learn business skills.* Young people need to be given the opportunity to learn business skills during their school education to better equip them to either work in a business or to consider starting their own business.
3. *Opportunity to practice enterprise.* As children grow and develop, they should be provided with opportunities to undertake enterprising activities and this should be reinforced by society. This does not just encompass business-related activities but focuses on creating new opportunities and innovative enhancements of schoolwork, sport and recreation.
4. *Possession of a network of enterprise.* There should be a well-established network of independent, family contacts and acquaintances able to reinforce familiarity and provide market entry opportunities for people seeking to launch new ventures. 'Know-who' is often as important as 'know-how'.
5. *Education in business management skills.* Provision should also be made for both formal and informal transfer of knowledge and skills into the process of small business management. Formal courses in business management need to be accompanied by an informal framework of support and mentoring (perhaps from other entrepreneurs) in how to successfully operate an independent business.

2.2.4 Mentors, Advisors and Support Systems

The entrepreneur does not exist in isolation. To grow and develop, entrepreneurs need a support network. This usually consists of accountants, marketing specialists, government advisors, bankers, industrial specialists, employer associations, and even university research and educational programs. A strong support network can be critical to the ability of a small business to survive and grow. Strategic networks can be beneficial to fast-growing small firms and can assist in sustaining their long-term objectives (Havenes & Senneseth, 2001). Furthermore, when small business owners make use of multiple sources of professional advice, e.g. accountants and marketing agencies, their overall business performance is superior (Kent, 1994).

Outsider advisors can assist the owner-manager in adapting to environmental change and in integrating systems within the business to achieve organisational efficiencies (Bracker & Pearson, 1985). The key for many small business owners is to forge a strategic network that can provide support when required at different stages of the firm's development (Ostgaard & Birley, 1994).

Despite the importance of business support networks, the majority of small business owners prefer to obtain information from the popular media, and many rely

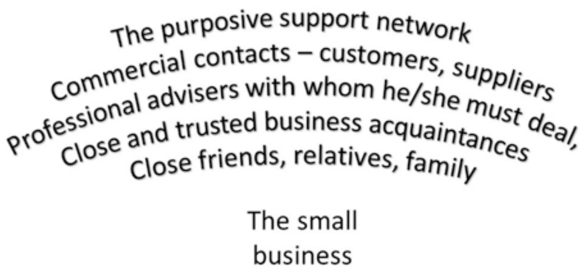

Fig. 2.2 The layers theory and proximity effect
Sources: Bridge, O'Neil, and Cromie (1998), Gibb (1988), Torrès (2004))

heavily upon family and friends for advice – often placing a low value on the opinions of professionals such as accountants, bankers and lawyers (Bennett & Robson, 1999; Smetlzer, Fann & Nikolaisen, 1988; Smeltzer, Van Hook & Hutt, 1991). This has been described by Torrès (2003) and Moles and Rohmer (1978) as the 'proximity effect'.

This 'proximity effect' concept was conceptualised by Gibb (1988) in what he referred to as the layer theory. Figure 2.2 illustrates the proximity effect and layer theory, where it can be seen that the small business lies at the heart of a series of concentric layers of external supporters. These usually start with the owner-manager's family, relatives and close friends, and then move outwards to their close business associates, then professional advisors, customers, suppliers and commercial contact such as the bank manager.

For many small business owners, particularly within micro-enterprises, the primary external support is from personal rather than professional contacts. This pattern of behaviour is also found among entrepreneurial owner-managers engaged in high levels of innovation who appear to rely more on the voice of the customer to guide their decision-making, rather than rely on the advice of professionals (Mazzarol & Reboud, 2006).

A business mentor is typically an experienced business person who is empathetic and usually independent of the business, who volunteers his/her time to provide advice and act as a sounding board over an agreed period of time. Mentoring may be organised formally via an official program offered by a mentoring organisation or informally by the individuals involved. By contrast, advisors are normally employed by business consulting organisations or government organisations/agencies, to provide business intelligence for fees. Specialist professional service firms offer specific advice e.g. law, accounting, auditing, taxation, information technology, intellectual property or investment banking. Advice for entrepreneurs may also be provided within incubators or accelerators, from peer networks of entrepreneurs or business networks such as the Chamber of Commerce (WEF, 2013).

2.2.5 Universities as Catalysts

Universities can contribute to the EE as catalysts for change through their academic programs, research, and economic development activities (Fetters, Greene, Rice, &

Butler, 2010; Mazzarol, Battisti, & Clark, 2016; WEF, 2013). Academic programs produce graduates with the knowledge and skills to contribute to growth of new and existing companies. Via internships, students contribute to problem solving for organisations; training high technology, science and engineering students in business/entrepreneurship areas enables them to develop their new ideas into marketable products and ventures. Theoretical and applied research on new and emerging domains and fields contributes to the knowledge-based economy. Staff and student connections with industry/business to address their problems/issues enables the University to have influence on their growth and performance. Converting new ideas into innovations is encouraged and supported by Universities by providing infrastructure for commercialization via research centres, or by supporting incubators, accelerators or technology parks on or close to campus.

2.2.6 Education and Training

The focus of education and training system is to provide the knowledge and skills required by the workforce operating in an entrepreneurial economy. To support innovation in a wide range of industry sectors, the workforce needs educated and trained employees and entrepreneurs. The generic and specific skillsets needed by each sector are determined by consultation with industry professional bodies and education providers. Specific formal and informal education and training programs for entrepreneurs are also recommended (WEF, 2013).

2.2.7 Human Capital and Workforce

Human capital represents the total knowledge, talents, skills and abilities of individuals that can contribute to the workforce and create economic value. This was rated by entrepreneurs as one of the top three most important EE components for growth of early stage companies (WEF, 2013). There are many different kinds of talent and expertise needed in a dynamic entrepreneurial knowledge economy. As global markets change, business models, employment systems, and workforce patterns also change e.g. the rise of nano-businesses such as iPros and independent contractors in lieu of employees (McKeown & Phillips, 2014).

2.2.8 Local and Global Markets

Access to markets is very important for early-stage and growth companies (WEF, 2013). Yet there are many challenges for new market access including geographic locations, distribution channels, visibility, and access to key decision makers. Assistance is potentially available from suppliers and customers, as well as from industry/trade organisations. Market segmentation is a key process for identifying and evaluating potential target markets. Establishing and leveraging productive relationships with large companies is recommended for early stage and growth companies (WEF, 2013).

2.3 The Heterogeneity of SMEs, an Issue for Both Researchers and Policy Makers

As discussed in Chap. 1, despite the importance of SMEs to the national economy, significant gaps remain in the conceptual foundations of the research undertaken in this area (Tan, Fischer, Mitchell, & Phan, 2009). One of the most fundamental problems is the paucity of effective definition and classification of what is an SME or small enterprise. There is no universally accepted definition of the SME concept. Different definitions are used around the world with a variety of measures relating to employment, turnover, assets under management and independence of ownership (OECD, 2004).

Given the diversity of the SME sector it is probably impossible to develop a single globally accepted definition. However, although there is unlikely to be an overarching definition of what a small enterprise is, the lack of clarity around the way in which such firms are defined has significant implications for both academic research and government policy. A lack of appropriate definition impacts negatively on research as it can distort findings (Headd & Saade, 2008). There are so many different sizes and types that unless better definition or definitions of small firms emerge, research is at risk of producing findings that cannot be replicated in further studies, lack external validity and confound comparative studies.

Many units of analysis have been used to study SMEs. These include the level of R&D expenditure (high-tech firms); the age of the business (start-up firms); the type of ownership (family firms); where they are located (home-based businesses), the purpose for which they were established (social enterprises), their rate of growth (Gazelles), and their speed of internationalisation (Born Globals). Even in these much-studied outlier groups there continues to be a lack of adequate definition to guide research. The number of employees remains widely used as basic definition criterion.

2.3.1 Micro and Small Firms

As outlined in Chap. 1, nano and micro-enterprises typically comprise the majority of all enterprises in an economy. For example, in Australia, 88.5% of all businesses are non-employing nano-firms (61%), or micro-firms (27.5%) with fewer than 5 employees (ASBFEO, 2017). Within the European Union (EU), an average SME employs 6.8 people, although this number varies from country to country. In Slovakia, for example, the average number of persons employed by SMEs is 12.5, and in Estonia 10 people. By comparison, the average number of people employed by each SMEs in Cyprus and the Czech Republic is five (European Union, 2007).

The proportion of micro-enterprises and small firms rises within regional, rural and remote areas as compared to urban and city areas (BTRE, 2003). Throughout the developing world, micro-enterprises offer an alternative to the lack of employment opportunities provided by the public sector or large firms. From rural Africa to urban South America, micro-business is the main source of economic advancement for women, young people, ethnic minorities, the poorly educated and migrants (Halvorson-Quevedo, 1992).

Where the economic environment is harsh and government welfare support for unemployment is low, the proportion of necessity entrepreneurs is likely to rise. A study of 160 small firms in Nigeria found harsh conditions produced more micro survival-focused firms, rather than growth-oriented, innovative enterprises (Yushuf & Schindelhutte, 2000).Micro-enterprises are typically family owned and operated businesses that provide the primary means of income and wealth creation for those families, thereby making them an important element in the social and economic life of their communities. Creating and sustaining micro and small business ventures within communities is therefore a key factor in economic development.

As in most countries, the overwhelming majority of French companies are micro-enterprises: in 2011, out of 3.1 million companies, 3 million had fewer than 10 employees. In the same year there were 137,500 SMEs excluding micro enterprises (between 10 and 249 employees), 5000 intermediate-sized enterprises ("Entreprises de Taille Intermédiaire" (ETI), with between 250 and 5000 employees), and less than 250 large enterprises ("Grandes Entreprises (GE), with more than 5000 employees). In comparison with Germany and the United Kingdom, France has a higher proportion of micro enterprises and a lower proportion of large SMEs (Table 2.1).

2.3.2 Medium-Sized Firms

Firms with between 50 and 250 employees frequently have the greatest potential to become large firms. How they grow and how their owners cope with growth are important areas of concern. By comparison with their micro and small counterparts, the medium-sized enterprises are usually better structured, have better systems and possess a greater capacity for innovation and growth.

In Germany, medium-sized enterprises, or *Mittelstand*, were acknowledged as a significant engine of growth within that country's economy in the 1990s (Simon, 1992). Their role in the diffusion of innovation and R&D in the German economy is considered as being a key determinant, especially during the 2008–2009 global economic crisis, of a strong German economy as such firms performed better than many larger businesses (Bourgeois, 2009).

Table 2.1 Comparison of structure of France, Germany and the United Kingdom in terms of unit size, 2016

Country	Germany	France	United Kingdom	EU 27
0–9 employees	81.9%	95.1%	90.1%	94.2%
10–19 employees	10.1%	2.6%	5.5%	3.9%
20–49 employees	5.0%	1.5%	2.8%	2.1%
50–249 employees	2.5%	0.6%	1.3%	0.9%
Over 250 employees	0.5%	0.1%	0.3%	0.2%
Total (2016)	100.0%	100.0%	100.0%	100.0%

Source: https://ec.europa.eu/eurostat/fr/web/structural-business-statistics/data/database

Such firms, although family owned, are often active within international markets and strive to benchmark their products and services against global best practice. Innovation within these firms is often high as they invest strongly in R&D in order to win or retain contracts. Close cooperative relationships between these firms and their leading customers and suppliers are hallmarks of their competitive success. There is also a noted willingness by management to build strong partnerships with employees in order to secure enhanced productivity levels.

2.3.3 Nano Firms and ETI

At both ends of the spectrum described above, from the micro firm to the medium sized firm, two additional categories have recently emerged: the nano-firm, and in France the ETI (for Entreprise de Taille Intermédiaire: intermediary sized firm), corresponding to a part of the German *Mittelstand*. Indeed, the comparison with Germany and their dynamic *Mittelstand* led France to identify an intermediary category between SMEs and GEs: the ETIs (between 250 and 5000 employees), which is supposed to be more likely to grow and to be profitable.

Research has examined the potential for these ETI firms (Chabaud & Messeghem, 2014). This has focused on their business models and dynamic capabilities (Claveau, Séville, Prim-Allaz, & Ambroise, 2014), In terms of growth, it identified a series of common factors among this group of French ETIs (Grandclaude, Nobre, & Zawadzki, 2014). Their main characteristic is their capacity to grow, and this is likely to lead French policy makers to provide such firms with more support. These ETI firms also seem to have survived the Global Financial Crisis (GFC) of 2007–2009 better than many of the larger firms.

As discussed in Chap. 1, quantitative definitions of small business tend to be the most common. They also tend to focus on measures of employment and financial performance, not just because these are relatively easily measured, but also because these measures support their focus on the small business sector as a source of employment and economic growth.

Government agencies usually require definitions that are measurable and not easily open to subjective interpretation. This is particularly important for regulation and enforcement around taxation or financial assistance programs. However, such definitions do not always provide the level of flexibility and subtly that accurately represents the actual diversity of SMEs, as a firm's identity is not influenced only by a few quantitative measures such as employment size or turnover. Such measures are also context dependent and differ across industries and national jurisdictions. In Chap. 4 we discuss the relevance of another type of classification enabling e more subtle understanding of the heterogeneity of SMEs.

2.4 Enterprise, Entrepreneurship and Small Business Management

Entrepreneurship and small business management are frequently considered as representing the same thing. This is not so, and it is important to identify how these two concepts differs from the other. The areas of entrepreneurship and small business management are conceptually different. On the one hand, entrepreneurial studies focus on theoretical frameworks within which to understand the entrepreneur and the various forces that create motivate and sustain their behaviour. On the other, small business management is frequently about process.

Definitions relating to entrepreneurs can be traced back to at least the nineteenth century with a focus on risk taking and business management (Brockhaus, 1987). The key ingredient in entrepreneurship is the creation of something new, or the new entry of ideas (Lumpkin & Dess, 1996). It is generally associated with the identification of an opportunity and then the successful exploitation of this opportunity using innovation (Shane, 2003). Small business management is more associated with the actual process of organising, managing and controlling the venture (Winslow, Solomon, & Tarabishy, 1999).

Definitions of Key Terms

Enterprise – the exercise of enterprise attributes in any task or environmental context.

Entrepreneur – someone who demonstrates a marked use of enterprising attributes, usually in commerce or business.

Small business – the owner-managed independent business of a size arbitrarily defined, relatively, as small in relation to the structure of the industry sector in which it operates and with respect also to the size structure of business as a whole.

Entrepreneurial – the marked use of enterprising behaviour, usually in a commercial or administrative context.

Enterprise culture – a set of values, attitudes and beliefs supporting the exercise in the community of independent entrepreneurial behaviour in a business context.

Intrapreneur – someone who demonstrates a marked use of enterprising attributes within a large company or bureaucratic institution.

Source: Gibb (1988).

Gibb (1988) provides a list of definitions to assist with clearly identifying the difference between entrepreneurs, small business owner-managers, and those who merely display enterprise within their own occupations. Although entrepreneurship is broader than small business management as an area of investigation, small business remains important within entrepreneurship.

In many respects, small business defines entrepreneurship as it involves the application of enterprise attributes to a business or commercial environment. A small business owner has chosen to take a calculated risk in launching a new venture. Their ability to identify the potential of a particular business opportunity is frequently evidence of their creative tendencies. By pursuing the challenges of small business, the owner-manager is also demonstrating their ability to strive for achievement and seek autonomy. They will also find it difficult to survive in business if they lack strong drive and determination.

By its nature, entrepreneurship is more theoretical or conceptual and can encompass both small and large firms. Small business management is largely an applied subject in which the entrepreneurial characteristics of the owner-manager are important, but where the managerial environment and the tasks that are associated with the successful operation of the small venture are important.

2.5 Characteristics of the Entrepreneur

The principal characteristics that define the entrepreneur tend to be a strong drive to achieve and a sense of competitiveness. People who we may describe as entrepreneurs tend to be creative and frequently open to new ideas and opportunities, but they also seek to do things quickly and can be impatient. Such people are often good initiators and have the ability to launch new ventures. Just as there are many different types of small business, there are also many different types of entrepreneurs. In an attempt to classify these different entrepreneurs, academics have created numerous typologies and taxonomies. These usually involve measures of the individual's risk-taking propensity, growth orientation or strategic vision. Filion (1996, 2000) has proposed a taxonomy comprising six entrepreneurial archetypes, known as the 'woodcutter', the 'butterfly', the 'libertine', the 'bricoleur', the 'convert', and the 'missionary'.

Table 2.2 lists these six archetypes along with their strategic focus. This taxonomy can be very useful when seeking a better understanding of the behaviour of SME owner-managers, and can help explain why some may behave in certain ways. Asking small business owners who are primarily 'woodcutters' to become high growth 'missionary' types, or to expect the 'libertine' to focus more on their business, may not be worthwhile.

Table 2.2 Taxonomy of entrepreneurs

Archetype	Orientation of the firm	Common strategies	Vision
Woodcutter	Survival = success	Continuous	Product and customer oriented
Butterfly	Profits	Contingent	Market and profit oriented
Libertine	Leisure	Rational	Leisure and profit oriented
Bricoleur	Personal achievement	Evolving	Product and market oriented
Convert	Security	Revolutionary	Product and values oriented
Missionary	Conquest	Progressive	People, team and globally oriented

Source: Filion (1996, 2000)

2.5.1 The Woodcutter

The first type of entrepreneur hates the crowd, and is sure they are wasting time when discussing business with others. They like to work hard and very efficiently. They are ambitious, and like to 'sharpen the saw and cut trees.' They are usually able to do their skill better and quicker than anybody else. They thus prefer to work alone and to be their own boss. If their product were to meet success, they would then hire people and make them cut trees. However, they are rarely fully satisfied with the rhythm and quality of work done by others. The 'woodcutter' likes people like himself or herself who work hard and speak seldom, and their firm is very production-oriented. If they ever take time and look around, they would notice the whole forest and start to grow their business. However, they rarely take time to see the whole forest. The 'woodcutter' is the most common type of person who becomes the owner-manager of an SME. If they are successful, they may turn into a 'missionary' type.

2.5.2 The Butterfly

This entrepreneur likes to get involved deeply with their business, but this usually doesn't last long. They like things to happen quickly, and know how to assess the strengths and weaknesses of a firm, and how to recognise business opportunities in the environment. They like to launch businesses and to sell them. The 'butterfly' likes to buy firms having difficulties, to reduce their costs, make key changes, and then sell them. If they get interested in a business, it is always to make profit out of it. They usually have a very wide and dense social network and know everybody. They always know exactly the person able to solve a production issue or somebody able to advise them on cost reduction issues. However, things have to move forward fast, or else they get bored and start looking elsewhere. Also, because there are always solicitations, they could leave quite suddenly. You could describe them as a weathervane, an opportunist, a chameleon, or a seducer. They like changes; and are bright but unable to deepen. When getting older, they can become a 'libertine'.

2.5.3 The Libertine

This type of entrepreneur loves leisure, entertainment, parties and games. They typically have an active social life and have at least one intensive and expensive hobby. The business they own and operate is primarily a financial support for their non-business activities, an easy way to get resources for their passions. For example, they would have chosen a seasonal cyclical activity, working hard during part of the year and then be free to practise their hobbies. They are not highly committed to their business, especially on an emotional level, and restrict their commitment to financial profit. This type of entrepreneur often has come from a wealthy family, e.g. third or fourth generation owning the business, having always been involved in leisure and sports, and their life relies on these activities. When getting older, they frequently become politicians, and politics replaces sports in their priorities.

2.5.4 The Bricoleur

The ‘bricoleur’ is an entrepreneur who dedicates all their free time to their firm. It is their hobby, and it takes all their energy. It becomes a way of demonstrating accomplishment. They usually have another job, an official one, and they keep it to secure funding for their firm. They thus remain unbalanced between two very different kinds of activity: in their official job they make decisions at an operational level and avoid administrative activities; in their firm they should be able to cope with strategic decisions and administrative duties but find it difficult, boring or useless. They want to do everything in the business and are not really able to delegate. They thus find it hard to leave their official job and dedicate all their time to this new venture. This person can oscillate for years between the two activities. Some could become ‘woodcutters’ or ‘converts’ if they managed to actually jump into the business; otherwise they could evolve into a ‘libertine’ type, having become accustomed to a double life.

2.5.5 The Convert

This type of entrepreneur once had a revelation, and now their entire life is focused on this firm, which is usually the starting point of a new life. They were seeking an accomplishment and have at last found a way to exploit their potential. The business venture becomes a kind of holy temple; their emotional commitment is very high. They build a perfect abstract rationale, grounding all of their actions and protecting this firm. Sceptical outsiders will be rejected and fought. The world gets very soon divided into two categories of people: (i) those who are with them and support them; and (ii) enemies – those who don’t support them. They will love and praise the first and be suspicious toward the second, considering that they simply can’t understand because they haven’t had the revelation yet. They like to do more than just observe and analyse results. They think they know better what is good for the firm. The ‘convert’ is thus unable to delegate. Individual creators or inventors are often this type. Converts may also include people who come from R&D or marketing activities, but these people tend to succeed more easily. Their commitment can turn into obsession, and they may turn into ‘missionary’ entrepreneurs.

2.5.6 The Missionary

This individual, once they have launched their business, knows their product or service perfectly well. They are passionate about their mission and are convinced that their firm is a real ‘plus’ for the community. They often come from another of the archetypes, have been successful, but instead of retiring or selling the business they want to use it to achieve new accomplishments. Their employees usually have a lot of autonomy. They have left the firm quite early, seen the forest and even beyond. The 'missionary' sometimes has lost interest in the trees, and has organised their firm so that it can work without him. However, they remain linked to their firm and are above all interested in people, in change management and in innovation. They want to build a team based on goals, progress and learning. They want to be a stimulator and catalyst, and to show the way. The 'missionary' communicates their enthusiasm both to the community and to their firm, which is thus able to grow.

2.6 Myths of the Entrepreneur

Timmons (1999) notes that several myths surround entrepreneurship. These include the notions that: entrepreneurs are born not made; that anyone can start a business; that entrepreneurs are gamblers who want to dominate the entire show; entrepreneurs want to be independent, they should be young; they are only motivated by the dollars to be earned; and if they have enough start-up capital they cannot lose. All these notions are myths. In general, the characteristics found among entrepreneurs are also found throughout the general population, although they are not always concentrated in sufficient proportions in all occupations or groups. Michael Gerber (1986) has argued in his book *E-Myth: Most Businesses Don't Work and What to Do About It* that most people who launch a new business venture are technicians and not entrepreneurs. For example, a plumber may start his own business, but may retire many years later having earned little more than wages.

Bhide (2000) has identified several myths about entrepreneurs. The first myth is that 'most successful entrepreneurs take wild, uncalculated risks in starting their companies'. While there is always risk in the establishment of a new commercial venture, the risk actually increases as the business grows and develops. Risk actually increases with the life cycle of the business and is frequently greater later rather than earlier in its development. It is for this reason that many – perhaps most – small business owners chose to deliberately cap their firm's growth, and maintain its operations at a level they feel is comfortably within their levels of risk tolerance (Hanks, Watson, Jansen, & Chandler, 1993).

A second myth associated with entrepreneurs is that 'most successful entrepreneurs start their companies with a break-through invention – usually technological in nature'. Despite the media hype surrounding exciting new technologies and the companies that develop them, such business ventures are actually quite rare. The vast majority of new ventures offer little in the way of technological revolution, although the more successful do offer an innovation in some form. Differentiation of product or service is usually critical to the success of a new venture, particularly one that is to grow. However, technological innovation is frequently of less value than innovations in marketing and management systems, and many successful firms have merely adopted good ideas from others, rather than invent totally new solutions (NCOE, 2001).

Five Myths About Entrepreneurs

Risk taking myth: Most entrepreneurs take wild, uncalculated risks in starting their companies.

High-tech myth: Most successful entrepreneurs start their companies with break-through inventions, usually technological in nature.

Expert myth: Most successful entrepreneurs have strong track records and years of experience in their industries.

Strategic vision myth: Most successful entrepreneurs have well-considered business plans and had researched and developed their ideas before taking action.

Venture capital myth: Most successful entrepreneurs start their companies with millions in venture capital to develop their idea, buy supplies, and hire employees.

Source: NCOE, 2001.

A third myth is that 'most successful entrepreneurs have strong track records and years of experience in their industries'. Research undertaken with the firms within the Inc. 500[1] list of fast-growing firms in the United States found that 40% of founders had no previous experience in that industry sector prior to establishing their company (Bhide, 2000). In many ways, the person that has no previous experience in a given industry brings to their venture a fresh perspective, unburdened by pre-existing notions of how they should or should not behave. This is often the basis for innovative ideas and strategies that would not be considered by persons who were comfortably established in the industry.

The fourth myth associated with entrepreneurs is that 'most successful entrepreneurs have a well-considered business plan and have researched and developed their ideas before taking action'. Although the need for formal planning will become necessary as the business grows and becomes more complex or in need of attracting external resources such as venture financing, in its early years this is not vital to success. Only 4% of Inc. 500 firms' founders undertook any formal research process prior to establishing their companies, and less than a third had prepared a formal business plan prior to launching the venture (Bhide, 2000).

Finally, the fifth myth is that 'most successful entrepreneurs start their companies with millions in venture capital to develop their idea, buy supplies, and hire employees'. This is probably the greatest of all the five myths and is fuelled by media coverage of the venture capital deals negotiated by prominent companies – and no doubt fostered by some within the venture capital sector that make their money from such deals.

Although venture capital plays an important role in the growth of many firms, it is only one means of financing new ventures, and is a relatively uncommon means.

[1] See www.inc.com

For example, in 1999 fewer than 4000 of the 700,000 new businesses that were founded in the US were funded by venture capital (NCOE, 2001).

Even in the high technology sectors, many prominent companies, e.g. Microsoft and CISCO System, were initially founded without venture capital, relying instead on personal savings, debt financing and cash flow for early growth. The majority of highly-successful Inc. 500 firms did not rely on venture capital to get started, with the average start-up capital being around US$10,000 (Bhide, 2000).

Entrepreneurship is, therefore, shrouded in myths and misconceptions. While sometimes a difficult concept to define, it can be viewed in association with a set of psychological characteristics that serve as antecedents for the generation of ideas frequently resulting in the foundation and growth of new business ventures.

2.7 The Process of Entrepreneurship

The process of entrepreneurship has been likened to a three-step process that in simplistic terms describes the stages through which the entrepreneur must move when seeking to establish a new business venture (Shane & Venkataraman, 2000). These three stages are:

- *Opportunity recognition* – the process of identifying the business opportunity and developing sufficient passion to want to drive it forward to a reality that generates wealth. The importance of opportunity recognition is recognised by Timmons (1999, p. 37) who states: ‘The process starts with opportunity, not money, not strategy, not networks, not the team, not the business plan.’
- *Marshalling of resources* – the entrepreneur is unable to achieve their goals alone. They must seek people, money, equipment and support in order to follow their vision. This capacity to marshal appropriate resources, usually in the face of risk, is an important feature of the entrepreneur.
- *Developing capability* – the successful entrepreneur is able to marshal sufficient resources to start a business and then learn how to develop the new venture’s capabilities to achieve prolonged sustainable growth.

This three-step process is an important framework for understanding how entrepreneurs seek to initiate and develop new business ventures. The highly creative nature of entrepreneurs means that they are frequently alert to market opportunities, and are able to identify good ideas with commercial merit. For many entrepreneurs, the problem is having too many good opportunities from which to choose. This often sees them attempting to take on too much at once without the resources to do anything properly.

Once the entrepreneur has committed himself/herself to their opportunity, they must marshal sufficient resources to see their goals achieved. This often finds the entrepreneur attempting to ‘beg, borrow and befriend’ resources from others. The essential resources they will need to assemble include money, markets, and management. Money involves raising sufficient capital to fund their new venture, while

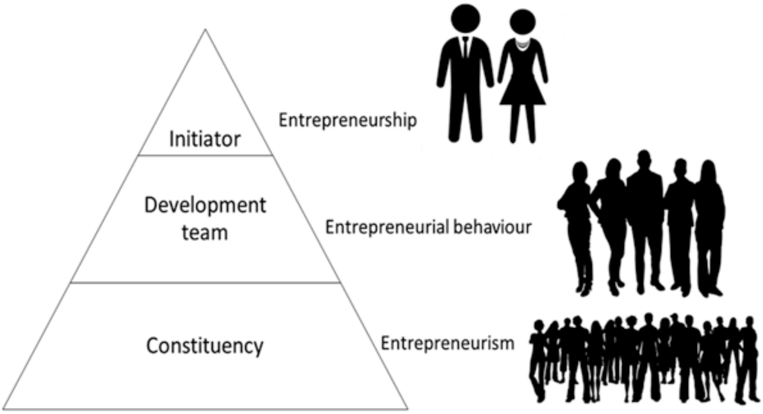

Fig. 2.3 The entrepreneurship implementation and support pyramid

markets are associated with developing the product or service and then getting it to market. Finally, management involves the skills – including planning, leading, organising and delegation – required to keep the business operating smoothly.

Finally, once the entrepreneur has managed to launch their new venture and it is trading, they must identify successful formulas that work well for them. These may include selling or marketing systems, product configurations, or production processes. Whatever the formulas, if they work, they should be retained on an ongoing basis. The capacity to keep the business operating over the long term will depend on the entrepreneur's ability to build such capability.

Kourilsky (1995) suggests attention be paid to three levels of activity in what she refers to as the entrepreneurship implementation and support pyramid shown in Fig. 2.3. In this model, the initiator is the one who identifies the opportunities and offers the passion to lead the group toward achievement of a goal. Such people are risk-oriented and frequently have enterprise tendencies, namely: the need for achievement, the need for autonomy and independence, creativity, moderate or calculated risk taking, and an internal locus of control.

The development team is then recruited by the initiator to achieve his/her objectives. Most of the development team will be less entrepreneurial but may have a sense of purpose and a close understanding of that individual's ideas. Such people are also by nature 'entrepreneurial'. This team is frequently involved in recruiting and marshalling resources for the venture, but under the overall leadership of the original initiator. Finally, the constituency is made up other stakeholders who are not entrepreneurs but who support the first two layers. They support the new venture and will allocate their time and resources to its enhancement. Kourilsky (1995) defines such behaviour as 'entrepreneurism' to distinguish it from entrepreneurship.

While conceptual in nature, this model reflects the leadership role taken by entrepreneurs in society, and their ability to initiate new ventures and build around them an initial team of like-minded individuals who can help them to achieve their vision. It is this assembly of the development team that parallels the process of marshalling resources. Eventually they will need to secure the support of a wider constituency who – whether as customers, suppliers or employees – will help to build the capability of the venture and secure its future. Business has been described as a team sport, and there is little doubt that successful entrepreneurs have the capacity to attract and recruit others to their cause. However, this is not something that is always found among small business owners.

2.8 Entrepreneurs vs. Owner-Managers

According to Lumpkin and Dess (1996): 'The essential act of entrepreneurship is new entry'. This refers to the act of launching a new venture and can involve: starting up a new business, spinning out a new company from an established business, or creating new business activities within an established firm. It can be achieved either by the creation of new products and services, or by entry into new markets.

Entrepreneurship involves 'the discovery, evaluation and exploitation of opportunities to introduce new goods and services, ways of organising markets, processes and raw materials through organising efforts that previously had not existed' (Shane, 2003). In summary, entrepreneurship is the process of creating new entry opportunities and can involve both new business start-ups as well as the development of existing firms.

Within the small business context, the concept of the entrepreneur is not always appropriate. Due to the complex and rather vague notion of what constitutes an entrepreneur, many academics take the view that the term should not be used within the field of small business research (Hornaday, 1990). There is a preference instead for the term 'owner-manager', which is viewed as being more accurate in its definition (Moran, 1998).

While an entrepreneur can refer to an individual engaged in both small and large business ventures, the notion of an owner-manager is generally associated with small firms. Owner-managers by definition both own and manage their business ventures. As owners they are carrying all the financial risk associated with the firm. Most small business owners have financed their venture by investing personal savings and borrowing from banks using their personal assets, e.g. homes and property, as security. This contrasts with the individual that secures venture capital or public listing and essentially shares the financial risk with others. From a management perspective, most small business owner-managers are responsible for all the functions required to make the firm successful. This includes administration, planning, production, marketing, financial control, human resource management and even the sweeping of floors.

Definition of the Entrepreneur

An entrepreneur is an individual who establishes and manages a business for the principal purpose of profit and growth. The entrepreneur is characterised principally by innovative behaviour, and will employ strategic management practices in the business.

Definition of the Owner-Manager

Small business owner … an individual who establishes and manages a business for the principal purpose of furthering personal goals. The business must be the primary source of income and will consume the majority of one's time and resources. The owner perceives the business as an extension of his or her personality, intricately bound with family needs and desires.

Source: Carland et al. (1984).

As discussed previously, the majority of small firms are micro-enterprises, with most having no employees other than the owner-manager (ABS, 2016). The owner-managers of such firms do not have the luxury of delegating work to others, or even the systems that managers from larger organisations frequently take for granted. These owner-managers must not only carry out the productive work of the business, but also find time to keep the books, pay wages, collect and pay GST, target new customers, service existing customers, purchase their own materials, and do all the other numerous things that comprise the functioning of a business venture. It is also common for small business owner-managers to lack the necessary skills required to perform many of the management tasks they are frequently faced with. Understanding this task environment surrounding the small business owner-manager is essential to successfully helping such individuals, or launching a new venture of your own.

2.9 Effectuation Theory

For the majority of entrepreneurs embarking on their first entrepreneurial venture, there are few sign posts and rules. Sarasvathy (2001) has sought to explain the entrepreneurial process through the theory of effectuation. This suggests that an individual seeking to launch a new venture will need to apply an effectuation process rather than a causation process.

In the causation process, there is a clear sense of the variables that need to be controlled in order to achieve a given outcome or end result. This implies cause-effect logic in which investment of time and resources in a project will lead to relatively predictable outcomes. This type of process is well suited to the exploitation of known markets and established knowledge. For example, a company might seek to increase market share in existing markets through competitive strategies aimed at enhancing their brand image, or the promotion of existing products and services. Causation processes work well in static, linear environments in which there is an underlying logic that, if the future can be predicted, it can be controlled.

By contrast the effectuation process is more suitable where the variables – and even the end state – are unknown or unpredictable. The focus is on the control of things that might assist in articulating through the process into an uncertain future. Effectuation assumes that the environment is dynamic, nonlinear and ecological in

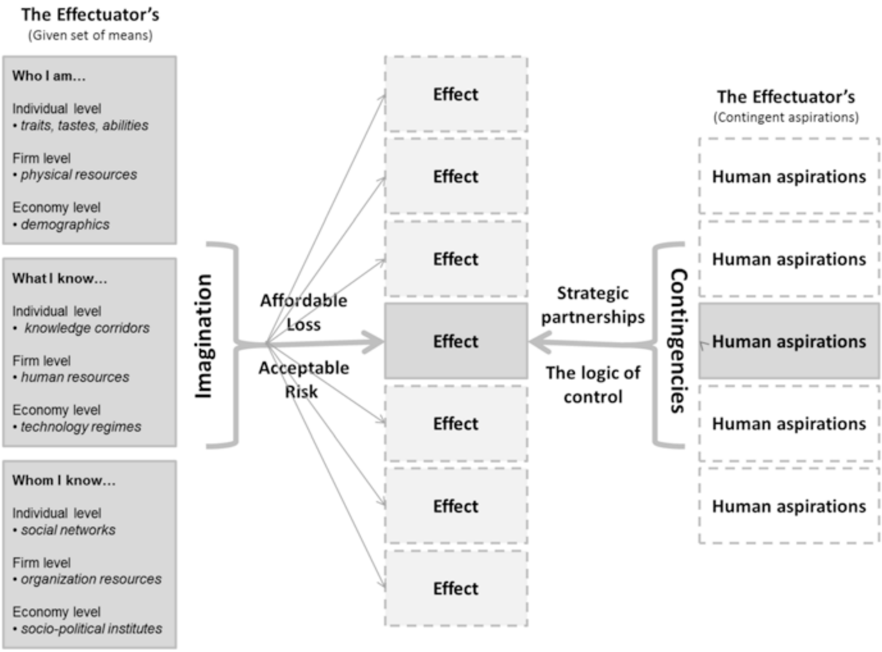

Fig. 2.4 The theory of effectuation
Source: Sarasvathy (2001)

nature. It can be useful in the creation of new markets and products in which strategic alliances and collaborative strategies are important for success.

Figure 2.4 illustrates the conceptual framework of the theory of effectuation. As shown, the '*effectuator*', who is seeking to undertake an effectuation process begins not with certain knowledge of the end state they are seeking to achieve, but a given set of means that consist of who they are, what they know and whom they know. This occurs at the individual, firm and economy-wide level. The individual has their personality traits and enterprising tendencies. They are able to access information from a given set of 'Knowledge corridors' and they will possess a given set of social and professional networks that contain people they can turn to for advice and support. Within the business venture there exists a given set of physical, human and organisational resources that the entrepreneur can apply to achieving their goals. Surrounding the venture is the economy or task environment that shapes the characteristics of the market into which they seek to trade.

Unlike causation, the effectuation process cannot focus on maximising potential returns through the selection of the best options. All that the *effectuator* can do is use their imagination and determine what they can afford to lose and what risks they can accept going forward. As they take action towards their objectives, they shape their aspirations using their imagination and the effects that they receive from what is an iterative process of continuous learning involving strategic partnering with others – including customers. Sarasvathy (2001) suggests four principles of effectuation theory:

1. *Affordable loss*, rather than expected returns;
2. *Strategic alliances*, rather than competitive analyses;
3. *Exploitation of contingencies*, rather than pre-existing knowledge; and
4. *Control of an unpredictable future*, rather than prediction of an uncertain one.

She suggests that successful new ventures are best served by focusing on forming alliances and partnerships than on undertaking sophisticated market research and competitive analyses. Marketing in the effectuation process involves 'seat of the pants' marketing and selling via alliances rather than well-designed surveys and test marketing. Financial management is less likely to be based on net present value (NPV) analysis and more on short-term assessments of affordable loss and acceptable risk. It is also suggested that *effectuators* are more likely to fail, but would be able to manage failure more effectively and eventually build more successful firms over the longer term.

Since its emergence, the theory of effectuation has emerged as one of the key theoretical frameworks to help explain the process of new venture creation. It has been applied to innovation and new market creation in technology (Sarasvathy & Dew, 2005). Its usefulness to managers lies in its recognition that new ventures, particularly those that involve disruptive technological innovations, are often unpredictable in terms of their future strategic directions. The notion that such ventures are well served by a formal approach to business planning and strategy may be false. Of more value is the entrepreneur's ability to network and control risk.

2.10 Models of New Venture Creation

Whatever the distinction between the concepts of entrepreneurship and small business management, these two converge at the point of new venture creation. It is in the process of establishing a new business venture that the entrepreneur's opportunity-seeking behaviour and desire for new market entry is married to the harsh reality of small business operation.

Research into the process of new venture creation has sought to identify both the forces motivating an individual to launch a small business start-up, and the critical ingredients required to make the venture a success. According to Gartner (1985), new venture creation requires the interaction of four key factors. The first of these is the individual or individuals that chose to launch a new venture. Characteristics that have been closely associated with entrepreneurial behaviour are: the need for achievement, an internal locus of control, willingness to take a calculated risk, the desire for independence, and other issues such as age, education, past work experience and whether or not the individual has entrepreneurial parents.

In addition to the individual, the new venture creation process requires consideration of environmental and organisational variables likely to impact on the firm.

Important environmental variables include the owner-manager's ability to access markets, suppliers, skilled labour, property and facilities, transport and communications infrastructure, and finance. For many firms, their capacity to grow may be adversely affected by a lack of access to venture capital and managerial support. Industry characteristics such as the level of rivalry between firms, the power of suppliers and buyers, and the threat of substitutes and new entrants can also impact on the start-up process. Finally, successful new ventures need to organise their operations to follow either a differentiation or cost leadership generic strategy (Porter, 1991). The owner-manager must determine how best to configure the business to ensure maximum success, including considerations of forming joint ventures, licensing agreements, franchising systems and other structures.

Against the background of these environmental and organisational factors, the individual owner-manager then undertakes the actual new venture creation process. This new venture creation process involves: identifying the business opportunity, accumulating the necessary resources, and building the capability within their firm. This capability building, in term, requires the marketing of the product or service, the actual production of the product or service, and the building of systems within the company (Gartner, 1985). Timmons (1999) argues that several critical forces – that operate in combination through a dynamic process that is controllable – drive the creation of new business ventures. These factors involve:

- *Opportunity* – the entrepreneur needs to identify an opportunity that is sufficiently attractive to warrant the expenditure of time or money.
- *Leadership* – the new venture is usually given its initial drive by the efforts of a lead entrepreneur or entrepreneurial team.
- Resource allocation and creativity – the new venture requires the creative allocation of resources, e.g. time, money and intellectual property. Most new start-ups lack adequate resources and must find ways to 'bootstrap', or what some refer to as 'beg, borrow and befriend' (Hall, 1992).
- *Fit and balance* – the entrepreneur needs to ensure that there is an adequate relationship between the resources available, their fitness for the purpose to which they are applied, and the capacity to balance frequently-competing needs.
- *Integrated and holistic* – unlike larger firms, the small and medium-sized enterprises are unable to enjoy the luxury of having specialist departments with staff who focus on only one narrow area of responsibility. Management of the SME requires an integrated and holistic approach in which everyone must learn to 'muck-in'.

The Timmons model of the entrepreneurial process is illustrated in Fig. 2.5. This model is dynamic and does not have all the essential elements of an equal size all the time. It can be seen that the three primary elements of opportunity, resources and team must exist in some proportion as the new venture is created. The owner-manager who seeks to start the new business must consider: the level of demand for their product or service within its market, and how profitable the product will be. How quickly it might return their investment is also an important consideration.

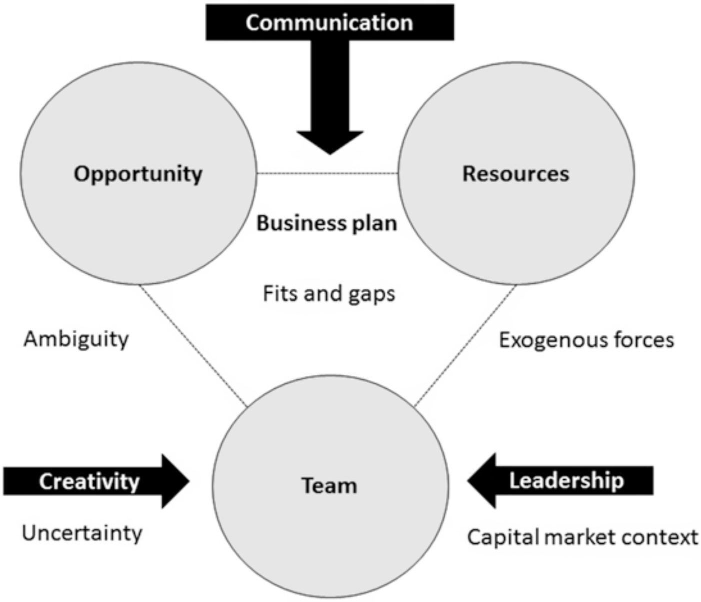

Fig. 2.5 Model of the entrepreneurial process
Source: Timmons (1999)

In assembling resources, the start-up entrepreneur must realise that they cannot usually have all necessary resources assembled prior to launch. This requires them to be rather parsimonious in their allocation of finances, time and human resources. 'Bootstrap' financing is an approach commonly adopted by small firms in their early years, usually from savings, private loans from family and friends, or from retained earnings generated from cash flow. According to (Stevenson, Grousbeck, Roberts, & Bhide, 2000), the following checklist is important when seeking to employ 'bootstrap' financing:

1. *Implement proven market ideas*. This will assist in getting sales moving quickly.
2. *Look for a quick break-even*. The project or new venture should break-even as quickly as possible. If not, the entrepreneur will be forced to seek alternative sources of capital.
3. *Look for high gross profit*. The higher the profit margin of a new product or service, the more retained earnings that can be generated.
4. *Sell directly*. The 'bootstrap' process is assisted if the product can be sold directly by personal selling. This assists sales growth and allows control of cash flows.
5. *Keep the team lean.* 'Bootstrap' financing does not usually permit the entrepreneur the luxury of hiring a large management team. The company must get what it can from the existing staff with everyone 'mucking-in'.

6. *Control growth*. Because capital is limited to cash flow, the firm cannot afford to allow expansion to get out of control. 'Live within your means' is the rule.
7. *Focus on cash flow.* 'Cash is king' as this feeds any growth.
8. *Cultivate banks early.* Learn how to deal with bankers and learn what they will want before you need them.

In developing the team, the entrepreneur must provide vision and motivation as the inspired leader of the new venture. Any new members should share this vision and purpose. Their motivation and passion for the new venture is important to their ability to eventually assume responsibility from the original owner-manager as the enterprise grows. The selection of team members is a difficult process for many small business owners who lack sufficient money to hire well-qualified and experienced managers. Instead they usually find themselves having to educate and develop their own people with a 'bootstrap' approach to human resource development.

The new venture is usually created in an environment of ambiguity and uncertainty. The exogenous forces that are frequently beyond the control of the entrepreneur and their team create market and financial constraints. How well the entrepreneur manages to balance these elements is important to overall success.

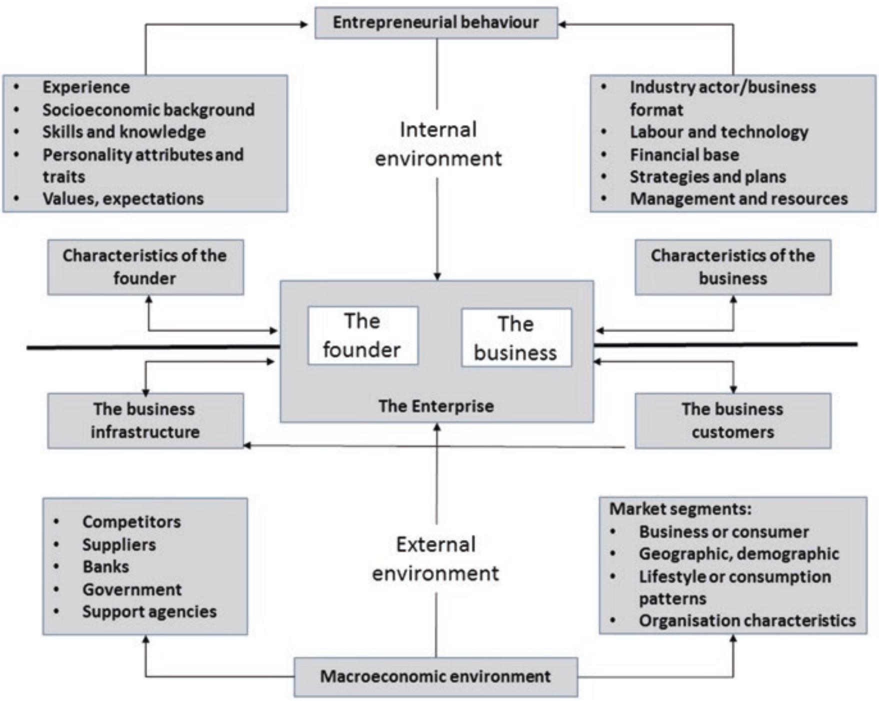

Fig. 2.6 Framework for new venture creation process
Source: Watson et al. (1998)

Watson, Hoarth-Scott, and Wilson (1998) have examined the small business start-up process and developed an analytical framework designed to illustrate the way this process works. Figure 2.6 shows this framework, which considers both the internal and external environmental perspectives, as well as the characteristics of the founder and the firm. This framework recognises that the new venture (enterprise) is a creation of the interaction between the owner-manager's characteristics and those of the business. How successful a new venture might be is likely to depend on the way in which these various factors interact.

2.11 The Stages of Small Business Start-Up

The key elements of the start-up process involve the entrepreneur's initial motivation to found the new business venture. This frequently emerges as a raw idea that may exist within the individual's consciousness for periods of years prior to a determined commitment to launching the business. The idea must first be validated through the individual testing their concept against the hard reality of the market place. Many individuals cannot move beyond this first stage as they find it too hard to bring all the necessary elements together to see the new venture created. Support agencies seeking to assist small business start-ups often place a heavy emphasis on the formal business plan. However, as noted above, most successful enterprise start-ups do not involve formal plan preparation.

In fact, forcing entrepreneurs to prepare formal written business plans prior to start-up might only impede their progress. Research into the foundation of micro-enterprises suggests that the majority of such start-ups undertake little formal business planning and associated market research prior to launch (Greenbank, 2000). Such firms engage in an incremental start-up process that involves gradually testing their ideas and building upon past experiences via informal channels.

Most owner-managers are unsure of what they are planning for and are likely to find following any formal plan overly restrictive. It is often more important that owner-managers be flexible and willing to adapt their operations to suit the conditions they encounter within their chosen markets. Until they have more experience of what they are seeking to achieve and where they wish to take their business, formal business planning is likely to be difficult to undertake with any confidence.

Once the venture has been launched, the entrepreneur will need to identify and marshal resources. If money or people are involved, the entrepreneur may be required to prepare a formal business plan. The key issues for consideration by a new business venture include:

- Does the entrepreneur have the required capability or experience to launch the business?
- Why should anyone buy your product or service?
- What increases the entrepreneur's chances of success, and what gives him/her a competitive edge or a unique selling proposition (USP)?
- Can the entrepreneur run the business by himself/herself?

- Can the entrepreneur raise the initial capital?
- Will the business yield an acceptable return?
- Does the entrepreneur want to do it?
- Does the business have a future?

The main stages of small business start-up are show in Fig. 2.7. It can be seen that the nascent entrepreneur must first acquire the motivation to start. Their raw idea then needs to be validated, usually through some process of market research or feasibility analysis. The identification of resources is then required and if these cannot be found, the idea may need to be reconsidered. In the formation of the new venture, the owner-manager will need to negotiate with others to secure the resources they need (beg, borrow, befriend). Once all the necessary resources for initial start-up are assembled, the business will be launched leading either to success or to failure (Gibb & Ritchie, 1990).

For many people, acquiring the motivation to start a new business venture may be triggered by events beyond their control. A distinction has been drawn between 'opportunity' and 'necessity' entrepreneurs, the former being those that are motivated by a desire to follow a market opportunity, while the latter are those who are forced into small business out of necessity (Acs, Arenius, Hay, & Minniti, 2004). Validating the idea may take considerable time and may involve market testing, the development of prototype products, and undertaking the design of business models to allow the idea to launch. The more complex or innovative the business idea, the more time it may take between the emergence of the initial idea, its validation and resource acquisition.

The success of a new business start-up is likely to depend on the ability of the owner-manager to combine their personal motivation and determination with a

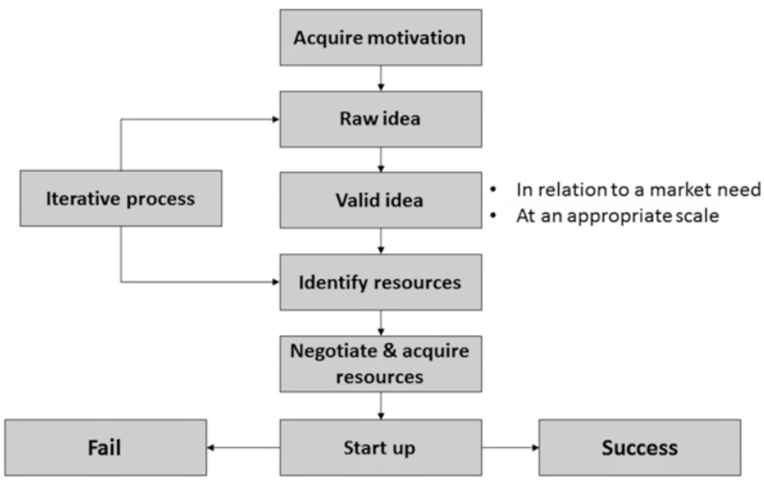

Fig. 2.7 The small business start-up process
Source: Gibb and Ritchie (1990)

well-considered idea that has been validated by a rational assessment of its likely potential in the market. Added to this will be the owner-manager's ability to secure the necessary resources, e.g. premises, plant, material and labour, and their ability to manage the venture once it has commence trading (Gibb & Ritchie, 1990).

2.12 Success and Failure in Small Business Start-Ups

Many small firms launch without the owner-manager undertaking adequate market research or feasibility assessment. Too many also lack adequate capital and fail to retain control over their cash flow (Lussier, 1995). The lack of suitable motivation and commitment, poor cash flow, lack of profitability and personal problems experienced by the owner-manager(s) are likely to be the greatest cause of small firms being abandoned during the start-up phase (Watson et al., 1998).

Surviving the first few years in small business requires the owner to keep a close eye on their operating costs. Prices should be set at a level that allows a decent profit margin. It is also important for the owner-manager to establish some key performance indicators to monitor business performance, and to set clear and achievable goals. The owner should also try to identify what works and what doesn't, and then ensure that they keep applying the successful lessons.

The Main Causes of Small Business Failure

- Underestimating the time required to bring the business to the point of break-even.
- Undercapitalisation of the business, particularly a lack of working capital to fund growth.
- Overestimation of the size of potential markets or sales growth.
- Lack of management/marketing skills by the owners.
- No unique selling proposition or point of differentiation forcing the venture to compete on price instead of value-adding.
- Low profitability caused by confusing high sales/turnover with high profit margins.
- Failing to retain profits in the business to fund future growth.
- Recruitment of the wrong people within the start-up team.
- Poor or inappropriate business location selection.
- Failing to monitor the business performance, particularly cash flow and profitability.

Many factors can contribute to the success or failure of a new business start-up. These can include the characteristics of the owner-manager (such as their personality or temperament), goals for starting the venture, skills, and decision-making abilities. Age experience and education levels might also play a role. The nature of the industry into which the new business is being launched can also be relevant. For example, the level of competition, market saturation and capacity for profit generation.

The strategic decision-making of the owner-manager and his/her ability to forge alliances with others may also contribute to success or failure. Finally, there are the resources that the owner can marshal and how well these resources can be configured within the business to generate products at competitive prices (Chrisman, Bauerschmidt, & Hofer, 1998).

2.13 Barriers and Triggers to Business Start-Up

Research into the triggers and barriers to new venture creation has found a series of ‘trigger’ and ‘barrier’ factors likely to influence individuals to either proceed with or abandon a new venture project (Volery, Mazzarol, Doss, & Thein, 1997).

Key trigger factors appear to include:

- the desire to invest;
- the creativity drive;
- the desire for autonomy;
- the desire to increase status within the community;
- the pursuit of a market opportunity; and
- the desire to earn more money.

Key barrier factors found were, including:

- the lack of start-up resources;
- compliance costs including the lack of suitable labour; and
- the hard reality of high risk and uncertainty.

An examination of the differences between those who had started new ventures and those who had taken steps to launch but then abandoned the idea found that both groups viewed the importance of these key factors in a similar way. For example, successful starters were just as likely to place importance weightings on some trigger factors as non-starters, and both starters and non-starters rated the factor creativity, i.e. the desire to create something new to use one’s talents and follow a dream, as being of greater importance to their decision-making than the other eight factors.

The key trigger factors of autonomy, i.e. the desire to be your own boss and work at a location of your choice), and money, i.e. to be able to earn more money and keep the proceeds of hard work, ranked in second place. The key factors of hard reality, i.e. the task is too difficult or the risks are greater than expected, and market opportunity, i.e. the pursuit of market opportunities and positive economic indicators, ranked joint thirds.

Of less importance was the trigger invest, i.e. to invest savings, superannuation, or redundancy payments, and the barrier factors lack of resources, i.e. lack of marketing, managerial or financial skills, or lack of information and difficulties securing finance or premises, and compliance costs, i.e. high taxes and fees, and government regulations. The trigger factor status, i.e. increase my status or prestige, ended up in last place (Volery et al., 1997).

Further analysis of this model has indicated that gender (i.e. women were found to more likely to abandon small business start-up plans than men), previous employment experience, and recent redundancy (i.e. government workers and those recently retrenched were more likely to abandon start-up plans) were all potential differentiators between starters and non-starters. However, the desire to create was the main differentiator between the successful and non-successful small business starters (Mazzarol, Volery, Doss, & Thein, 2001). Having a strong desire or passion to realise a dream, and to follow it through against potential obstacles, appears to be critical to successful small business creation.

While the external environment cannot be discounted, the findings of this research suggest that the personality of the entrepreneur may play an essential role in the start-up process. Those who effectively set up a new business venture are those who have an overriding drive to create. Both starters and non-starters appear to face similar types of barriers. Some non-starters did all the ‘right things’ to successfully launch a new business venture, that is, they saved money, drafted a business plan, and sought the advice of government agencies. However, they abandoned the idea to start because they lacked the passion to carry out their entrepreneurial dream.

Nurturing the creativity and passion of nascent entrepreneurs could therefore sustain the process of entrepreneurship, hence inducing a boost in business start-ups. This finding has important implications for small business assistance bureaus, industry policy-making and the entrepreneurs’ community. Indeed, a lot of government resources have been directed toward small business starters in terms of financial aids or advice. Most of these resources have been successfully used in building so-called ‘hard skills’, such as financial and business planning. However, it appears from this research that ‘soft skills’ such as networking and mentoring would also be of great use to owner-managers to help make their dreams come reality (Mazzarol et al., 2001).

These trigger and barrier factors have been examined in other cultures. For example, a study of 145 retired military officers from the Singapore armed forces using the same factors found that would-be entrepreneurs are motivated to start a business due to a combination of intrinsic and extrinsic rewards, plus a desire for autonomy and independence. However, key barriers likely to stop them from launching a venture included: the lack of financial capital, the lack of management skills, the lack of confidence, compliance costs, and the hard reality of getting a new venture off the ground (Choo & Wong, 2006).

As (Low & MacMillan, 1988) remarked, opportunities are created as a product of ongoing networks of relationships and exchanges. Opportunities come most frequently to people located at advantageous positions within networks. Furthermore, exploiting an opportunity requires certain resources, e.g. capital, information, and advice. Nascent entrepreneurs are therefore advised to evaluate and map their current networks. A mentors and social network have been the subject of both extensive behavioural science theory and research. However, the impact of these acculturation processes on the development of new business ventures has received less research attention and remains worthy of further investigation.

2.14 Case Studies of Small Business Starters and Non-starters

To better understand the situation facing individuals seeking to launch a new small business venture, the following case studies are provided from Western Australians who were interviewed as part of a research study into the start-up process (Mazzarol et al., 2001). Three of the cases involve people who successfully launched their business and were within their first 12 months of trading at the time of interview. The other two cases deal with people who had given serious consideration to launching a new venture, but abandoned the idea for various reasons.

2.14.1 Starter Case Study 1 – Ian, Graphic Designer

Ian was only 23 at the time of interview and had established his own graphic design enterprise after being made redundant 2 years earlier. He took advantage of the Australian Federal Government's New Enterprise Initiative Scheme (NEIS) to go into business for himself. The NEIS scheme assists eligible unemployed people to start a business venture by providing income support, business skills training, and start-up mentoring. Ian had no background in graphic design but that did not stop him. When asked about the main triggers for starting this business, Ian said:

> I have always loved creating things. I have always loved art. I was always drawing at school, and when I was made redundant, I thought about starting my own business. I was unemployed for a short period of time and thought about it. I was actually going to start picture framing first, and then I realised I did not really want to do that. If I was going to set up my own business, I wanted something that I enjoyed doing.
>
> The NEIS was very helpful: I have learned so much through this scheme…You don't need to start another job 'after hours,' and you can concentrate on running and improving your own business. Now the business is paying for itself.

Asked about barriers, Ian said:

> What I did was to buy a computer and I [taught] myself how to do it. I just use my own imagination; I don't have rules that I go by. It took me a while to learn it, and I was trying to earn money at the same time as I was learning, so there were a lot of mistakes.

Ian's case is typical of someone who overcame a lack of resources and skills. His desire to achieve his goal was so powerful that he found ways to overcome such impediments. Clearly, Ian gained substantial benefit from the NEIS support scheme. This highlights the importance of government and non-government support agencies in assisting entrepreneurs with both the foundation and development of their ventures.

It should be noted that Ian was able to overcome many apparent barriers to the successful foundation of his new venture by adapting and learning. As we observed earlier, the entrepreneurial person is creative, driven and determined, and they will overcome substantial obstacles to follow their passions.

2.14.2 2.14.2. Starter Case Study 2 – Luke, Education Software Consultant

Luke successfully started his own business developing and consulting on educational software approximately a year prior to the interview. The main reason he started the business was to make money, but the idea for this original business came to him a substantial period of time *prior* to the actual launch. Luke had been employed at a local college as a computer support officer, however he thought that he would prefer to work in the area of this business idea. He hoped to do this by combining some consulting with another full-time job.

Luke soon decided that it had to be one or the other, not both. He approached a contact who had several existing businesses and explored the possibility of this contact investing in his idea. They discussed in 'general terms' the potential for the business and made some wild 'guestimates' as to how much it would cost and return, rather than consulting an accountant or seeking other professional advice prior to starting.

Luke described the overall process as 'fairly smooth'. The main barrier had been obtaining the finance from his business partner. Furthermore, after visiting a small business assistance bureau, he was critical of the impression they gave: namely that he should have 'a concrete idea or don't bother coming'. He wanted someone to assist him to 'tease out' what he was interested in. He felt that small business assistance bureaus needed to provide this type of service in order to 'get solutions for small business', rather than only focusing on small business management.

This case highlights the time it can take an entrepreneur to consider and refine their business idea before actually launching it. Planning in the pre-launch stages can take years and frequently involves them talking it over with people they trust or with people they feel can offer useful advice. Small business support agencies and accountants are common points of contact for nascent entrepreneurs. However, as in the case of Luke, many small businesses are launched with little or no professional advice.

Luke's comments highlight a common problem with many small business advisory services – the heavy emphasis on formal planning. As Luke found, there is a tendency for many small business advisers, bankers and accountants to seek concrete ideas with financial forecasts and market research evidence. While such planning is desirable, it is unlikely to be what the nascent entrepreneur is capable of. Most need to talk about their ideas repeatedly until a clear vision of the concept is fully developed in their mind. Once they have such a clear vision, they can then proceed with confidence to start up.

2.14.3 2.14.3. Starter Case Study 3 – Geoff, Sports Equipment Manufacturer

Geoff and his wife successfully started a business that later collapsed. Before they started the business, both were unemployed. They were both bored of staying at home, both 'wanted something more' for themselves to do, and wondered what they could do with their time. They had an idea to make and sell a particular type of sporting merchandise. The couple contacted various professional sports teams and got a positive response for their idea. They also 'lined up' some clients or customers who were sports merchandise retailers and wholesalers. However, none of the banks they approached would lend to them unless they were 'already making money'. So, they used their own money to purchase the equipment and materials necessary to produce the sports merchandise.

Geoff and his wife began selling a limited range of the products after sports games and at local markets. Soon they had orders backed up and 'couldn't produce on the scale that was demanded'. Unfortunately, they had spent their remaining capital and couldn't purchase the materials to manufacture any more of the products. They again tried to raise additional financial capital – this time from the various sports teams and their sponsors. Although the consensus from such investors was that the idea was excellent and very marketable, they couldn't find anyone willing to lend further capital until the idea had proved itself by making large profits. This lack of capital was the main reason that Geoff and his wife had to shut their business down. They finally had to stop operating to cut their losses.

This case highlights the plight of the entrepreneur in the critical early years of a new venture. These survival years are where many firms fail. Most of these businesses don't go bankrupt; their owners simply decide to close the business because either they found too many difficulties, or because they decided it was not what they wanted to do. As with Geoff and his wife, a lack of adequate start-up capital and ready access to markets can be a source of failure. The entrepreneur must recognise that a business is not fully established until it is generating a good income for the owners and is financially sound.

2.14.4 Non-starter Case Study 1 – Helen, Marketing Officer

When interviewed, Helen was a professional woman who was working full-time in the marketing department of a large insurance company. She had been thinking of starting her own business for many years:

Being in marketing, you are always approached with new ideas and you've got ideas yourself, and your mind is always working away looking at opportunities in the marketplace.

She had already asked a few important people about her idea, and had gathered some information to see if it was a viable project. Helen believed that a business launch must be thoroughly planned, and therefore enrolled in a course on starting up a business. However, Helen soon thereafter had a baby which forced her to postpone her plan to launch her own business. Helen felt that the original trigger came from her family's background in small business. However, as she explained:

> Working in marketing and having made great proposals, and then for whatever reasons seeing these proposals rejected, is very frustrating when you believe in something. I think the reasons for being your own boss and not having to go through those lines is very tempting. … The most important trigger is … grabbing the idea, taking the opportunity that arises, and actually being able to do something about it without being [told] there is no [founding] for it and the timing is not right. You know that the door is closing and you can't open it again, but the management you are working [with] at the present time is not reacting.

Helen's case is typical of many professional people who become disillusioned with working for others and feel that they could do better on their own. Well educated and with good skills, Helen should have been well placed to start her own business. Her decision not to proceed was influenced by the birth of her child. As with many women, the conflicting needs of motherhood and career served to force a critical decision on Helen at that stage of her life.

2.14.5 Non-starter Case Study 2 – Michael, Specialist Health Services for the Elderly

Michael was still employed full-time and had not been able to get his business – specialist health services for the elderly – going by the time the interview took place. The main reason why he hadn't been able to start the business he described as 'psychological'; explaining that he needed the 'right partner, someone who would help spur him on'. He felt he did not have the confidence to do it himself and had tried once before with the same business concept elsewhere, but had failed for this same reason. He called himself a 'scared cat' and definitely didn't want to start a business alone.

Michael had done some market research, targeting a particular geographical area which did not have similar services available. He felt that the area was a 'booming market' for elderly services because of its demographic profile. He had spoken to people within the industry to see if the business would be viable and they were 'keen' and felt the service was 'needed'. Despite this market research and the validation of his idea, he remained reluctant to launch the business. Michael expressed a continuing interest in starting the business but felt it would be important to do more marketing that was 'comprehensive' as well as establish a business premises in the area – aside from, of course, having a partner to work with.

The case of Michael highlights the importance within the entrepreneurial character of a need for autonomy and a willingness to take a calculated risk. In Michael's case, he demonstrated the ability to generate a potentially good business concept, and had even undertaken market research and commenced planning. However, as he himself pointed out, he needed support to get the idea launched. If Michael had been able to find a partner with whom to share the risk and responsibility, it is likely that he would have launched the new venture.

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3 Surviving the Early Years

3.1 Introduction

> As noted, the first three years constitute a crucial period in the development of the small business since a vast majority fail and disappear during that period. This high failure rate has been associated with poor management. (Alpander, Carter, & Forsgren, 1990, p. 17).

This chapter examines the challenges facing small firms in their early years, and examines how best to screen new venture opportunities. The foundation of a small business is usually a personal decision by the owner-manager or managers who have decided to undertake the challenge and assume the risks associated with launching a new venture. A major factor that appears to motivate the formation of small firms is their owner-manager's desire to create new opportunities and pursue their dreams. The ability of a new small business to survive its early years is likely to depend on how well prepared the owners are and how well they research their prospective markets. In this chapter we explore the factors likely to adversely impact on new ventures. We also look at the research and screening tasks required to determine the attractiveness of various business opportunities.

3.2 Assessing Opportunities

It will be recalled from Chap. 2 that the three-step entrepreneurial implementation process involves the recognition of opportunity, the marshalling of necessary resources, and the development of capability.

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For example, … An opportunity has the qualities of being attractive, durable, and timely and is anchored in a product or service, which creates or adds value for its buyer or end user (Timmons, 1999, p. 80).

The creative tendencies that appear to define enterprising behaviour are closely associated with the ability of entrepreneurs to recognise opportunities. Many small firms find it hard to assess strategic options. They either lack information or they are too optimistic about the opportunity. Small business owner-managers as a general rule are optimistic and frequently find ways to achieve their goals, even when more 'rational' heads, e.g. bankers and accountants, are warning caution.

Common Problems in Small Business Strategy Evaluation

- Lack of market analysis.
- Overestimating the impact of marketing efforts.
- Underestimating the capabilities of competitors.
- Limited consideration of the pros and cons of strategic options.
- Little analysis of the cross-effects between products and markets.
- Problems of conflicting opinions.
- Lack of matching resources to support strategy.
- Insufficient and superficial financial analysis.
- SWAG – or 'scientific wild arse guessing'.

A common problem for many small business owner-managers in assessing the merits of a particular opportunity is the lack of market analysis. This is usually due to their inexperience in making such assessments, or their lack of resources or skill in collecting information. Furthermore, they have a tendency to be more reactive and lacking in long range strategic thinking (Pelham & Clayson, 1988).

Other problems stem from the owner-manager either overestimating the impact of their marketing efforts, or underestimating the capabilities of competitors. In the first case, the impact of advertising and other promotions frequently has a lagged effect. It requires a significant up-front investment for subsequent returns. The development of a well-known brand is one of the most important things that small firms can seek to achieve, however such brand equity may take between 5 and 10 years to generate. Overly-optimistic sales forecasts can result from this type of analysis, which can in turn lead to shortfalls in cash flow and profits.

Second, and in a similar manner, the firm that seeks to enter new markets may find the reaction from competitors unpredictable and surprising. Larger competitors frequently react swiftly to shut down emerging competition. A common reaction in Australia is the introduction of immediate price reductions coupled with aggressive selling and promotion. Although price wars are usually only won by the customer, the impact of an unexpected – and significant – price cut by competitors can have a devastating impact on a small firm's cash flows.

Even if the owner-manager is able to second guess their competition effectively, they may not adequately consider all the pros and cons of the various strategic options available to them. Large firms, in contrast, have relatively sophisticated screening processes that employ financial ratios such as return on investment (ROI), net present value (NPV) and return on capital employed (ROCE). Such sophistication will usually include the likelihood of potential cannibalisation of products or markets should the new venture succeed. This type of detailed financial and market analysis is the basis of any effective business plan. And it is usually not undertaken by small business owner-managers.

Small business owner-managers frequently make decisions based on their intuition. This has been described somewhat crudely as 'scientific wild arse guessing' (SWAG). A SWAG approach to opportunity assessment can have a 50/50 chance of success, and the odds may even be higher if the owner-manager is experienced in a particular market or market segment. However, the majority of small business owner-managers are limited in their resources. As such, they must be careful how they allocate their money, time and people. If they do not match their strategy with their resources, they can suffer inefficiency, poor performance and potential failure.

3.3 A Systematic Scanning and Building Process

Two main issues can be identified here: the lack of appropriate tools to assess the value of an opportunity very early in the process; and the difficulty for the potential entrepreneur to take into account the existing forces on the market and their future reaction to the creation. In the case of a creation based on an innovation, Santi, Reboud, Gasiglia, and Sabouret (2003) have proposed a three-step process avoiding these issues. Figure 3.1 illustrates the underlying concepts behind this approach. The revenue (rent) coming from the innovation is based on three components: the volume (annual sales due to the innovation), the rate of profit (thanks to the innovation) that can be expected, and the length of the innovation's anticipated lifecycle (time were the innovation exists in the market). The total rent obtained thanks to the innovation is the product of the three elements.

To assess the potential value of a future investment in either the creation of a new product or service or in the foundation of a new business venture, it is necessary to assess the future rent that might be generated from the innovation or invention over time. However, it is of paramount importance to at least have an idea of the forces that are likely to have a negative impact on the innovation. These external forces are threats that will work to erode away the rent that can be obtained from the investment.

What these external threats might be can vary depending on the nature of the innovation/invention/venture that is being launched, how quickly it can be adopted by customers, and how quickly competitors can copy it or find substitutes. Each

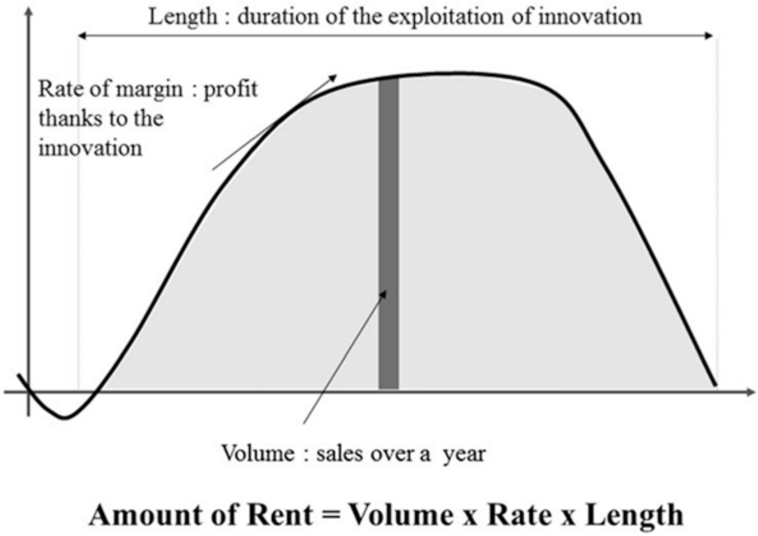

Fig. 3.1 The components of the rent model
Source: Mazzarol and Reboud (2009)

market segment into which a new product or service is launched will have different degrees of competition. In general, the larger the market diffusion and number of potential customers being targeted, the greater the potential competition is likely to be.

Assessing the merits of a future innovation therefore requires three steps:

1. First, the potential rent of the activity needs to be assessed depending on the size of the market addressed and its possible segmentation.
2. Second, an analysis should be undertaken of the Porterian[1] actors for this market and their bargaining power (e.g. suppliers, customers, complementary actors such as joint venture partners, banks), as well as of the Porterian threats (e.g. new entrants, substitute products, regulations). This will give the residual rent.
3. Third, an assessment should be made of the potential reaction of any existing competitors, and the need for more resources to create the business venture or new product development (NPD) and marketing team needed to fully commercialise the innovation. This analysis will then provide a better foundation for determining the likely rent return that might be extracted from future investment in the innovation.

[1] For Porter (1979, 1980) the competition on a market is shaped by the power of five forces: suppliers, customers, potential entrants, substitute products and the rivalry between the competitors of the market. Two additional forces have been added later: the regulation authorities and the complementors.

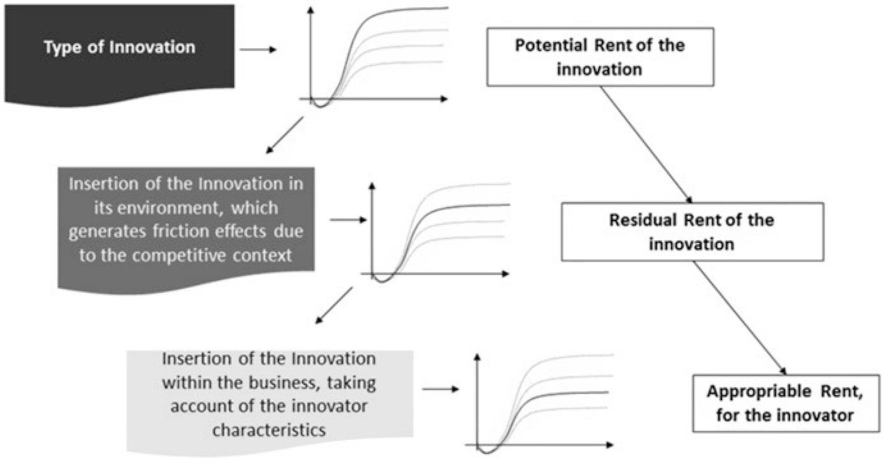

Fig. 3.2 The gradual erosion of the rent
Source: Santi et al. (2003)

It is worth noting that the real value of the opportunity is the appropriable rent, not the potential rent. This concept is illustrated in Fig. 3.2 where it can be seen that the type of innovation being considered for future investment will have an initial rent potential based on its anticipated volume, rate and length. However, once the second step of examining the Porterian forces and their likely impact on its success within its target markets is complete, it will see much of this initial potential rent eroded. This residual rent can then be assessed in step three against likely competitor reaction and against the availability of resources to take the idea forward. This final assessment will determine the final appropriable rent that the innovation can return.

While this process may appear complex at first glance, it is actually quite a simple process and need not involve sophisticated or complex financial modelling. The following are some key questions and issues that should be addressed when considering a new innovation/invention or venture.

3.3.1 Assessing the Potential Rent

You should look at how unique your idea is and whether or not it seeks to create an entirely new product and market or simply substitutes for existing products and markets. This is important because the more radical it is, the riskier the venture can be. If you are successful with a new idea that creates a new market (e.g. Facebook), you can potentially make a significant amount of money. Yet such ideas are typically very difficult to get commercialised.

If you are considering an innovation idea that only improves but does not replace existing products and markets, you should still assess two things. First, will it be easy for customers to quickly adopt it because it integrates into their existing technologies or lifestyles? Second, does it substitute or try to substitute an established standard or practice? Depending on how much it seeks to change/challenge the existing *status quo*, the more risk your idea will face.

To assess the potential volume of sales from this innovation, consider how large your future market or markets might be and how many units of your product or service will be sold in the first 2–3 years. Any future business venture should be assessed in terms of the potential sales that might be expected in the early years. Be realistic about this and don't fool yourself that, just because you and a few close friends or family support your idea, it will be easy to sell your product to everyone.

To estimate the rate of profit from your idea, consider whether you can launch and fully commercialise the product or business venture alone, or whether you need others. You may need to partner with customers and suppliers, or you may need support from joint venture partners, R&D centres and other third parties known as complementary actors. For example, if you have to sell via a wholesaler or retailer, or pay an agent to distribute your products, this can erode the amount of profit that you might otherwise earn.

To estimate the length of the lifecycle of your innovation, you should consider how easily the customer can switch to an alternative supplier, or how easy it might be for competitors to copy your idea. You can protect yourself from this by formally registering your designs, trademarks or patents (if applicable). Also, you can enter into legal agreements to supply exclusively for a period of time. The development of a brand name for your business and its products can also be a means of locking out competition and the risk of customers switching. You should also look at your industry and at the potential customers, and determine how likely they are to remain loyal.

3.3.2 Assessing the Residual Rent

The potential rent from your innovation/invention/venture can be eroded by a range of forces, such as the bargaining power of customers and suppliers as well as threats from competitors and substitutes. You should look at how unique your product or service is likely to be and the readiness of the target customers to buy. A key issue here is what is called the *Customer Perceived Utility Value* (CPUV). This is a measure of how much the new product or innovation is seen by customers as offering benefits for the sacrifices that they must make in order to adopt it. This can be explained as:

CPUV = perceived benefits – perceived sacrifices

It should be noted that, where a customer is faced with a new product or service that is a ‘substitution innovation’ and replaces an existing product or service, they will generally be in strong position to evaluate its benefits against the cost of its purchase price and any disruption caused by them switching. This is not the case for more radical ‘creation innovations’ where they have no benchmarks to guide their assessment.

A key consideration when assessing the CPUV of your innovation or idea is to determine how transparent the benefits will be in the eyes of the customer. Perception of value is a process of trading off the price paid for the benefits gained (Sweeney & Soutar, 2001). If the customer can easily observe any features and benefits and then test or trial the product to verify the performance improvements before buying it, they are more likely to purchase it. Also, of importance is how much risk the customer may feel is involved in the purchase decision.

Figure 3.3 illustrates the likely scenarios facing a new idea or innovation when the CPUV is evaluated. As can be seen, the best option is for there to be strong perceived benefits and low perceived sacrifices. This will offer a *Maximum* scenario, and generally should lead to a high sales volume. However, if the perceived sacrifices are high but the benefits are low, the outcome is a *No Way* result and future investment may not be worth it. The *Wet Firecracker* scenario is where both the perceived sacrifice and benefits are low, but in effect it is a situation in which few will really care and future adoption is likely to be low. Finally, there is the *Fall in Love* scenario. Here both the perceived benefits and sacrifices are strong. A customer will need to fall in love with the product to overcome the sacrifices. It is a difficult environment to sell into and an option SMEs should avoid as it is risky and will require significant marketing effort.

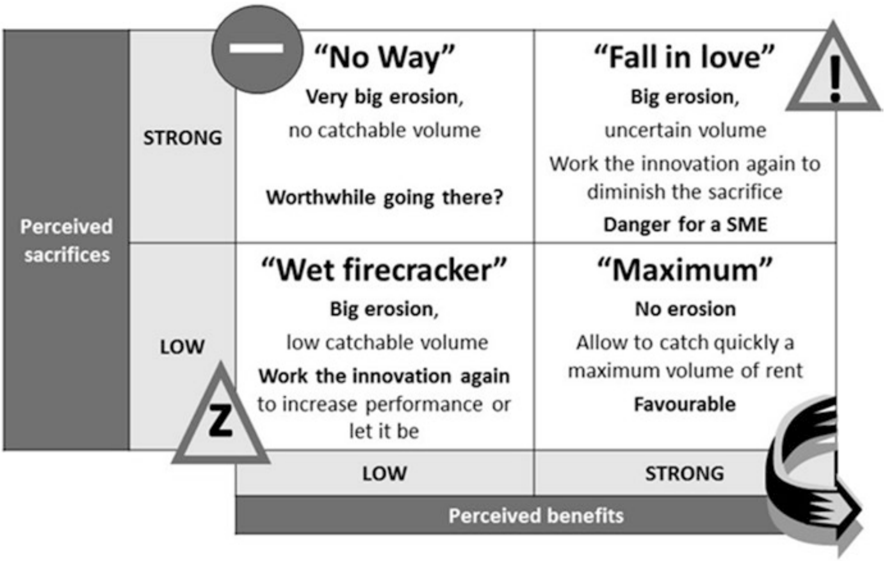

Fig. 3.3 CPUV and erosion effects on volume of rent
Source: Reboud and Santi (2003)

The power of customers and suppliers to negotiate prices and conditions is also something that should be considered. Many small firms are dependent on a few lead customers or key suppliers for their business. This can see them squeezed on margin and the profitability of their new products and services eroded. As noted above, where a small firm can secure its intellectual property rights via patents, trademarks and branding, the more likely it is that the bargaining power of customers and suppliers can be reduced.

In addition to considering the power of customers and suppliers, attention should also be given to the impact of government regulations or other barriers to market entry. Many good business ideas have been stymied by local governments not allowing the use of certain premises for some purposes, or by the inability of the business to secure the necessary licences and permits.

3.3.3 Assessing the Appropriable Rent

Once these influences on the potential and residual rent have been assessed, the final stage is to determine what the appropriable rent might be. Of particular importance is to consider how unique the new product or service will be within its chosen markets. It is also important to consider how strong any barriers that might block its sales volume might be. Where the idea is not unique, cannot be readily differentiated and the barriers to entry are high, there is unlikely to be any real business opportunity. However, where the product or service can be strongly differentiated and entry barriers are not so high as to shut out the new idea, there is likely to be opportunity. The ability to overcome existing market entry barriers and successfully deal with incumbent competitors is an integral part of any new business venture. Having a clearly differentiated product or service offering that can provide benefits to customers that outweigh any perceived sacrifices is crucial.

A key issue for small business start-ups and small firms seeking to launch new products or enter new markets is whether they possess the necessary resources and competencies to fully exploit the opportunity. There are usually many more opportunities available to the average small business owner or entrepreneur than they have the resources and time to chase. Many small business owners fail to exploit opportunities due to their lack of time, money, people and other resources. Just having a good idea does not guarantee that you will be successful. As we discuss in the following section, many small businesses fail due to a lack of resources – and a lack of the managerial competencies to make best use of what they already possess.

3.4 Causes of Small Business Success or Failure

In Chap. 2 the reasons for the failure of small business start-ups were identified as including: underestimation of the time required to get the business profitable, a lack of capital, poor location decisions, no unique selling proposition, and poor financial management. Lussier (1995) has examined the research evidence relating to the causes of small business start-up failure, and has identified 14 common problems:

1. *Capital.* New ventures that start up without adequate working capital are more likely to fail than those that are well funded. It is not essential for start-ups to have large inflows of venture capital or even bank financing. However, cultivating a relationship with the local banker is a sensible move. How much start-up capital is likely to be required will depend on the nature of the business? It is suggested that the owner estimate the costs of running the business and then double the number!
2. *Financial management.* A common reason for new venture failure is the lack of adequate financial controls and bookkeeping within the firm. Key bookkeeping tasks include cash flow monitoring in and out of the business. GST compliance – even if not required – is a good discipline, and forces the owner-manager to keep good records. Particular attention should be paid to overheads or fixed costs. These should be kept as low as possible.
3. *Industry experience.* While prior experience in a particular industry is not essential, start-ups managed by people with experience in that industry are more likely to survive than those managed by people without such experience. It is not essential that the owner-manager have full-time work experience in the industry, as often a hobby or interest can be converted into a successful business. However, the owner-manager should have a strong interest in the field.
4. *Management experience.* Again, although it is not essential for owner-managers to possess prior management experience before launching their new ventures, those with such experience are more likely to succeed. Owner-managers must be prepared to put in very long hours to ensure their new business succeeds.
5. *Planning.* The owner-manager that conducts some formal planning prior to launching their new venture is more likely to succeed. Such planning does not have to be highly complex. Knowing something about the market or potential customers, being aware of the key competitors, and identifying the firm's key competitive advantage are critical.
6. *Professional advisors.* The failure rate among small business start-ups is generally higher among firms that don't use professional advisors such as accountants. Professional assistance does not need to be costly, and government support agencies and small business development schemes are available.
7. *Education.* While many owner-managers without substantial formal education have succeeded, the evidence is that those with higher levels of education are more likely to succeed than those without. It is not necessary for the owner-manager to have all the education they need prior to starting, but it is desirable for them to be willing to undertake further education as required.
8. *Staffing.* One of the key causes of small business failure in the early years is an inability to recruit and retain suitable employees. It is unlikely that many employees will be required in the early years. However, when the firm begins to employ staff, care needs to be taken to select the best people for the job, and not just the cheapest.

9. *Product/service timing.* Those owner-managers who attempt to launch products or services into markets either too early or too late in the product lifecycle are more likely to fail.
10. *Economic timing.* The likelihood of failure is increased if the business starts-up during periods of economic recession.
11. *Age.* Those owner-managers who launch their firms at too young an age are more likely to fail than their more mature counterparts.
12. *Partners.* New ventures that are operated by a single owner-manager have been found to have a higher level of failure than those run by two or more people.
13. *Parents.* Owner-managers that have had parents with previous business experience may be more likely to succeed that those without.
14. *Marketing***.** New venture start-ups are more likely to succeed if their owner-managers possess marketing skills.

3.5 Opportunity Screening for New Ventures

Timmons (1999) highlights the importance of opportunity focus in the screening of new business opportunities. He provides a comprehensive list of considerations that should be addressed before a particular opportunity is followed. For many small business owner-managers, the absence of adequate resources to follow all their potential opportunities requires them to make decisions about which options provide the most effective return for their efforts. The more clarity their have in their overall vision and mission for their business, the more likely they will be able to remain focused. A lack of focus and direction can lead to strategic drift that may risk the owner-manager expending time, money and other resources for limited gain.

Many small businesses find themselves highly vulnerable to failure due to their owners not having given adequate attention to screening opportunities prior to launch. A common problem is under-pricing their products or services. This in-turn can lead to low profit margins. With inadequate margin, the business is likely to struggle financially. Getting into markets where the main point of competition is price-cutting is another trap for small business owners. Competing on price – particularly if profit margins are thin – is a sure way to get into difficulties. In considering new venture opportunities, the small business owner-manager should seek to avoid market segments that are highly price sensitive. Such markets should be tackled only if the owner-manager has undertaken a careful cost analysis and is confident that their business can make an adequate margin from the low prices.

Another reason many small firms become vulnerable is that they focus on highly-localised markets. If these markets are protected from substantial competition, the owner-manager can operate successfully. However, should the market become deregulated, the small business may suffer. This is a particular problem in rural Australia where cooperative retail stores that once operated in many country towns are now in decline as they face increasing pressure from large urban retail chains. This has also been the case for small subcontractors in industrial areas in France, where the tradition was to work exclusively with the same big contractor over long periods of time. However, when those big contractors had the opportunity to break these exclusivity agreements and choose the best price, they have in many cases shifted their subcontracts to overseas providers – including those in Asia.

Opportunity Screening for New Ventures

The following questions should be asked by owner-managers prior to launching a new business venture:

- Who is the new venture's customer?
- How does the customer make decisions about buying the product or service?
- To what degree is the product or service a compelling purchase for the customer?
- How will the product or service be priced?
- How will the venture reach all the identified customer segments?
- How much does it cost – in time and resources – to acquire
- a customer?
- How much does it cost to produce and deliver the product or service?
- How much does it cost to support a customer?
- How easy is it to retain a customer?

Source: Sahlman (1997).

The most likely successful start-ups are often found in market niches that have a relatively high level of uncertainty, but low capital and opportunity costs (Bhide, 2000). Unlike large firms that must frequently demonstrate high returns on investment before a new opportunity can be considered attractive, the small firm is often able to enter new market niches with significantly lower expectations (Harvard Management Update, 2000). Moreover, many large firms cannot easily access small interstices that remain available in the market for small firms (Penrose, 1959). This requires the small firm to focus either on a specific segment of the market or on a specific opportunity.

According to Sahlman (1997), there are nine key questions that any would-be entrepreneur should consider prior to starting up their new venture. These questions relate generally to the ability of the new venture to attract adequate customers to ensure its survival. The first question relates to a clear identification of who the customer or customers will be. Assessing market opportunities by undertaking adequate market research is an essential first step. Part of this analysis should be to find out how the potential customer actually makes decisions about buying this type of product or service. Knowing this will provide the owner-manager with an opportunity to target the customer's buying cycle adequately.

In determining whether the new opportunity is worthwhile, the owner-manager should evaluate the price sensitivity of the target market. As noted above, if the pricing structure is too low, the new venture will struggle to generate sufficient profits.

Critical to this analysis is establishing how much it will cost to produce the product or service and then to attract, support and retain a customer. Such analysis enables the new venture's gross profit margins and break-even points to be calculated. Opportunities with low gross profit and high break-even points are likely to be unattractive and risky.

Other questions that should be considered are the timing of cash flows into and out of the business. Critical here is the time it will take to secure payment from the customer and how this, in turn, affects the cash flow of the business. Many small firms experience severe cash flow problems that effectively force them out of business even when they are able to demonstrate reasonable profitability in terms of their product's pricing structure. Major capital costs such as equipment, shop fit out or even property purchases can place severe strain on a firm's early cash flow. It is important for the analysis of the business opportunity to consider having adequate working capital levels available (Sahlman, 1997).

In terms of competition, the new venture should be assessed in terms of how many and how strong the competitors may be. Conducting a SWOT analysis, i.e. **S**trengths, **W**eaknesses, **O**pportunities and **T**hreats, on the most likely competitors is recommended, with consideration of how strong these competitors are and whether they are able to control strategic resources that might make it difficult for the new venture to expand. For example, access by competitors to strategic real estate locations is a problem for many new firms.

The owner-manager should also make an assessment of how these competitors are likely to react once the new venture commences trading and begins eroding their market share. Many large competitors launch aggressive price competition responses to new market entrants. This can be highly damaging to new ventures that have low profit margins and limited working capital.

Small business owner-managers should consider the following questions *before* deciding to proceed with a new idea. Have they:

- conducted an analysis to assess the market demand?
- calculated the cost—in time and money—of marketing?
- fully assessed their competitor capabilities?
- exhausted other possible strategic options?
- examined the impact on their existing products/markets?
- addressed any dissenting voices within their firm?
- ensured their firm has the resources to achieve the task?
- fully costed the project and forecast cash flows?
- avoided making decisions using SWAG?[2]

The prospective owner-manager who devotes time to studying the business environment and seeking niches where unmet needs may be found, and who then creates appropriate product or services for such niches, is likely to enjoy enhanced success (Osborne, 1995). However, this must be backed up by a sound financial plan that

[2] SWAG – Scientific Wild Arse Guessing.

considers the level of funding required for the new venture and generates sufficient income to cover costs before it even generates dividends for the owner.

3.6 Start-Up Check List

Prior to commencing a new small business venture, consideration should be given to six important areas (Gibb & Ritchie, 1990):

1. the motivation and determination of the prospective owner-manager;
2. the business idea and its marketability;
3. the availability of resources;
4. the nascent entrepreneur's abilities and skills;
5. business planning; and
6. how the business will be administered.

Each of these six areas offers a useful screening process for the nascent entrepreneur, and each is dealt with in more detail below.

3.6.1 Motivation and Determination

The first of the six important areas from our 'start-up check list' to be considered prior to commencing a new small business venture is the motivation and determination of the prospective owner-manager. Drive and determination are characteristics commonly associated with entrepreneurs (Caird, 1993). Small business requires the owner-manager to possess more than average levels of motivation and determination in order to see the new venture succeed. An important question for the person seeking to enter small business is: 'Why are they going into business in the first place?'

Many people enter small business for the wrong reasons. For example, a retrenched middle level manager may consider starting their own business because they don't believe they can regain employment. While such people may succeed in their new ventures, this is not a particularly good reason to launch a new venture. People who have identified an opportunity and become highly passionate about seeing the idea develop are usually more successful at starting small businesses. Their intrinsic interest in the new business idea is often an essential ingredient in helping them to survive the tough times.

Another important consideration is the experience the potential owner-manager has in a particular industry or sector. Many would-be entrepreneurs launch successful new ventures without substantial experience in either business or their industry (Bhide, 2000). However, previous experience in business can be of significant value in enabling the small business to survive its early years. If the owner-manager lacks experience in either business or in their industry, they should quickly identify sources of assistance and advice. The owner-manager should also examine how much they know about the reality of operating the small business before launching.

This can be obtained, in some cases, from the former owners. It can also be obtained by spending time researching the industry.

Important Questions to Ask Before Launching a New Business Venture

- Why are you going into this particular business?
- What previous experience do you have?
- How much has been learnt by you about the business prior to start-up?
- Do you have family support for this venture?
- How will you live during the early years of the company's survival?

The level of support the small businessperson can expect from their family is also likely to be of importance to their future success. A small business is as much a social phenomenon as it is an economic one. Owners who have family support and encouragement are more likely to survive than those who don't have it. This can be of particular importance to women (Chea, 2003). Long hours, stress, financial risk and some periods of earning only limited income are all common experiences for small business owners in the early years. Such pressures can strain even the best family relationships. They has been defined as "stressors" by a wide study of entrepreneur's health conducted in France by the "AMAROK" group who has identified the dangers faced by many entrepreneurs who tend to overlook their health issues, putting their firm at risk (Torrès, 2013, 2016).

3.6.2 Evaluating the Idea and the Market

The second of the six important areas from our 'start-up check list' to be considered prior to commencing a new small business venture is the business idea and its marketability. Below we will look at: evaluating the business idea, evaluating the market for that idea, and then undertaking the appropriate market research to see if the idea is going to be viable.

3.6.2.1 Evaluating the Idea

The success of a new small business venture is likely to depend on its ability to attract customers and develop a steady volume of sales. In seeking to evaluate the merits of a particular business idea, the owner-manager must consider not just what their product or service is going to be, but also why it would be attractive to the market. Most successful new products fulfil customer needs, and have qualities or attributes that are sufficiently differentiated to offer a unique selling proposition (USP).

If a new business can offer added value, it can establish a USP that can be used to win new business. To assess what additional value a business might offer, market research should be undertaken to assess customer expectations, the competition, and niches that may be open for exploitation. Any product development and testing should be undertaken prior to launch. Suitable protection of intellectual property via patents or trademark registration should also be addressed.

3.6.2.2 Evaluating the Market

Most small businesses need to focus their attentions on niches within the market as they lack adequate resources to target all segments at once. As a general rule of thumb, the more saturated a market becomes, the more a business needs to seek niches where it can dominate or at least maintain its competitive edge (Porter, 1991). Segmentation of the market requires careful research in which the owner-manager seeks to identify where they make their most sales and/or obtain the best margins.

Assessing the Idea and the Market – Key Questions

- What is the product or service that you are seeking to sell?
- What specific needs does it meet in the target markets that are not being well met by other products or services?
- Has the product or service been adequately developed, tested and are its intellectual property rights being protected, e.g. via a patent, a registered design or copyright?
- Is the product or service ready to go to market?
- Do you have a clearly identified customer or customer group who have indicated a willingness to buy the product or service at a price that offers good profit margins?
- How many products can be sold in a given time period, and do your sales forecasts and profit margins allow your business to break-even quickly?
- How do you know that customers will buy in sufficient volume to justify your future investment in this business?
- Why will customers buy the product instead of alternatives from competitors?
- What competition do you face in your chosen target markets and what are the likely reactions of competitors when they see your product or service being sold?

Most businesses obtain around 80% of their sales from approximately 20% of their customers. Put another say, 20% of products generate 80% of sales (Koch, 1998). This 'Pareto principle' appears to hold true in most industries and means that the owner-manager can look for lucrative niches by segmenting markets. To do this, they need to conduct market research.

For example, the owner-manager of a restaurant made the following observations … My breakthrough was when I recognised, I had three distinct types of customer. I had breakfast clients, I had people who came in for quick and convenient lunches, and I had a steady stream of coffee and cake customers throughout the day. Looking at my sales records allowed me to work out the average income from each customer. But more importantly it helped me see what was most popular. I then put together a very simple customer attitude survey. This, together with ideas from my staff, helped me to decide what changes I needed to make to improve my café's appeal and my financial return with each type of customer. The results of this speak for themselves. (NatWest, 1999, p. 29).

3.6.2.3 Undertaking Market Research

Market research is an important aspect of screening new business opportunities. Unfortunately, many owner-managers fail to undertake even the most rudimentary market research prior to launching their business venture. A concern many have is that market research is complicated and costly, requiring the employment of expensive professional organisations. However, this is not the case and there is much market research that can be undertaken by the owner-manager alone and at minimal cost.

3.6.2.4 Determining Market Characteristics

An initial set of questions should be asked, including: how many customers are there, where are they, and what are their needs? Answering these questions will assist the owner-manager in determining the characteristics and overall size of the potential market. Depending on the market being targeted, these questions are likely to be answered using secondary sources or published documents. For example, government statistical agencies usually provide data that can be readily obtained, often via online sources, that provides high-quality data on a wide range of information that can be useful in estimating the size and structure of a market.

In Australia, the Australian Bureau of Statistics (ABS) is a ready source of such data. This includes the five-yearly census data can provide a highly accurate picture of the composition of a population in almost any area of Australia, with information as to age, gender, family size, income levels, education, ethnicity, occupation and type of housing. The ABS also generate a range of specialist reports on the trends and forecasts in geographic areas and industries. This is the same in France, where the *Institut National de la Statistique et des Études Économiques or* National Institute of Statistics and Economic Studies (INSEE) provides statistics and reports comparable to those provided by the ABS in Australia. In addition to these official statistical sources, the small business owner-manager can access reports produced by industry associations, government departments and private sector agencies. Many reports are accessible at little or no cost from websites.

3.6.2.5 Measuring Market Potential

For many small business owner-managers seeking to launch a new venture, another important question is whether or not the market segment they are targeting is likely to grow and by how much. Measuring the potential of a market is more difficult than simply describing it. And, the same data sources described above can be useful for this purpose. For example, image that you need to determine the likely future demand for a product that will appeal primarily to couples without dependent children. Examination of national census forecasts of future trends in the general population suggest that there will be a gradual increase in the proportion of childless couples over the next twenty years and a relative decline in families with dependent children (ABS, 2009).

3.6.2.6 Measuring Market Share

Owner-managers who already have an established business, or who are seeking to determine the level of competition they are facing, are likely to be interested in assessing the proportion of the market that they share with their key competitors. In some industries this is relatively easy. Real estate agents, for example, can make use of data provided by their local real estate institute that regularly reports sales by area as well as prices achieved.

Many industries collaborate over the collection of such sales data and share it via their respective associations or institutes. However, not all industries are so collaborative, and owner-managers may be forced to estimate market share via more indirect methods. This may be achieved by examining the number of firms competing in a given industry and looking at the size of their operations, the number of outlets, trucks or warehouses and trying to 'guestimate' the overall share that each firm has. In some cases, the owner may be able to gauge a reliable estimate by talking to key suppliers or customers that deal across an industry with all firms. Such suppliers and customers are well placed to estimate market share by examining their own purchases and sales volumes.

3.6.2.7 Sales Analysis

One of the most important considerations in market research is monitoring your own sales trends. Entry into a new market – or the launch of a new product – should be preceded by a sales forecast against which a budget can be developed. As the firm continues to trade into this market, the owner-manager should carefully monitor sales performance against the forecast. Of importance is not only the total volume of sales, but the general growth rates and trends. Are sales growing steadily or is the monthly growth rate slowing? Are there some products or market segments that are performing better than others? Monitoring such trends is likely to assist the owner-manager in taking corrective action early and avoid becoming caught in stagnant markets, or with unsold products or excessive inventory levels. Such market research can be done with internal company data alone.

3.6.2.8 Studies of Business Trends

The final area of importance within the context of market research is examining trends in the business or industry and seeking to determine which sectors have grown and why. In many cases, the owner-manager can obtain indications of such industry trends by accessing published reports such as those generated by the ABS or other government agencies. However, some of the most valuable information can come from primary sources in the form of data gathered directly from the market by the owner-manager. Customers and suppliers can provide valuable input, particularly if they are large national or international firms. Such organisations undertake their own market research and forecast trends.

Among the most valuable sources of industry trends is economic forecasting. Small business owner-managers can obtain economic forecasts and assessments from a variety of organisations. For example, local chambers of commerce and some government agencies maintain in-house economists who generate regular economic forecasts and distribute their reports to their members or to the general public. Most banks also employ economists who generate similar reports, usually incorporating forecasts and trends.

3.6.3 Assessing the Need for Resources

Another important area to be considered prior to commencing a new small business venture is to determine the availability of resources.

Factors Influencing Business Location Decisions

- *Nearness to markets* – e.g. access to customers, parking, public transportation, etc.
- *Competitor presence* – e.g. existing competition in the area.
- *Labour supply* – e.g. proximity of residential areas, wage levels, etc.
- *Government regulations and taxation* – e.g. local government zoning and rates.
- *Transportation services and costs* – e.g. proximity to airports, rail, road, sea freight terminals and networks.
- *Long-term development plans* – e.g. will there be sufficient space for future growth of the business over 3–5 years?
- *Availability of suppliers* and their ease of access to the business location.
- Personal preferences by owner-managers – e.g. proximity to home.

Source: Mazzarol and Choo (2003).

In determining the level of resources required for a new business venture, the owner-manager must consider how large the operation needs to be within its market. While the size of a new venture may be determined by the financial capacity of the founders, some firms – e.g. manufacturers – cannot be launched successfully if they do not have at least minimum economies of scale and scope. The owner-manager must establish clear parameters for the venture including:

- *Premises*. How large will these premises need to be, where will they be located and will they be purchased or leased?
- *Machinery***.** What equipment will be required immediately and, in the future, will it be purchased or leased, and what financial arrangements can be secured for this?
- *Stock*. How much stock will need to be kept in inventory, who will supply it, and what payment terms can be obtained from suppliers?
- *Transport*. If transport is required, should this service be contracted out or handled in-house? If in-house, the need for transport vehicles must be assessed.

- *People*. How many employees will the business require and where will suitable employees be found? The costs of employing people, e.g. wages, on-costs and training, and how they will be managed should also be considered.
- *Partners.* What kind of partners could help you to develop your business – technical centres, small business advisory services, universities, IP lawyers, or accountants? Or have you identified large customers who could help you to develop a new product?

The location of the business can be a critical decision for many types of small firms. For example, retailing is usually dependent on having access to passing traffic and customer parking. Good locations are likely to cost more, but could be well worth it. There are numerous options for business premises. Many start-ups are choosing to operate from home because they can keep overhead costs low. However, the type of business to be launched will determine what is required. Local government zoning regulations should be examined carefully *before* committing to a new venture. Such regulations can impose significant restrictions on the way a business operates.

If the new venture requires any specialist resources such as technical or managerial assistance, these should be identified. For example, a common need of small businesses is expert assistance with tax and financial management. The owner-manager should seek to appoint an accountant relatively early, and develop a productive relationship with this person.

Finding start-up capital will also need to be considered. Later we will look at this issue in detail. The majority of small firms are launched with bootstrap finance – which involves the use of the owner's personal savings – and seek to operate from cash flow and retained earnings. If a small firm seeks external capital, it will usually require either securing debt capital from a bank or securing equity capital from other sources. Both banks and venture capitalists will be more likely to loan or invest in a new venture if the owner-manager has assessed their market, calculated their resource requirements, forecast cash flows and developed a plan.

Few small businesses will be eligible for venture capital financing, and therefore most are forced to rely upon bootstrapping and debt funding via banks. Most banks will seek to secure any borrowing against collateral typically held in the form of personal assets such as land or other physical property. The family home is the source of collateral for many small business owners, which places the overall cost of a business failure significantly higher than might otherwise be the case. Manufacturing firms tend to require much greater capital investment than do service firms. However, manufacturing businesses also tend to experience much faster growth rates than service businesses. In the 1990s, high technology firms within the information technology sector grew at substantial rates, although the gloss was subsequently rubbed off these 'internet-based' firms in the early years of the twenty-first century as the technology bubble burst.

Despite the apparent focus on venture capital funded technology start-ups, the reality of how such fast growth businesses are funded is quite different. A study in the United States (US) of their fast growth Inc 500 companies found that 30% were founded with less than US$5000 in capital, and that only 8% actually sought venture capital. Such firms also had ownership structures that were evenly divided between the owner-founders and others (NCOE, 2001). Finally, the owner-manager should consider how the business is to be structured. This requires a decision over the firm's legal structure – e.g. sole trader, partnership or private company – and may be determined by the owner's circumstances. Incorporation is a somewhat more complex and expensive process than the other legal forms, but offers enhanced flexibility, growth potential and taxation benefits.

3.6.4 Assessing Personal Abilities

Also, to be considered prior to commencing a new small business venture is the abilities and skills of the nascent entrepreneur. The management of a small business requires the owner to be a 'jack of all trades', and to commit him or herself to long hours of frequently stressful work. It is difficult to provide a comprehensive picture of the exact set of personal abilities and skills required for successful small business management. However, the owner may benefit from having some previous experience in business or management (Olson & Bokor, 1995). As noted earlier, the owner-manager will need to consider the impact of launching the new venture on their family and their own personal health. Of importance will be their ability to identify a network of potential support to which they can turn in case they strike roadblocks or obstacles along the way (Chell, 2000).

It is to be encouraged that an owner-manager undertakes an honest self-assessment of his or her own skills and abilities. This is not designed to discourage them, but by conducting a personal SWOT analysis the emerging owner-manager can identify what their strengths and limitations honestly are. Small business management requires the owner to understand their operations in a holistic manner. For example, if they don't have good financial management or bookkeeping skills, they will need to seek either assistance or education.

Research undertaken into the relationship between small business start-up and personality – other personal characteristics – has proven inconclusive in identifying the 'best mix' of qualities an owner-manager should possess (Storey, 1994). In the US, highly successful start-up companies within the Inc 500 list are found to have owners with previous experience in the industry. At least half had some former management experience, and many had even suffered failure in previous ventures. Within this group, males tended to dominate females with around 93% of Inc 500 firms being male-owned (Sexton & Seale, 1997).

3.6.5 Planning and Teamwork

The fifth area to be considered is business planning. Planning the general direction of the new venture is critical to success, but the key point to remember is that it is the process of planning that is important and not the plan itself. Planning will be dealt with in greater detail in Chap. 4. It is sufficient to say that business plans should be viewed as a means to an end, and not an end in their own right. The best plans are simple and easily interpreted by whomever needs to use them. Most small businesses don't plan in a formal way. However, if they do plans, they will need plans for three key reasons:

1. To communicate their vision and mission to customers or suppliers.
2. To secure debt or equity financing from external parties.
3. To coordinate the activities internally of staff.

Each of these three types of planning purposes is likely to require a different emphasis. Of these three, the most important – for the long-term development of the business – is the third. Without being prescriptive, the majority of plans should consider cash flow, financial reporting (e.g. profit and loss, balance sheet), unit costs (for pricing and break-even analysis), and targets or objectives.

Most objectives should focus on the three key areas:

- *Money* – gross profit, variable and fixed costs, cash flow and working capital requirements.
- *Markets* – sales forecasts, break-even sales required, market share, customer needs, USPs (unique selling propositions of the firm and its products), and the marketing mix (product, price, promotion, place, people, process and physical evidence).
- *Management* – team building, systems (e.g. information technology), staffing requirements, and the management skills required as well as training and education.

According to Sexton and Seale (1997), the most common form of fast growth small firm found in the US Inc 500 is partnerships of approximately two to three people. Such ventures also quickly established a board of directors that served to guide the founding entrepreneurs, and involved a high proportion of external members. Even if the company did not have a formally constituted Board of Directors, it maintained an informal panel or board of key individuals to whom the owner-managers could turn for advice and guidance.

Team building becomes important as the small business owner seeks to develop their business. Owners must learn to delegate and pass over their knowledge and skills to their people via a process of mentoring, i.e. coaching, and training. They are unlikely to be able to enjoy the opportunity to find time to develop their business beyond a certain level if they cannot get the support of an effective team (Darling, 1990).

3.6.6 Assisting the Survival of the New Small Firm

The final area to be considered prior to commencing a new small business venture is the administration of the business. Whether a small business venture is founded from scratch or purchased as a going concern, the new owner-manager will face a difficult period in establishing their company and securing its long-term survival. Professional and government agencies seeking to help small business owner-managers survive their early years need to focus attention on four key areas:

- Foreseeable problems.
- Problems that cannot be easily foreseen.
- Problems arising from a lack of business systems.
- Inadequate strategic thinking (DUBS, 1995).

3.6.6.1 Foreseeable Problems

As outlined above, the owner-manager seeking to launch a new venture must give consideration to the feasibility of the idea and its likely acceptance in the market. Inadequate market research or assessment coupled with poor product quality or inappropriate pricing can be detrimental to the firm's survival. The owner-manager must also ensure that they have sufficient resources to successfully exploit their market opportunity. A common problem for small firms is to overtrade, e.g. take on too much work, and place an excessive burden on their limited human, physical and financial resources.

Financial stress is probably the most likely issue that must be overcome by firms in their early years. Unfortunately, too many small firms are founded with inadequate working capital and poor financial controls. If sales forecast or profit projections do not meet expectations, the business is likely to find itself in difficulties. Other common mistakes made by novice owner-managers include: under-pricing, poor cash flow management, and excessive drawings. The management style of the owner-manager should also be considered as this can have a significant influence on their firm's success (Alpander, Carter, & Forsgren, 1990).

Under-pricing of products or services is a common problem among small firms and is frequently attributed to the owner-manager wanting to secure sales quickly. However, although cheap prices attract customers, they can also create a situation in which the owner-manager is working harder and harder to service their growing list of contracts but making little real profit. Low prices usually result in low profit margins, leaving the owner-manager in the unenviable situation where they are turning over increasing sales but showing only modest retained earnings. Owner-managers should be cautioned against under-pricing, and their attention needs to be focused on gross profit, e.g. sales less cost of goods sold, and not sales turnover.

Cash flow management is another key area requiring early attention. Poor cash flow management can result in a situation in which the firm may have good sales growth but finds itself running out of cash. Timing the cycle between receipt of incoming payments from trade debtors and outgoing payments to trade creditors is crucial to ensure that the firm maintains its ability to cover its short-term liabilities.

Excessive drawings by the owner-manager remain a further problem that should be foreseeable. Most small firms are created as the primary means of income for their owners. It is therefore necessary that the owner-manager draw an income from the business in the form of wages or dividends. However, there are many owners who draw too much income from the business in order to fund a lifestyle. Such drawings – if excessive – weaken the firm's financial resources and can place the business into crisis if there is a sudden demand for cash.

Management problems facing novice owner-managers include a lack of technical competencies – particularly in such key areas as financial skills or marketing. For many owner-managers, the workload associated with launching a new business ventures can place strain upon their family life, undermining the vital support needed in this area. Small firms managed by partners or joint directors can become vulnerable to disputes between such individuals over strategy, rewards for effort, functions and management style.

3.6.6.2 Unforeseen Problems

In addition to those problems that should be foreseeable, the small firm must also focus on those problems that are less predictable. Some of these problems include downturns in the economy, customers or suppliers suddenly adjusting their contracts, government regulations being changed, shifts in the market and illness or accidents affecting the owner or their staff.

Realistically there is little that the average small business owner can do about economic swings or government policy changes. However, by careful monitoring and forecasting, they can better prepare themselves for such external shocks. Regular consultations with suppliers and customers can serve to provide early warning of future changes in demand or supply, and participation in industry networking groups can help the owner-manager be better informed of market trends (O'Keeffe, 1998).

Risk management strategies designed to prepare against accidents or illness can be developed in concert with external advisors. For example, the owner-manager can take out key-person insurance policies to provide for loss of earnings if they or members of their staff suffer accidents or illness. Maintaining adequate levels of fire and general insurance is also sensible.

3.6.6.3 Basic Systems Consolidation

A major weakness of small firms in the early stages of their lifecycle is their lack of managerial and administrative systems necessary for basic control and reporting. The most common areas for early attention are in the areas of: cash flow management and planning, sales and profit forecasting and budgeting, planning for liabilities (e.g. tax planning), and production control systems designed to monitor utilisation, wastage and rework rates and quality (Corner, 1998).

Additional systems are required to monitor sales trends and gather regular feedback from customers with respect to satisfaction and future requirements. Further, as the business grows in scale and scope, it is likely to require increasingly sophisticated systems of office and human resources management. Developing systems of this kind require the input of a wide range of experts, and it will be important for owner-managers to identify a well-qualified network of advisors upon whom they can call for assistance in implementing such systems. Helping small business owners to identify such an expert network is an important role that might be provided by small business support agencies (Kent, 1994).

3.6.6.4 Strategic Thinking for Survival

Finally, the most important assistance that can be given to a novice owner-manager is to assist them to think and act more strategically (Hitt, Ireland, Camp, & Sexton, 2001). This should not be confused with business planning, although the development of formal business plans may be an outcome. A common problem for small business owner-managers is that they are so consumed with daily survival and short-term crisis management that they lack adequate long-term focus and direction.

Owner-managers that take a strategic perspective generally shift away from such short-term orientation and begin to look more holistically at their business and where it is going. Issues that might be faced by the novice owner-manager include: diversifying their customer base so as to avoid becoming overly dependent on one large contract, and planning ahead to manage debt levels and secure access to future human and financial resources.

Owners need to 'blueprint' their future organisation, sketching out the size of its workforce and the type of people that will be needed to make it function. Building and re-building the organisational administrative and management systems required for such future business operations are also areas requiring attention.

The strategically-oriented owner-manager should also look at developing their own managerial skills and determining how they can offset any weaknesses that may exist in expertise or experience. Education and training of the owner-manager in basic financial, marketing or management skills is one option. However, the owner-manager should also look to the development of a network of professional advisors and peers with whom they can confer prior to making important strategic decisions (Smeltzer, Van Hook, & Hutt, 1991).

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4 Planning and Strategy in the Small Firm

4.1 Introduction

> The process of starting a new business is like jumping from rock to rock up a stream, rather than constructing the Golden Gate Bridge from a detailed blueprint. (NCOE, 2001, p. 16).

Small business owner-managers have been found to have a less sophisticated approach to formal business planning than their counterparts in larger firms. This is generally related to a lower level of systematic data gathering or a low level of statistical analysis. However, owner-managers are strategically aware and realise the consequences of their decisions (Rice, 1983). The lack of formal business planning has been attributed to the high failure rate among small firms particularly among start-ups (Castrogiovanni, 1996).

4.2 Strategic Vision Not Strategic Planning

In starting any planning process, the owner-manager of a small firm needs to have a clear idea of where they are going, why they are going there, and how they might get to wherever it is they chose to go. As Lewis Carroll describes in *Alice in Wonderland* when Alice asked the Cheshire cat for directions the conversation went as follows:

Alice:	'Would you tell me please, which way I ought to go from here?'
The Cat:	'That depends a good deal on where you want to get to.'
Alice:	'I don't much care where.'
The Cat:	'Then it doesn't much matter which way you go.'
Alice:	'…so long as I get somewhere.'
The Cat:	'Oh, you're sure to do that, if only you walk long enough.'

(Carroll, 1865 p.47)

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This simple illustration highlights the importance of knowing where you are going, or you run the risk of ending up somewhere that you would rather not be. According to Hall (1992a), to ensure a clear focus and direction for a small business, the owner-manager should give consideration to developing a clear vision and mission for their business. In addition, they need to understand their core skills, i.e. the things they are really good at, and identify the key resources, e.g. the people, patents, markets, products, and equipment, etc., that are likely to be essential for their business success. The more successful owner-manager is likely to be one who can scan the environment and identify opportunities or threats that may emerge.

Bhide (2000) found that formal planning among successful entrepreneurs was rare, at least in the early stages of their business development. Only 28% of the successful entrepreneurs whom he studied had prepared a full-blown business plan prior to the launch of their new venture. Forty-one percent had not prepared any formal plan at all, and 26% had only a rudimentary 'back of the envelope' plan (Bhide, 1994). Of more importance was the ability of the entrepreneur to 'hustle', i.e. using their selling skills and communications ability, to secure strong market positions in industries where possession of proprietary assets is not the main basis of competition (Bhide, 1994, 2000).

A study by Ernst & Young (2004) of 135 winners of the Australian Entrepreneur of the Year Award found that the majority (72%) considered that their greatest contribution to their business venture was the ability to provide vision and focus. The most common motivation for these entrepreneurs in launching their venture was to create a business that would fulfil their vision of the future.

> **For example,** … According to Ernst & Young (2004): A strong vision is an essential part of entrepreneurship but successful entrepreneurs also have the ability to plan the journey towards achieving their vision. The Entrepreneurs' Barometer found that forty-six percent of successful entrepreneurs nominated effective strategy as the key factor in the success of their business.

Eighty-five percent of the entrepreneurs surveyed by Ernst & Young (2004) were still engaged in active day-to-day management of their ventures, and were largely optimistic about the future outlook for their firms. While only 36% were involved in export markets, at least half were seeking to move into global markets over the short to medium term, e.g. 2–3 years. The majority (60%) were seeking to raise external financial capital to assist with their business growth, but most were planning to use this funding to invest in the organic growth of their existing business model rather than to acquire other businesses. This suggests that these entrepreneurs had confidence in their own business models.

Borch and Huse (1993) studied 660 small firms, looking at the relationship between their internal resources and the strategic orientation of their senior management. This study found four types of strategic orientation:

1. *Managerial firms*. These tended to analyse their markets and made use of marketing strategies for enhancing their competitive positioning.

2. *Technological firms*. These were actively seeking to gain a competitive edge by launching new products that applied technological innovations to identified market niches.
3. *Traditional firms*. These were generally risk-adverse firms and avoided growth and major changes requiring strategic shifts of direction.
4. *Impoverished firms*. These lacked any coherent strategies and were typically reactive to the market and their competitors.

These strategic profiles are consistent with those found in larger firms (Miles, Snow, Meyer, & Coleman, 1978), and suggest that the firms with the greatest chance of successful growth are the *Managerial* and *Technological* firms.

4.3 Strategic Myopia and Strategic Options

A major problem for many small business owners is that they suffer from what can be described as '*strategic myopia*' (Mazzarol & Reboud, 2009). This is a condition in which they possess only short-term and not long-term vision. It is the problem that affects the *Woodcutter* entrepreneur, referred to in Chap. 2, who is so focused on cutting his or her wood that they fail to take the time to look around the forest and work out where they are going.

The reasons so few small business owners engage in strategic planning is often attributed to their lack or time, or their lack of the knowledge and skills to develop a plan. They are also viewed as being unwilling to formalise their plans and share their ideas and strategies out of fear that these will be stolen. While these reasons are probably partially true, it is also likely that many simply see little need to engage in strategic planning, because they know where they are going and how they will get there. If their business is operating in a stable environment with little uncertainty and they know how to make their product or deliver their service, why would they bother developing complicated strategic plans?

4.3.1 Three Strategic Options

A study of 21 small business owner-managers in Australia found at least three broad strategic types (Mazzarol, Reboud, & Olivares 2006):

1. *Growth focused*. Growth focused firms require a clear market opportunity, the ability to apply sufficient resources within the business, good management systems for human and financial control, a clear point of innovation, access to strategic network support, and a means of funding expansion. Relatively few of the firms in the study were focusing on robust growth. Three of the owner-managers had seen their firms grow fairly significantly over the previous 3 years, but most faced the dilemma of limited markets.

2. *Lifestyle focused*. Many owner-managers seek lifestyle rather than growth as a strategic goal. The option of lifestyle requires a consolidation of the business and the implementation of systems to ease the workload of the owner-manager, allowing them time to extract good profits but without adding extra work or stress. This option is largely about making the business run more efficiently. This strategic option was the most common choice for the owner-managers in the study. For many, the key strategic goal was not to seek growth, but to work the business more profitably with less stress. In this respect a common feature of these owner-managers was the restructuring of their firm's portfolio of products and customers to weed out low margin activities and to 'work smarter not harder'.
3. *Exit focused*. For some owner-managers, the strategic goal is focused on retirement, succession planning or the future sale of the business. This can be a particularly difficult strategy and one that requires careful preparation. The exit strategy option requires the owner-manager to prepare their business for succession transfer or sale. This option usually requires the establishment of systems to improve efficiency and profitability, and as such it is similar to the lifestyle option.

What is highlighted by this are three generic strategic options for small firms, which we define as: (1) stasis, (2) exit, and (3) growth (Mazzarol & Reboud, 2009). These three options are summarised in Table 4.1.

Table 4.1 Three generic strategic options

Stasis	Exit	Growth
Key areas of focus:	Key areas of focus:	Key areas of focus:
Consolidation	Preparation of firm for trade sale, succession or closure	Innovation
Efficiency	Valuation & wealth creation	New product development
Maintenance of existing products	Team building	Commercialisation
Management of existing markets	Systems development	Market expansion
More inward looking	Grooming a successor	Vision for future growth
		Capacity building
		Identifying market opportunities
Key requirements:	Key requirements:	Key requirements:
Operational management	Financial control & reporting	Visionary leadership
Financial control & reporting	Business valuation	Strategic planning
	Succession planning	Alliances & networks
		Business model development

Source: Mazzarol & Reboud, 2009

The *stasis* option may at first appear a passive strategy, or even one for underperforming firms, however this is not so. Research evidence from several hundred SMEs suggests that this strategy is common amongst firms that have experienced periods of rapid growth, or that have reached a point of maturity where their owners have decided to cap any future expansion (Mazzarol & Reboud, 2009). This strategy is not passive, and requires the firm to devote much of its time to tidying up and consolidating its systems and procedures. It can be likened to a mountain climbing team taking time to rest at a base camp prior to climbing further.

More commonly known are the *exit* and *growth* options. These are discussed in more detail in subsequent chapters. However, at this point we can note that the decisions to exit or grow are strategic ones that require significant planning. As outlined in Table 4.1, the exit option often involves a decision to sell or transfer control to a second generation. In Chap. 14, we discuss in more detail the succession planning process. Planning an exit strategy involves the small business owner valuing their firm and making sure that all financial matters are squared away so as to present a tidy balance sheet and good back office systems.

The growth option is the strategy that has most captured the imagination of academics, policy makers and the general public. As outlined in Chap. 1, the fast growth *Gazelle* firms only comprise a very small proportion of all SMEs, but they can make a significant contribution to the level of job creation, wealth creation and export income. Growth strategies are most commonly associated with entrepreneurial firms, and they require the small business owner to focus on innovation and the process of developing new products and services, or entering new markets, or even exporting. Such a strategy requires visionary leadership, the ability to forge strong strategic alliances, and the skills to formulate and implement effective strategic plans based on sound business models.

4.4 The Benefits of Planning

The benefit of formal planning to small business performance has been debated within the academic literature for decades. Some have argued that formal strategic planning is more appropriate within larger firms and of limited benefit to the financial performance of small business (Robinson & Pearce, 1984). Despite such views, the empirical evidence to support the case for formal planning having a benefit to small firms has been both inconsistent and contradictory (Pearce, Freeman, & Robinson, 1987).

Schwenk and Shrader's (1993) examination of 14 research studies relating to formal strategic planning and performance in small business was unable to offer conclusive support to the benefits of such planning to small companies. However, it did reject the notion that formal strategic planning was appropriate only to large firms (Schwenk & Shrader, 1993). Empirical studies of small business performance and the relationship with formal planning suggest that such plans do make a difference, although the precise nature of the link between the two is poorly defined. A study of 51 small firms by Robinson, Pearce, Vozikis, and Mescon (1984) found formal planning to be beneficial to business performance regardless of the growth stage in which the business found itself. Start-up firms tended to be more profitable if the owners engaged in formal planning, and firms engaged in growth stages were likely to benefit from higher sales growth if they conducted formal planning.

A further study by Olson and Bokor (1995) of 442 small start-up firms supported the case for formal planning enhancing business performance, although this was found to be context dependent. Characteristics of the entrepreneurs – prior management experience or previous work history – were found to be significant. Sexton and Van Auken (1985) undertook a longitudinal study of 357 small firms in Texas over a four-year period. They found formal planning was conducted by only a relatively small number of firms, and concluded that the adoption of systematic planning might not take place unless a strategic-planning orientation was adopted. And, failure rates among firms with high-levels of formalised planning were significantly lower than among firms that had little or no formal planning. Robinson and Pearce (1983) also conducted a study that found no significant relationship between planning and financial performance within the small business, but found a significant enhancement in growth rates among formal planners. It raises the question, initially mooted by Bracker and Pearson (1985), as to whether it is the plan or the *process* of planning that is important in determining small business performance (Bracker & Pearson, 1986). Mazzarol (2001), in a study of small business owners in Australia, found significant relationships between formal business planning and growth in sales revenues – but this relationship was not evident in terms of profitability.

> **For example,** … It is unlikely that the possession of a written business plan will – by itself – cause harm, but it is also unlikely to be essential to success, at least in the very small firm. Formal business plans can be useful in assisting the entrepreneur to 'communicate' with or sell their ideas to external professional networks (e.g. accountants, bankers) and may also assist in enhancing relationships with suppliers. Overall the process of planning rather than the plan itself is likely to be more important to small business performance (Mazzarol, 2001, p. 43).

This has been further supported by additional research undertaken by Mazzarol, Reboud, and Soutar (2009) that suggests that small business owner-managers who have a strong growth orientation are likely to have an enhanced sense of their strategic vision, and ability to communicate this vision to their employees.

Formal business planning within small firms is frequently associated with a process whereby the owner-managers of the firm systematically attempt to examine their business environment and establish a framework and direction for future activities. Several elements encompass such a process. The first of these is the preparation of a mission statement, which examines the current situation facing the business and forecasts for future growth. This is then followed by the establishment of objectives and strategies to achieve this growth. Finally, these elements must then be documented for internal and external stakeholders, and a monitoring-evaluation process established (Linder & Vick, 1984). Also, of importance are the small business owner-manager's personal objectives and his or her ability to learn from any past successes or mistakes (Howard & Emery, 1985).

Of special importance are the initial conditions at the time where the future owner-manager has started to think about their project. Truche and Reboud (2009) have identified three main drivers among these initial conditions: the technological assets available for or accessible to the owner-manager at this time; the cultural context and competences surrounding the owner-manager; and his or her personality and personal abilities. These elements will have a strong influence on the strategic intent and thus on the resulting business model of the firm. Finding the best fit between mission, opportunities and the firm capabilities is frequently a major challenge for owner-managers (Bryan, 1998). External consultants such as accountants or other business advisors can assist effective business planning within small firms, but it is the owner-manager who must take ultimate responsibility for the plan and its implementation (Bracker & Pearson, 1985).

Brinckmann, Grichnik, and Kapsa (2010), undertook a meta-analysis of 46 published academic research studies on the value of formal business planning in small firms. This suggested that both new and established firms gained benefits from formal planning. However, these benefits were substantially greater for small business managers than entrepreneurs engaged in start-up ventures. The reason for this was that small business owners operating within established firms and relatively known task environments are in a position to be able to plan, and to get benefits from such planning. This is not the case for entrepreneurs seeking to create new business ventures within unknown and highly dynamic and uncertain market environments. In essence, what emerged was an unsurprising finding that where the firm's management is operating in a relatively stable environment where the conditions relating to both its product and market conditions are relatively known or predictable, formal planning is useful. Yet, in conditions of high uncertainty and lack of information, a more flexible and adaptive response is needed.

> **For example,** … Thus, founders and small business managers are advised to go beyond the oftentimes informal and undocumented business planning, but develop written documentation which helps them in clarifying their own approach and also assists in the communication with others. The empirical studies … find that more sophisticated planning activities (frequent planning meetings, market and scenario analysis, use of computers, portfolio analysis methods) increase the performance of firms. Hence, founders and small business owners should institutionalize the planning approach in their business routines to facilitate systematic planning, replacing the frequently found random planning processes (Brinckmann et al., 2010, p. 37).

4.5 The Major Types of Business Plan

While the academic debate over the value of formal written business plans continues, the majority of small business owner-managers view such documents in a pragmatic way. For most, the preparation of a written business plan is undertaken in response to the demands of other parties rather than something they initiate themselves. At least three broad types of plan are likely to be found among the small business community: plans for applications for finance, plans for customers and

Table 4.2 Three major types of business plan

Application for finance	Plan for customers & suppliers	Plans for internal use
Bank financing plans:	Customer plans:	Strategic plans:
Collateral	Reliability of supply	What is the vision?
Capacity to repay	Quality of product	What is the mission?
Cash flow	Pricing	What are the values?
Character	Innovation	What are the critical assets?
Venture capital plans:	Supplier plans:	Operational plans:
Team structure	Market share growth	What are the KPIs?
Market opportunity	Maintenance of reputation	When is the deadline?
Product innovation	Loyalty of relationship	Who is responsible?
Return on investment		
Payback period		

Source: Mazzarol & Reboud, 2009

suppliers, and plans for internal use. These are listed, along with their key areas of focus, in Table 4.2.

4.5.1 Applications for Finance

This first type of business plan is prepared for financial institutions and sources of equity finance in order to raise capital. The plan prepared for a bank to raise debt financing is fundamentally different from that prepared for a venture financier when seeking equity investment capital. An application for a bank would be likely to focus on the tangible assets that the applicant has and the capacity the business has to repay its loans. Banks typically seek long-term relationships with their clients and are generally unwilling to lend to businesses that cannot demonstrate either good trading history or the ability to secure loans against such tangible assets as property or fixed capital items. A bank has only two exit strategies from a business loan: the first is to recover the principal and interest as specified in the lending contract, and the second is to recover their money from the sale of assets from a liquidated business.

In preparing a business plan for a bank or debt financier, the most important issues to focus on are likely to be: your capacity to repay the loan; your trading history; your cash flow which demonstrates your repayment ability; and your assets against which a loan can be secured. Where the business has an established track record and a strong balance sheet, it may be possible to use the business' assets to underwrite the loan. A business that owns its own premises and the land upon which they are located can use these assets. For many small business owners however, they must use their personal assets – usually the family home – as collateral for raising debt financing.

By contrast, a venture capitalist will be more attracted to the management capacity of the applicant and their vision for the development of the firm. Venture capital investors seek to exit from a deal after a relatively short time period, e.g. 3–5 years, and they will want to receive a good return on their investment, i.e. better than what they could get from alternative uses of their capital. Most small businesses will be unlikely to secure venture capital unless the business has significant innovation and strong market growth potential. However, there are often many private investors who would be willing to take an equity position in a small business who may be less concerned about high growth and high return.

When preparing a business plan for an equity investor, it must be realised that this person is not lending the small business money; rather, the equity investor is taking partial ownership in the venture. As a shareholder and part owner, they will expect some control and the ability to participate in the future strategic directions of the business. Owner-managers will need to focus in the plan on the competencies of the firm's management team, the future market and growth opportunities the business has, and the ways in which they will use the money to both grow the business and return value to shareholders. If the investor is seeking a relatively short-term return, the plan should clearly state the exit strategy that the investor can expect to follow and over what time period.

4.5.2 Plans for Customers and Suppliers

Small business owner-managers who are selling to large customers or who are supplied by large firms may be asked to prepare a business plan in order to secure the strategic relationship. Such a document is designed to reassure the customer or supplier that the owner-manager has the capacity to meet the demands of being part of the value chain. A plan for this type of recipient would need to focus on the firm's capacity to control its costs, maintain its quality, meet target expectations, and grow in conjunction with the needs of the customer or supplier partners.

A business plan prepared for a major customer will need to emphasise the capacity of the firm to deliver on time, on cost and on quality. The customer will be keen to see that the owner-manager has quality assurance systems in place, or is taking steps to put these things in place. It may also need to outline the operations or production and supply chain management systems that it has in place or will put in place over time. Plans prepared for suppliers will need to focus on the owner-manager's capacity to build up a market and grow the business potential for expanding the supplier's own market share. This is also likely to be important when seeking to secure a contract to import products from overseas or from one state to another.

4.5.3 Plans for Internal Use

As a firm grows, small business owners may find themselves employing staff. If the employee numbers expand to a sufficiently large level, the business will need to become more formal in their planning. Business plans for internal company purposes serve to coordinate the activities of the workforce – and particularly that of the managerial team. Such plans should be developed with the active involvement of all key employees, and any documentation should be kept as brief as possible.

Ideally a simple document that is easy to interpret and can be circulated to all involved personnel is best. This may be a single page business plan (e.g. plan to a page), that outlines the firm's vision, mission and key strategic goals. This type of plan needs to focus on the vision and mission of the firm, what key targets it is trying to achieve, as well as any performance benchmarks including deadlines. Plans for internal use should be viewed as working documents that aim to tie together the thinking of the owner-manager(s) with their key employees and to guide actions. Such plans should be linked closely to the firm's budget process and should include adequate performance benchmarks. In summary, to be effective an internal business plan for a small business needs to be simple, accurate and useful.

4.6 Key Issues in Business Planning

The tendency in small business is to organise around people rather than around functions. At first this is necessary because the owner-manager(s) are the only employees working in the business. They may also seek help in the early years from relatives, friends and family who just happen to be available. However, in many firms – particularly in family owned and operated firms – the business hires relatives or friends giving less attention to their capabilities and more consideration to the politics of the family unit. This is generally not a good practice over the longer term.

Key Issues for Small Business Planning:
Organise around *functions* not people.

Prepare an organisation chart of the blueprint structure for the business.

Prototype the positions, and replace yourself/the owner-manager with a system.

Source: Gerber (1995).

It is important for the small business owner-manager to learn to organise around functions rather than around people. This is likely to require them to think carefully about the overall blueprint they may have for their business – both now and into the future. A good rule of thumb has been to recruit on attitude and train later. However, take care—particularly in management positions—not to pick a person for personality reasons and find that they cannot or do not wish to fill a specific role.

Do's and Don'ts of Business Plans
Do's

- A plan must be simple.
- A plan must be accurate.

(continued)

- A plan must be useful.

Don’ts

- Plans cannot save management from decision-making.
- Plans should not be rigid or inflexible.
- Plans are only as good as the people who carry them out.

Once the small business owner-manager feels that they have a clear vision of where they wish to take the business, and once they have set their goals, they need to consider the type of structure the business will have and/or they need to consider the suitability of their current business structure. It may be useful to redesign the firm starting with a blank sheet of paper, and then to prepare clear job descriptions or duty statements for the staff that will be needed. Preparing job descriptions in a very small firm is likely to be difficult as few organisations of this size can afford the luxury of specialisation. And, the dynamic nature of small business may make the job description redundant fairly quickly. However, most employees need to know what is expected of them and the owner-manager needs to know what sort of employee they need.

It may be useful for the small business owner to initiate steps to try to replace themselves with a system or a people-system combination. This would free up time and give the business owner more opportunity to build the business. An important consideration for small business owner-managers is to realise that they need to work toward a time when the business they have founded will no longer require their hands-on involvement for its operation. Only by gradually developing internal capability—usually through team building—can the owner-manager find the necessary time and space to grow the business. Furthermore, few potential buyers or venture capital investors are likely to be interested in a business that cannot survive without the day-to-day involvement of the original founders.

4.7 Writing a Business Plan

A business plan should be viewed as a blueprint for the business model that underlies the venture. Designing a sound business model is similar to how an architect designs a new building. Initial sketches are converted into a detailed blueprint that shows those who will build the actual structure, what is to be constructed, and how it will be built. The business plan offers a common language for all those who will work within the venture team, setting out a clear vision and objectives that all stakeholders can understand and apply (Grupp & Maital, 2001).

According to Sahlman (1997), a good business plan should have at least four key elements: (i) the opportunity; (ii) the environmental context; (iii) the risk-reward,

Table 4.3 General layout of a business plan

Section	Description
Executive summary	A short (<3 pages) summary of the key elements of the plan. Should outline the business model and if it is aimed at raising capital it should state how much money is required, how it will be used and what the anticipated return to the investor is. This is often the first and last section that will be read by investors.
Company overview	This section provides a description of the business and its trading history. It might include some brief information on the industry or market in which it operates. Information on the firm's ownership, management and governance structure should be provided. It is also worth highlighting any distinctive competencies the firm might possess.
Product or services	This section describes the firm's products and services so as to give the reader sufficient understanding of their nature and value. Past sales and market share data, patent ownership rights and other relevant information can be included. Additional information can be included in the appendices
Market opportunity	One of the most important sections. It should provide the reader with a clear understanding of the size and anticipated demand for the products and services. Also included are findings from market research, customer feedback and any testimonials
Competition and threats	This section provides an objective summary of the main competitors, including their products, pricing and marketing strategies, strengths and weaknesses. Other threats such as government regulations, customer switching behaviour and potential substitutions should also be included if relevant.
Economics of the business	This section summarizes the key performance indicators (KPI) likely to be critical to the future success of the business. This should include gross profit margins, sales revenue required to cover fixed and variable costs, a break-even analysis, and cash flow forecast. Ideally this should be supported by graphs.
Marketing strategy	This section should outline a clear pathway to market or growth for the business. It should include pricing and sales strategies, plus any details of future marketing and promotional campaigns. It might also contain information on any distribution systems, third party agreements and post-sales warranty and service issues.
Operations	This section outlines how the products or services will be produced. It may cover any major plant and equipment requirements, facilities, employment and use of sub-contractors or outsourcing. How quality will be measured and controlled may also be relevant along with work health and safety, and environmental issues.
Management team	This section should provide a detailed explanation of the firm's organisational structure and the key managers working within the business. An organisation chart showing structure (both current and planned) with lines of reporting is also a good idea. Any significant outside advisors (e.g. accountants, lawyers) should also be mentioned.
Financial plan	This section should show any past financial reports (i.e. balance sheet, profit & loss), and also make forecasts of future growth. This is particularly important if the plan is designed to raise money from banks or investors. All assumptions relating to future cash flow and profit projections should be clearly stated.

(continued)

Table 4.3 (continued)

Section	Description
Appendices	This section might contain product brochures, resumes of the management team, independent reports from auditors, market research firms, and letters of support from customers or suppliers.

Source: Timmons (1999), Golis (2002)

and (iv) the team. Each of these is discussed below. Table 4.3 lists the general layout and key elements of a business plan. However, plans can be much less detailed and should be developed in relation to what they are being tasked to do. Often the shorter they are the better.

4.7.1 The Opportunity

The plan should make clear to the reader the business or market opportunity that the venture is seeking to follow. It should explain how the venture will create new value for both the customers and the shareholders, and how sustainable this can be. The products or services that are to be sold and the customers who will buy them should be clearly identified. The plan should also make it clear that the customer is well understood and should demonstrate when, how and why the customer will buy the products/services.

4.7.2 The Environmental Context

The plan should also outline a sound understanding of the industry or market within which the venture is to operate and any key trends that might enhance or hinder its growth. A discussion should be provided that addresses any political, economic, social or technological factors that might affect the business – both the things that can be controlled and those that cannot need to be identified.

4.7.3 The Risk-Reward

The plan should make a clear statement of the profitability of the proposed venture, and an objective assessment of how much cost and risk will be required to achieve this outcome. If a major investment is required, the forecasts should include calculations of the likely break-even and time to break-even, as well as the anticipated returns and payback period for investors. A realistic evaluation of the things that might go wrong – and how these will be managed – should also be explained.

4.7.4 The Team

A key part of the plan is a description of the team that will manage the venture. A quality management team is more likely to succeed than one that is poorly balanced in terms of its skills or expertise. Access to third party expertise such as accountancy firms or lawyers and other advisors should be outlined. If the venture has a board of directors or an advisory board, it is important that their profiles are provided. The current and future employment or staffing formula for the venture should be outlined along with a human resource plan or strategy to acquire the right people while retaining existing ones.

4.8 Designing the Business Model

The business plan is only a blueprint for a well-considered business model that should have been thoroughly examined and discussed prior to the preparation of the actual planning document. The business model of an entrepreneurial venture is more generic than the financial or strategic design that is part of its structural configuration. It seeks to generate a mechanism that can deliver value to a target customer or market segment in a sustainable manner, and with an appropriate allocation of resources to achieve this outcome. While the concept of the 'business model' has become widely used in management circles, there is surprisingly little underlying theory relating to this concept.

What Is a 'Business Model'?

A business model is a conceptual tool containing a set of objects, concepts and their relationships with the objective to express the business logic of a specific firm. It is a description of the value a company offers to one or several segments of customers and of the architecture of the firm and its network of partners for creating, marketing and delivering this value and relationship capital to generate profitable and sustainable revenue streams.

Source: Osterwalder, Pigneur, & Tucci (2005).

Prior to the 1990s relatively little attention was given to business models in the academic research literature. During the period 1998–2010 a relatively small number of studies were published exploring the concept and its application to entrepreneurship and innovation (Trimi & Berbegal-Mirabent, 2012). However, the emergence of technology-based businesses, in particular online or internet-based e-business models provided an impetus to this academic interest. Key areas of focus were the ability to understand how to capture value and increased revenue by configuring the business model to attract and retain suppliers and buyers (Mahadevan, 2000). Attention was also given to how value was captured by firms engaged in the commercialisation of innovation, as illustrated by Chesbrough and Rosenbloom (2002) in the examination of the Xerox PARC R&D facility at Palo Alto, California.

With the emergence of interest in entrepreneurship and new venture creation in the first decade of the twenty-first Century, a renewed focus on business models grew. However, even by the mid-2000s there was still no generally accepted definition of what a business model was, how it was constructed, or what its best configuration should comprise (Morris, Schindehutte, & Allen, 2005). The concept of the business mode remained poorly understood.

> **For example,** … The concept of a business model has no established theoretical grounding in economics or in business studies (Teece, 2010).

Academic research into business models began to move from the largely operational, into the realm of strategic management. It was recognised that the business model was a strategic rather than an operational tool for managers who had been trained to plan rather than implement (Hrebiniak, 2006). The key elements of importance to the design and development of business models were gradually identified. A key issue was understanding how to design products and services that create and capture value for customers, while simultaneously generating profit for the business. The configuration of the firm's key resources and processes so as to deliver this value in a consistent and sustainable manner were also identified as key areas of focus (Johnson, Christensen, & Kagermann, 2008; Osterwalder et al., 2005).

In recent years, the process of business model analysis and design has become recognised as a key strategic tool for entrepreneurs and managers seeking to capture value and build successful, sustainable enterprise (Amit & Zott, 2001, 2012; Teece, 2010). It is a conceptual tool that can be applied to any industry and should be undertaken in conjunction with any business planning and strategy.

> **For example,** … No matter what the sector, there are criteria that enable one to determine whether or not one has designed a good business model. A good business model yields value propositions that are compelling to customers, achieves advantageous cost and risk structures, and enables significant value capture by the business that generates and delivers products and services. 'Designing' a business correctly, and figuring out, then implementing e and then refining e commercially viable architectures for revenues and for costs are critical to enterprise success. It is essential when the enterprise is first created; but keeping the model viable is also likely to be a continuing task. Superior technology and products, excellent people, and good governance and leadership are unlikely to produce sustainable profitability if business model configuration is not properly adapted to the competitive environment (Teece, 2010, p.174).

4.9 The 'Business Model Canvas' for Business Model Design

One of the most popular tools for analysing and designing business models is the "*Business Model Canvas*" for business model generation developed by Osterwalder and Pigneur (2010). This is a framework that comprises nine key areas or "building blocks" that need to be considered when designing business models. It is important to note that the *Business Model Canvas* is a strategic planning tool, and that the interrelationship between the nine areas of the framework can differ depending on the nature of the business or the industry in which it is seeking to operate. The notion of a "canvas" is to recognise that good design should start with a blank page or canvas upon which new ideas, assumptions and concepts can be drawn without the relative restrictions of conventional business planning. Time should be spent brain storming, visualising and testing new ideas with the *Business Model Canvas* tool. These should be tested within the market through customer engagement and discovery, then idea validation, before the final business model takes shape (Blank & Dorf, 2012; Osterwalder & Pigneur, 2010).

Figure 4.1 illustrates the *Business Model Canvas* with a list of questions that we have added into each of the nine boxes. As can be seen, the centre of the canvas has the *value proposition* that the business model seeks to make to the customer. This is a central pillar for any business model design. On far right is another key pillar that addresses the *customer segments* that the business model is being designed for. Over on the far left is a third major pillar relating to the *strategic partnerships* that need to be considered within the business model. Linking these three key pillars are four additional building blocks relating to *customer relations*, *channels*, *key activities* and *key resources*. The bottom of the canvas has two additional areas relating to the *revenue stream (monetising),* and *cost structure how much it costs).*

In the *Business Model Canvas*, the *value proposition* pillar can be understood as representing the logic of "**<u>What</u>**" the business model needs to generate in order to over value to target customers. The *customer segments* pillar addresses the logic of

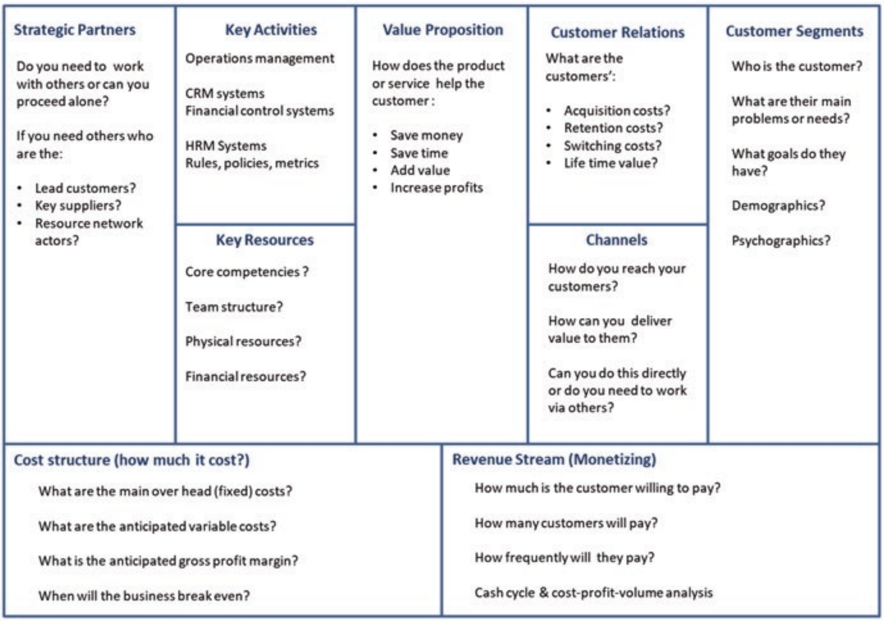

Fig. 4.1 Elements of the business model
Source: adapted from Osterwalder and Pigneur (2010)

"**Who**" the end user or target customer is. Once these pillars are explained the two linking blocks of *customer relations* and *channels* deal with the logic of "**How**" the business model can deliver value to the customer. These four areas relate largely to external market-oriented issues.

On left hand side of the canvas the *strategic partners* pillar addresses the logic of "**What & Who**" might be required to ensure that the business model can deliver the *value proposition*. It is linked to the central pillar via the *key activities* and *key resources* blocks, which address in turn the "**What & How**" and "**Who & What**". The elements on this side of the *Business Model Canvas* are largely focused on internal resources and capabilities.

Finally, the *revenue stream* area also looks at "**How**" the business model will be able to generate sufficient income to make the model workable and sustainable. The analysis emerging from the four building blocks on the top right-hand side of the canvas should feed into this area. In turn, the *cost structure* block on the bottom left hand side addresses the issue of "**What?**" it will cost to build the business model. Here the analysis of the cost of activities and resources required to deliver the *value proposition* need to flow into the *cost structure*. Where the firm cannot find these resources or capabilities alone it will need to consider *strategic partners*, and any costs arising from these relationships need to be identified. Each of the nine building blocks of the *Business Model Canvas* are discussed in the following sub-sections.

However, Grupp and Maital (2001) suggest several considerations need to be made before the development of the business model commences. These issues are discussed in the context of the *Business Model Canvas* elements.

4.9.1 Customer Segments and Market Segmentation

Before the *value proposition* can be fully addressed it is first necessary to get an in-depth understanding of the customer, who they are. Of importance are the key tasks of understanding what their main problems or needs are, and what goals they have.

4.9.1.1 Basic Assumptions

According to Grupp and Maital (2001) it is important to start with an examination of the market, and seek to gain a comprehensive understanding of the customer's perspective of the situation. Is there any demographic (i.e. age, income, education, marital status, occupation, gender, location), or psychographic (i.e. values, attitudes, lifestyles) trends that suggest the market place is changing fundamentally? There should be a clear understanding of why and how prospective customers buy the products or services that are being planned, and whether or not there are any needs that are not being met by existing suppliers. Once the overall customer and market environment is understood, the next most critical element to understand is the way profit is driven within the market. Will the new venture or product offer sufficient opportunity to generate substantial profit margins, or will prices be too low due to customer reluctance to pay premium prices? Threats from new entrants or substitutes should also be considered.

4.9.1.2 What Are the Target Market Segments?

Every market needs to be segmented in order to ensure that the product or service can be adapted to meet the needs of the end user. Not all customers will want or need the same things, and it is unlikely that any single product can satisfy all customers. Segmentation strategies can be undertaken using a variety of measures including the customers' demographics and psychographics. The size and potential responsiveness of each target segment needs to be carefully considered.

4.9.1.3 What Do the Targeted Customers Want?

Customers within each market segment will have different expectations and past experience of the product or service that is being offered. Research of customer expectations and behaviours should be undertaken when developing the business model. Customers have three types of need: (1) basic, (2) spoken, and (3) unspoken. While the first deals with what they expect the product to do and the second with what they say they want it to do, the third is often the most important to identify. Satisfying an unspoken need will allow you to delight the customer by offering them a benefit that they had not expected or even thought of. This type of need cannot be identified by simply asking the customer what they want. It requires you to research how they currently use existing products and services. It then involves looking for ways to enhance the customer experience or reduce their time or cost of using such things.

4.9.2 The Customer Value Proposition (CVP)

The primary focus for any business model is its product or service offering to the customer and its ability to make a proposition of value. Teece (2010) suggests that the key questions that should be asked about a business model are:

- What is the specific customer value proposition that the business is to offer?
- What is the best mechanism to assemble the organisation's resources to deliver this?
- How might imitators be held at bay?

The key considerations within the product area of the business model are related to the customer or target market and getting an understanding of the customer's perspective about the new product or service. Whatever the product or service that is being offered, a primary consideration should be to understand how the product or service helps the customer secure value. This is typically achieved by saving them money or time, adding value or increasing their profitability.

4.9.2.1 What Is the Overall Customer Value Proposition?

The customer value proposition (CVP) is focused on taking the answers emerging from the questions raised in the *customer segments* area, and using them to generate a product or service solution for the target customer that solves a specific need or problem and makes an offer that satisfies or fulfils this need (Johnson et al., 2008). Research into customer perception of value suggests that it is a complex trade-off between what price is to be paid and what benefits are to be obtained. The price paid or the cost of the product or service is weighed against the perceived quality of the product, service and technical service issues. These can be influenced by brand image, the image of the supplier, and the perception of risk associated with the purchase (Sweeney & Soutar, 2001).

4.9.2.2 Customer Selection

An important first question for any new venture is to decide on which customers the business is to serve (Grupp & Maital, 2001). This is less easily dealt with than might first appear to be the case. Frequently a new innovative venture will identify a wide range of potential market opportunities and yet it will not be able to easily decide which of these it should target. The selection of the *first* customer can be a critical issue, as this decision can determine the speed with which a new innovation is diffused within a target market. For many small entrepreneurial ventures, the role of leading customers is to assist the business with ideas, funding and market access. It is of some importance then that the initial customer base is selected. Customers who might readily partner with the venture are highly valuable. Customers that can be retained and who will be loyal over time are also highly valuable.

4.9.3 Customer Relationships

Once the customer segment has been selected, there needs to be consideration of how this market niche can be better served by the new venture than by existing competitors. It is most important for the new venture to identify what the existing standards or benchmarks are in the industry and then to seek ways to provide *customer delight* (Hall, 1992a). The process of delighting the customer is to exceed the current levels of cost, service or quality being offered in the market and to use innovation to maintain such an advantage. Within industrial markets, attention should be given to identifying and understanding the nature of the customer's customer. By ensuring that the product or service assists the customer to service *their* customers better, the new venture can secure a position of strength in its selected market space.

Over time, the profitability of any particular market segment is likely to determine the sustainability and growth potential for the venture. Attention should be given to whether or not leading customers will be willing to pay premium prices for the product/service offering, and how easily the venture will be able to reach such customers on a regular basis. At the end of the analysis, the most important issue will usually be whether or not the price that can be secured in the chosen market is sufficient to generate a profit margin that will sustain the business.

In terms of *customer relations,* the cost of winning and retaining a customer needs to be considered. Some customers are likely to be easier to acquire than others, but they may be only loyal for a short time. The costs incurred by a customer in switching from one supplier to another is also of importance. This can be measured in both direct and indirect costs.

For example, a customer who has a long-term investment in a particular technology, and knows how it works may consider that the cost of switching to an alternative is more than just the purchase price, but also the cost of re-learning the new system. The lifetime value of the customer is also important because once a customer is won, the aim should be to keep them loyal.

4.9.3.1 What Key Customer Relationships Must Exist?

The ability to deliver value to the customer will depend not only on the quality of the product but also on the quality of the service experience and the ease and convenience of delivering it to them. It is a good idea to draw up a list of the various types of customer relationships or points of contact with each market segment, and determine how to build them into relationships that can offer a competitive edge.

For example, the development of the *iTunes* website offered a competitive point of customer relationship for Apple as it rolled out its *iPod* MP3 player. It has continued to evolve this business model via the 'App Store' for its *iPhone* and *iPad* devices. The *iTunes* software and website offers Apple a dedicated point of customer contact and an opportunity to obtain data on customer purchasing behaviour, as well as offering the customer product updates and cross-selling to other products. It also serves as an isolating mechanism that can potentially lock out the competition that might otherwise erode Apple's relationship with its customers.

4.9.4 Channels – Your Go to Market Mechanism

Once the customer is fully understood the challenge of how to reach the target customer and deliver value to them needs to be addressed. Can the business do this alone and without outside help, or does it need to work via a distribution system or network? The "*go to market mechanism*" is an area that is often overlooked in developing the business model (Grupp & Maital, 2001). For example, will there be a process of direct selling by the principals, or will it employ a sales force?

If a sales force or agency system is used, consideration will need to be given to commissions and reward structures. Franchising has become a popular mechanism for this but can involve significant legal and administrative costs. Perhaps the ideal model is to go directly to the customer and to establish control and a reputation via a face-to-face process. For example, the decision by Dell Computers to use the internet for direct selling was an example of a strategic *go to market mechanism* that succeeded.

4.9.4.1 Differentiation

Any new business venture is going to struggle in the market if it fails to offer a clear point of differentiation over the competition. It is therefore important for the firm's basis of differentiation to be identified and a unique value proposition to be developed that allows a clear reason for the customer to do business with you. Knowing who the key competitors are and what they currently offer as their main points of differentiation is an essential starting point. Competitors will hardly stay static in the face of direct competition, so consideration will need to be given to what they are or are likely to do over the foreseeable future – e.g. 1–5 years. The final offering to the market must be capable of convincing the customer that the new venture offers a better deal than the competition.

4.9.5 Revenue Stream – Capturing Value

The analysis from these customer-focused areas of the business model should allow an assessment of the *revenue streams* likely to be drawn in from the target market. This is where the real value of the business model can be captured. Important considerations are how price sensitive the market is and how much the customer is willing to pay. Also, of importance are how many customers will be captured in a given time, and how frequently they will purchase. Answers to these questions will allow a full assessment of the likely cash flow cycle and cost-profit-volume dynamics of the business model.

4.9.5.1 Value Capture

An important consideration in any new business model is how it will capture the value that it has created for the customer. Many dot.com start-ups failed because they did not find how to acquire a sufficient income stream from the value they had created through their online websites. Will the customer pay you directly or via a third party? Using agents or intermediaries to collect your revenues can pose problems for cash flow and control.

Given the nature of the customer and their purchasing behaviour, it is necessary to determine how frequent or irregular any income might be, as this can affect cash flows and many new businesses that have had excellent products or services as well as good margins have starved due to the lack of a regular cash flow. The number of customers likely to be repeat purchasers is also important. As it usually takes less time to get an existing customer to purchase from you than it does to secure a brand-new customer, a business that can rely on a base of regular customers is preferred.

In addition to determining how the business venture will capture value from the customer, attention should also be given to how the shareholders will be rewarded. As has been noted earlier, the shareholder should be offered a clear exit strategy, and clear policies need to be developed over the payment of dividends versus the reinvestment of profits back into the venture.

4.9.5.2 Financial Analysis of Operations

The financial dynamics of the venture should be carefully assessed as the business model is being refined. Once price is known, the variable and fixed costs associated with the production, distribution and sale of the product/service should be examined. Where possible, the level of fixed costs or overheads should be kept to a minimum, i.e. 'keep the team lean'.

Fixed costs raise the break-even point for the venture and make it riskier to launch the venture. By contrast, variable costs are more dynamic and allow the venture to ride out periods where income is slow. The level of fixed or variable costs within the business model can be determined by decisions to sub-contract or outsource key functions rather than carry these within the fixed costs of the venture. Several important questions that need answering are discussed below.

4.9.5.3 What Is the Revenue for Each Product/Market Area?

Once the key target market segments have been identified, attention should be given to estimating what anticipated annual revenue might be obtained from each one. If there is past experience from previous years of sales, this data should be examined. It is important to identify which target segments are likely to grow and what market share could be obtained within a given time period.

4.9.5.4 What Is the Cost Structure?

An important consideration in any business model is the cost associated with establishing the venture or bringing the new product to market. Overhead costs need to be examined to see if these can be reduced in order to allow the venture to reach break-even a quickly as possible. Also, of importance are any variable costs that will impact on the firm's gross profit.

4.9.5.5 What Is the Profit Margin?

The gross and net profit margins are important when determining the overall profitability of the venture. Each target market segment needs to be examined in order to evaluate potential profit margins. For example, some target segments will be more price sensitive and will not allow you to command the same price point as another less sensitive segment. If costs of production and delivery are the same for both segments, one will generate superior profit margins over the other.

As a general rule, the higher the profit margin the better. Furthermore, the most important figure to consider is gross profit margin rather than net profit margin. This is the more dynamic figure and it is common to find different products or segments of the market having different gross profit margins due to differing variable costs.

4.9.5.6 What Are the Financial Measures?

Against each product and market area you should consider such things as the time it takes to recover money from customers and how long it might take to reach break-even. The time it takes to receive payment from customers can be vital to the survival of a small business start-up that needs regular cash flow to maintain its solvency. It is also important to work out the time to break-even, as this will impact on the amount of up-front capital needed to sustain the business in its early years.

4.9.6 Key Resources

The opportunities identified in the previous areas of the *Business Model Canvas* now need to be examined in terms of the key resources that will be required to deliver the CVP. *Key resources* refer to the people, equipment and other assets that the venture needs in order to fulfil the mission and deliver the CVP. It can encompass "core" or *distinctive competencies*, which are the skills and knowledge that are required to compete at the required level (Prahalad & Hamel, 1990). It can also encompass the firm's organisational structure, governance and team composition, plus the physical facilities that will be needed to house the operations. Another important part of the resource set is the partnerships and strategic alliances that are going to be needed for the entity to fulfil its purpose.

4.9.6.1 What Core Competencies Are Required?

It is useful here to list the skills, abilities and other resources that are likely to be needed to allow the venture to deliver its CVP in a consistent way to the target customers. Any gaps that are identified within the firm's own resources should be filled via alliances where possible.

4.9.6.2 The Management Team

Each member of the management team should be examined to ensure that they fully understand the new venture's products or services and have a working knowledge of the market, production processes and the financial structure. If the team has not previously worked together, attention should be given to personalities and getting to know each other. Who the managers are and what specific skills they bring to the company should also be considered? Of particular importance is the overall integrity of these people. Background checks can be useful to ensure that they are who they say they are, and extreme care should be taken in recruitment, selection and appointments.

4.9.6.3 What Is the Best Way to Structure Teams?

The team or teams of people who are to make the business model work and deliver the CVP need to be designed, and attention should be given to how large they should be and to their composition. It is important to build teams that have the right combination of skills and abilities, as well as the right leadership.

4.9.6.4 Organisational Configuration

As discussed elsewhere in this chapter, the best organisational structure needs to be found to complement the proposed strategy and available resources. How centralised or devolved the new venture will be and whether managers are to be grown organically or recruited externally are important issues. Corporate governance in the form of the executive management team and board of directors should be carefully clarified. Attention should also be given to setting up a structure that promotes a good communication flow and allows for organisational learning.

4.9.6.5 What Physical Facilities Will Be Needed?

The business model must also consider the physical facilities that will be required. It is useful to make a list of the things that might be required, such as websites, ICT systems, buildings, plant and equipment. Each will have a cost.

4.9.6.6 Capital Intensity

Consideration should also be given to the level of capital intensity required by the new venture. As noted above, the need to acquire high cost capital items can significantly increase the fixed costs of the business and force up the break-even point. However, the use of automated systems may assist in reducing labour costs over time and may thus justify higher initial set-up costs. Another consideration is whether the venture needs to possess state-of-the-art technology and systems, or whether it can make do with less sophisticated equipment in the early years. Capital items can often be acquired second hand at a much lower cost than a new purchase, and are frequently able to perform well despite their level of financial depreciation.

4.9.7 Key Activities

In addition to the resources required it is also important to consider the *key activities* that will need to be undertaken to ensure that these resources are appropriately used to deliver value to the customer and the firm. These activities can include a wide range of things depending on the nature of the business. Typical areas related to customer relationships management (CRM) systems, financial management and control systems, operations management practices and HRM systems, plus any related polices, rules and metrics. Consideration should be given to the overall scope of business operations; the purchasing systems and how future R&D and new product development is to be managed.

4.9.7.1 Scope of Operations

Once the customer has been fully examined, the next area to be addressed is the operational management of the venture. Key questions that need to be answered include:

- What products are to be sold?
- Which activities should be retained?
- Which should be outsourced?

In terms of the type of products that are to be sold, the longer-term issue of product-market growth should be examined to see if the product can form the basis for a range of new product lines with the potential for exploitation of alternative markets.

Most new technologies have the capacity to be employed within a range of market segments, with each new market posing a different set of entry requirements and product-service configurations that can impact the way the venture structures its operations. For example, a business that has sold into the civilian market may see an opportunity to secure contracts in the defence sector, but they may lack the competencies and contacts to fully exploit this due to differences in tendering and procurement processes.

For many firms, there will need to be a decision made as to what operations are to be undertaken in-house and which are to be outsourced. Sub-contracting work is popular with many businesses due to the fact that it reduces the level of direct investment required into the company and moves some of the costs of capital and human resources off the balance sheet. However, sub-contracting can also prove dangerous if strategic-level assets or capabilities are allowed to leak out of the firm to sub-contractors (Quinn & Hilmer, 1994).

4.9.7.2 Purchasing Systems

For many firms, suppliers play a most important role in providing critical inputs without which the business will not operate. Key suppliers can also be a source of value adding through the transmission of ideas, knowledge and the transfer of technologies. As part of the development of the business model, it is important to consider how supply chain relationships will be handled. Will suppliers be retained on short- or longer-term contracts and will ecommerce be employed to provide a lower cost of transaction? Inventory control and logistics management systems employing computer management linked to suppliers can be a major source of competitive advantage and cost reduction. Suppliers should be viewed as potential partners who offer value and who form part of a team. Where suppliers are kept at arm’s length and treated as little more than cost burdens, the opportunities for innovation and strategic networking can be lost (Jarillo, 1988).

4.9.7.3 R&D and New Product Development

Innovation through ongoing research and development (R&D) and new product development is often essential to the success of the new venture over the long term. However, the entrepreneur needs to consider whether the R&D function is to be retained within the venture or outsourced. It may be useful to form a separate venture to focus on R&D, thus allowing production and implementation work to be carried out by another business.

When developing an innovation strategy, some of the key considerations include: how much should be spent on R&D? and how can the R&D function be linked closely with the work of the marketing, production, financial and other functions in the venture? R&D teams can also tend to become too focused on the research, and need to be provided with systems to ensure that they keep to strict timetables for the completion of projects.

4.9.7.4 What Is the Best Configuration of Key Systems?

Attention must also be given to the way in which the various systems relating to human resources, operations, culture, policies and various other key performance indicators (KPI) are to be configured so as to keep track of the ability of the business to deliver value.

4.9.8 Strategic Partners

Once the issues examined in the previous sections have been addressed it will be important to identify whether the business model can be managed alone or if it requires collaboration with others. This can involve lead customers willing to work with the firm to *co-create* a new product or service. Key suppliers can also be a valuable partner assisting with technology transfer and knowledge. Third party firms that provide resources (i.e. banks, venture financiers, university research centres) can also assist, playing the role *resource network actors* (Holmlund & Törnroos, 1997).

The development of new and existing market segments often requires the formation of strategic alliances with customers, suppliers and third-party complementary firms that can assist in providing competencies that are not available within the venture. This is particularly the case for small firms and start-up ventures that lack resources.

4.9.8.1 The Support Networks

In addition to the management team that will control the new venture, some consideration should be given to the formation of a wider network of supporting specialists and organisations to which the venture can turn when needed. This can include the services of a legal team, an accounting professional and a marketing agency. The new venture will benefit from having a high-quality advisory board or formal board of directors. These people should be recruited from a range of backgrounds and skill sets, and should have the ability to network the venture to a wider set of industries or markets if possible.

4.10 Strategy as a Continuous Process

Business planning commences with strategy formation. No plan can be of much use unless the strategy upon which it is based is valid. Strategy and planning are closely related but are not the same. Planning is a 'single loop process', while strategy has been likened to a 'double loop process' (Heracleous, 1998). In Fig. 4.2, strategy implementation is shown within the context of the three-step process of *strategic analysis*, *strategic choice* and then the *implementation* of the strategy. However, it

Fig. 4.2 Strategy as a continuous process

also recognises the reality that strategy is not a linear process. If strategy is to be seen as an ongoing process, this framework is a useful reminder.

A business plan that has operational applications over a defined lifecycle is single looped because it usually contains clear objectives that are implemented, measured in terms of their achievement, and eventually completed. By contrast, strategy is a more continuous process that takes place over a longer period of time. Strategy is still implemented via business plans but involves the business setting a given direction, exploring the viability of that direction, taking feedback from the market and continuously adjusting its focus and direction in the light of that feedback. For the small business, this iterative 'double loop' process involves a constant dialogue with customers, suppliers and other people both inside and outside the firm to assist the owner-manager in determining if their strategy is on the right track.

As noted earlier, most small business owner-managers suffer from strategic myopia, i.e. a process of short range, reactive thinking that is too operational and typically results in them losing sight of the strategic direction that they should be heading in. Rather than moving their business along a path that they have determined, they find themselves responding to short term issues triggered by internal and external forces. They feel that their business is running *them* rather than the other way around. Strategic planning is often viewed as being something that only large firms can afford to do, and of little relevance to small businesses. This view, however, has been disputed and it is now recognised that small firms can also benefit from strategic planning and should adopt a strategic approach to their management (Sandberg, Robinson, & Pearce, 2001).

In this model, a clear vision and mission for the business must precede strategy implementation (otherwise known as planning). The owner-manager then needs to clearly identify their critical success factors (CSFs), which are the core skills and key resources required to undertake the mission and achieve the vision. Once these elements are understood, the owner-manager can begin to set objectives for subsequent use in a business plan. By following these steps and establishing a strategy, implementation (planning) will consume a large degree of organisational energy but will be absolutely in line with market developments and the choice of strategic direction. Most of all – when viewed as a live process – implementation will be flexible in responding and adapting to updated analyses and in the refinement of strategic choices (i.e. critical success factors and objectives).

The following sub-sections look in more detail at: vision and mission; critical success factors; and objectives.

4.10.1 Vision and Mission – Where Are You Going and Why?

An important step in strategy formulation is the establishment of a clear sense of direction for the business. The common aim for most businesses is to develop a vision statement that seeks to articulate future direction. Vision is concerned with finding the future that is wanted for the business, and then determining what action is required to achieve it. Small business vision is also concerned with finding the future that the owner-manager wants for the business, and determining any action required to achieve that future. Consideration should be given to where the business will be positioned within the market, who its customers will be, what changes will be expected in the future, and what lifestyle its owners will enjoy. Two things are required to achieve success:

1. *Vision* – a clear statement of the future you want to achieve.
2. *Teamwork* – a team effort to move the business towards that vision.

Once a clear vision for the business is identified, it should be communicated to all staff. Everyone needs to look forward 3 years and ask the following questions:

- Who do you want to do business with?
- How should employees within the business be treated?
- What management style is best suited to the firm?
- What is the best position to hold within the firm's industry?

All answers should be written down, shared with each other, discussed and circulated for all employees to consider. The more a vision is discussed with others, the better. Employees will be guided by the sense of direction it provides, while suppliers and customers are also likely to be more positive once they understand where the firm plans to go (Hall, 1992a).

Achieving Focus and Direction

The key elements for achieving a clear focus and direction for the business are:

- *Mission* – having a clear sense of what business you are in, writing this down and getting all employees to understand it and how they can contribute to its fulfilment.
- *Personal vision* – understanding what your long-term aim is as a small business owner, and what personal goals you have or hope to achieve.
- *Leadership vision* **–** being able to communicate your vision to others, particularly your employees.
- *Core skills* – ensuring that you have the skills to fulfil the vision, offering a competitive advantage over competitors and being able to renew these skills.
- *Key resources* **–** ensuring you have the key human, financial and physical resources essential for business success.
- *Environmental scanning* – having the ability to scan the business environment, collect market intelligence, identify threats and opportunities and develop management strategies to cope.

Sources: Hall (1992a), Mazzarol (1999).

Tarnow (1997) has suggested the use of unifying action declarations (UADs) to assist in the establishment of vision and mission statements. According to this concept, the UAD consists of a short statement that is designed to suggest an action, but identifies this action only vaguely. The UAD should also include a social categorisation. The fact that the action identification is vague enables more participation from all stakeholders for as long as possible. It also permits as much individual variation as possible by not being too prescriptive, thereby facilitating creativity and hopefully innovation.

The need for social categorisation is to aid in attracting people to the cause of the statement. For example, Nokia Corporation's vision statement 'Life Goes Mobile' is a reflection of the shift in technology that will convert the mobile telephone into a hand-held multimedia computer that will inevitably become an indispensable part of everyone's life. Their mission statement is 'Connecting People', which involves the concept of mobile communications and data transfer. Both the vision and mission statements are short, and contain UADs suggesting actions by people and Nokia's employees.

The mission statement must make sense in terms of the vision and the strategic direction or strategic intent of the business (Hamel & Prahalad, 1989). The internal environment must have the capability to make and market; the offering must be relevant to the customer and be able to meet the challenge of competitors; the mission must indicate how competitive positioning will be sustained in light of future market pressures.

The mission fulfils the following:

1. It ensures unanimity of purpose throughout the organisation.
2. It serves as a focal point for individuals to identify with the organisation's purpose and direction.
3. It establishes the general organisational climate, i.e. the culture.

Developing Vision and Mission Statements

A vision statement should clearly spell out the future you want. It should be a short statement that is constructed to:

- suggest action;
- identify how this action might be undertaken; and
- involve a social categorisation to engage people.

The mission statement should be a call to action and should try to define:

- the strategic intent of the business;
- the critical success factors; and
- the role of internal and external stakeholders.

Sources: Tarnow (1997), Strong (1997).

As Strong (1997) outlines, the mission statement is an important foundation in the formulation of strategic planning. Most mission statements have several components that might include: purpose, key objectives, policies, values, customer or market needs, and environmental considerations.

A mission statement assists to: clearly define the business, aid planning, and communicate the organisation's purpose to others. Mission statements need to be: short, clear and simple, able to clearly state the purpose of the business, avoid too many generalities, and focus on the business as it is in the present rather than the future. Critical success factors also need to be taken into consideration. The organisation should look back at where it has achieved most of its success in the past, and then look forward to where it may achieve its success in the future.

Mission statements need to be short (i.e. 6–10 words), clear and simple. They need to clearly state what business you are in, avoiding any generalities. And, they should focus on what the business is *now* rather than what it might be in the future (Hall, 1992a).

4.10.2 Critical Success Factors – What You Need to Succeed

Critical success factors (CSF) must be viewed as future aspects by which business performance should be measured. In other words, CSFs are what the owner-manager needs to be successful at in order to achieve the mission of the firm. CSFs help to identify how the small business will be seen at a given future point, as well as the means by which the success of the owner-manager will be measured. It is important to develop a balanced mixture of strategic and tactical issues when considering CSFs.

CSFs are generally written as a verb (action) followed by a noun (e.g. area, product, service):

- *We need to maximise productivity…*
- *We need to continuously develop new products…*
- *We need information at the point of use…*

Once the critical success factors have been identified, they provide a focus for deciding upon the actions or objectives which need to be met.

The core skills of the business (core competencies) are the things that it has developed over time and is really good at (Prahalad & Hamel, 1990). This set of skills should be considered valuable not so much by the firm, but by its customers. Furthermore, these core skills should not be readily obtainable from competitors or easily copied by competitors. Hall (1992a) recommends consideration of the following:

- What has been the basis of the firm's success to date, i.e. products, services?
- How does the business get its customers – i.e. face-to-face, advertising, mail shots?

- How can the firm make use of core skills to increase business?
- Discuss ways to update core skills regularly – e.g. benchmark the business against the best practice in its industry, encourage continuous improvement within the firm, etc.

Key resources are the things that the business must have to survive. The owner-manager should identify all the key resources that are essential to the successful operation of the business. Consideration should be given both to the things that are important, and whether the business has an effective supply of these things. Some of these key resources could be: people, information, contacts, materials, technology, partners, energy, capital, and company image.

4.10.3 Objectives – What You Must Do to Succeed

Objectives are best defined as what needs to be done to meet the critical success factors. Combined, the objectives should meet the CSFs and therefore achieve the mission. Objectives are tangible, should identify ownership, and should be set using quantifiable measures. This may mean that a single objective may contribute to one or more CSFs.

To define an appropriate objective, the statement needs to define 'what' and 'where':

- *We will train and develop …*
- *We will source new suppliers …*
- *We will operate under new shift/working patterns …*

From Critical Success Factors to Objectives

Critical success factors	Objectives
Have an effective management team	Train, develop, promote
Offer highest quality products	Undertake product R&D
Increase market share	Research and advertise

Once the actions have been identified, the final stage is to decide how these will need to be carried out, by when and by whom. This is the implementation stage of the strategy process. While CSFs are generally written from the perspective of what is needed (e.g. we need …), objectives are written from the perspective of what is to be done (e.g. we will …). As illustrated above, a CSF such as 'we need to have an effective management team' would be matched by an objective that focused on 'we will train, develop and promote effective managers'.

When designing objectives, remember that – to be useful – an objective must possess three key criteria:

1. *A quantifiable performance benchmark* – such as sales turnover, profit, return on investment (ROI) or market share.
2. *A deadline for completion* – an objective without a deadline or time frame for completion is little more than a wish.
3. *Ownership of the task* – the objective must be allocated to an individual or group to take responsibility for its achievement. Failing to allocate ownership of an objective is likely to result in the task being ignored or not completed.

4.11 The Strategy Development Framework

The process of developing strategy can be complex, and numerous texts have been written on the topic. The *Strategy Development Framework* (SDF) (Mazzarol, 2015), shown in Fig. 4.3 offers a way to simplify the process. The SDF draws together a range of existing concepts used in strategy formulation and represents them as an integrated framework. This is designed to provide an overview of the main areas that should be considered when developing strategy. It provides managers with an easy reference point for strategic planning. The main elements of the SDF are discussed below.

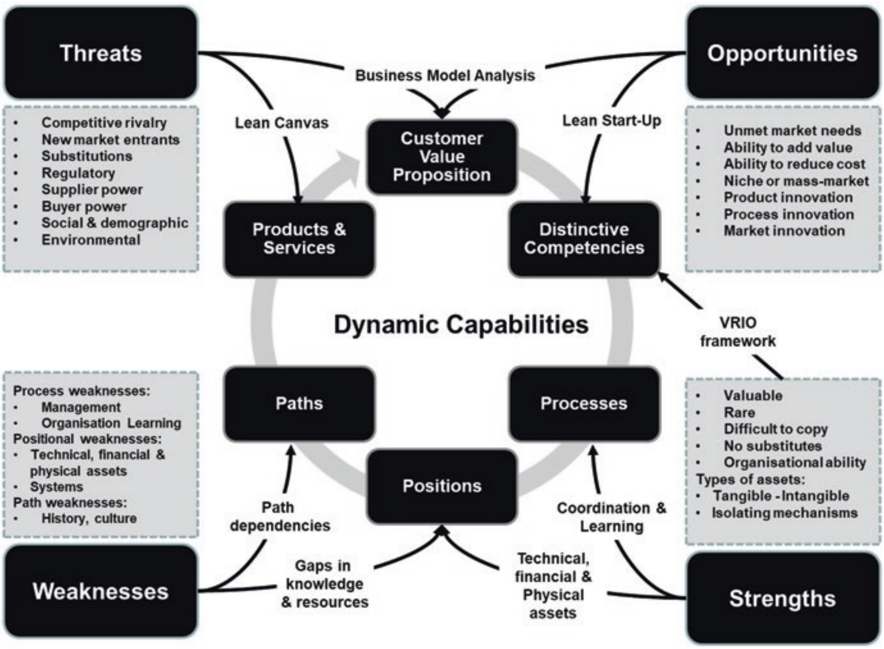

Fig. 4.3 Strategic development framework
Source: Mazzarol (2015)

4.11.1 TOWS Matrix Analysis

On the four corners of the framework are the core elements of the SWOT analysis with the model placed in reverse showing as Threats, Opportunities, Weaknesses and Strengths (SWOT). This approach to the SWOT analysis enables a more systematic approach to be undertaken focuses on the firm's external task environment first providing a TOWS Matrix (Proctor, 1997). All items above the middle of the SDF diagram relate primarily to issues external to the organisation. Those at the bottom relate primarily to issue internal to the organisation. The items listed adjacent to each of the four elements of the TOWS Matrix are important areas for consideration in the planning phase.

4.11.2 Assessing Competitive Threats

An initial starting point for using the SDF is to undertake an assessment of the likely threats facing the implementation of the business model. Here it is useful to employ a "*5-Forces Analysis*" assessing: (i) the overall level of competitive rivalry found within the target market; (ii) the ease of entry to new businesses; (iii) potential substitution threats; (iv) supplier bargaining power; and (v) buyer bargaining power (Porter, 1979, 1980, 2008). Attention should also be given to any regulatory, social and demographic, or environmental factors likely to impact the business model. This analysis should be undertaken concurrently with the use of the *Business Model Canvas* and overall design and development of the business model as discussed in the preceding sections.

4.11.3 Assessing Market Opportunities

Following on from the assessment of threats is an assessment of the anticipated market opportunities. As noted above, this can be undertaken concurrently with the use of the *Business Model Canvas* as the business model is being designed. Important considerations here are related matching the customer to the product or service.

On the customer side, it is important to explore what the customer may need, in particular any unmet needs. An example is the success of Nintendo with their *Wii* gaming platform. Unable to compete directly with Sony's *PlayStation* or Microsoft's *X-Box*, Nintendo identified a segment of the market that was not being targeted by those incumbent products. The core target customers for the *PlayStation* and *X-Box* were men, who wanted high definition, realistic game play requiring relatively high levels of skill. Nintendo positioned the *Wii* at the women and children market segment, offering a quality product that was fun and easy to use.

It is important that the analysis finds ways to offer a CVP that the customer will want. This can be based on a *differentiation strategy* that seeks to add new value, or a *cost-leader strategy* that can help to lower costs (Porter, 1996, 2008).

Considerations should also be given to whether the targeted customers are found in mass or niche market (Murray, 1988).

Once the customer analysis is complete attention should be given to the nature of the innovation that needs to be developed and commercialised in order to satisfy this anticipated need. Managing the innovation requires consideration of the nature of the product, process and even market innovations required. The interaction between four elements need to be understood. The first is the type of innovation (i.e. incremental or radical). The second is the nature of the market environment (i.e. uncertain, complex). Also important is the configuration of the business structure and processes that might be relevant to the innovation. Finally, there is the ability of the innovation to deliver enhanced performance (i.e. growth, market share) (Tidd, 2001).

4.11.4 Assessing Resource Weaknesses

As shown in Fig. 4.3, the SDF involves an examination of the firm's available resources that can be used to meet threats and exploit opportunities. Attention should be given to assessing the *key activities* and *key resources* identified within the business model with a view to assessing process weaknesses in management or organisational learning. *Positional weaknesses* in relation to technical, financial and physical assets should also be identified, which is usually fairly easily done as these resources are generally tangible. However, less easily identified are *path weaknesses*, which involve the history and culture of the organisation that might serve to impact on how readily the firm adapts, innovates and pivots. Any major weaknesses in these areas can feed into the *path dependencies* and *gaps in the knowledge and resources* that will impact the firm's *paths* and *positions* thereby affecting how well it can configure its resources and achieve success through *dynamic capabilities* (Teece, Pisano, & Shuen, 1997).

4.11.5 Assessing Resource Strengths

Counter to the assessment of the firm's resource weaknesses is the need to fully assess the strengths it has in its resources that can provide a foundation for the development of a competitive strategy. The ability to possess resources that are valuable, rare, difficult to copy and with no readily available substitutes offers a firm the basis of a sustainable competitive advantage (Barney, 1991). In particular, if the firm can develop an organisational ability to "bundle" or reconfigure assets, both intangible and tangible, so as to create *isolating mechanisms* (i.e. patents, proprietary knowledge) it can develop *distinctive competencies* that provide a competitive advantage. This is what Barney (2002) refers to as the VRIO framework (value, rare, imitability, organisation).

The SDF describes the process of assessing market threats and opportunities, matching them to internal resource weaknesses and strengths, and applying *dynamic* *capabilities* to the continuous generation of new products and services to deliver a CVP. It also recognises the need to make use of a range of tools such as business model analysis and the *Business Model Canvas*. However, it also recognises the value of integrating the *Lean Start-Up* process (see Chap. 9), particularly in the identification of *distinctive competencies*.

4.11.6 Dynamic Capabilities

The items in the centre relating to what Teece et al. (1997) refer to as *Dynamic Capabilities* are also important. However, these relate more to the implementation of the strategy. As can be seen from Fig. 4.3, these elements are related in an iterative loop, which reflects the dynamic nature of strategy formulation and implementation. Strategy is non-linear in nature as opposed to planning. Plans are the implementation tool of strategy.

A strategy typically looks out over anywhere from 3 to 5 years or more. It seeks to achieve a large or major vision or goal for the entire organisation. It is often not clear how a strategy will be fully implemented as there is usually insufficient information to know what is going to happen. By contrast, plans operate on shorter lifecycles with 6–12 months being the most likely timeframe for any workable plan. However, much depends on the nature of the organisation, its industry and how dynamic the task environment is within which it is trying to operate.

Within the SDF there are several arrows connecting the four elements of the TOWS Matrix to the elements within the *Dynamic Capabilities* loop. These related to a range of strategy tools and concepts that can be applied by managers when developing strategic plans or assessing strategy options and assessing business model designs.

The findings from the TOWS Matrix and *Business Model Canvas* analysis should be used to define the CVP. However, the *Distinctive Competencies* assessment should aim to link the assumptions, or hypotheses about what constitutes customer value and future growth options, with the VRIO framework. Of importance is need for managers to recognize that just possessing resources is not sufficient to achieve competitive success. The defining skill of entrepreneurial firms is their ability to apply organisational learning, creative thinking to “re-bundle” existing assets (both tangible and intangible) into new innovative products or services (Alvarez & Busenitz, 2001).

This ability to apply effective coordination and learning into *processes* that can both create and apply these resource bundles to deliver value to the customer is critical (Teece et al., 1997). Of particular importance is the firm’s ability to adapt and change.

> **For example,** … Change is costly and so firms must develop processes to minimise low pay-off change. The ability to calibrate the requirements for change and to effectuate the necessary adjustments would appear to depend on the ability to scan the environment, to evaluate markets and competitors, and to quickly accomplish reconfiguration and transformation ahead of competition (Teece et al., 1997, p. 521).

Also important are the decisions the firm makes in relation to the *positions* it takes in relation to the deployment of its resources. This includes the technical, physical, financial, human and knowledge assets it possesses. For many firms, particularly small firms, all the necessary resources for success will not be available. This requires consideration of forming strategic alliances to help fill in any identified resource or knowledge gaps.

Over time the firm should develop its ability and capacity to successfully implement its strategy and operate its business model. This experience generates a *path dependency* that can provide a source of strength if conditions remain static and the firm's *competencies*, *processes* and *positions* continue to be suitably configured. However, if the task environment changes this "history" may serve as a constraint to innovation and change (Teece et al., 1997). This highlights the need for the firm to be open to new ideas and willing to learn.

> **For example,** … To be successful for any length of time a firm must innovate…Since innovation requires a certain amount of pre-existing capabilities…, firms need to be able to learn. In order for firms to innovate the skills and resources to sustain innovation must be present (Alvarez & Busenitz, 2001).

4.12 Environmental Scanning and Market Assessment

As discussed above, the small business owner-manager needs to develop a clear focus and direction for their venture with well-defined CSFs and objectives. However, before these can be confirmed and validated, they must first undertake an environmental scan and market assessment. The purpose of this is to estimate the potential for future sales and to ensure that they have considered all potential opportunities and threats.

Strategy in this context can be defined as the process of matching the external opportunities identified in the market with the resources and capabilities found within the business. At least nine key issues need to be considered by the owner-manager when seeking to undertake a strategic assessment of their firm's market and industry setting:

1. *Industry trends*. How large is the industry into which the business is seeking to operate? What is known of its history, growth trends, business life-cycle and customer group behaviour?
2. *Competitors*. Who are the current major competitors – both direct and indirect? (It should be possible to list names and addresses). What are their strengths and weaknesses, their market share/penetration, and their likely response to new entrants? What is your likely window of opportunity?
3. *Target markets***.** Can the firm's target markets (customer segments) be clearly described? It should be possible to describe in detail: the size (e.g. number of potential customers, geographic area, expected growth), customer needs, the level at which needs are now met, demographics, purchasing decision processes,

the influencers, and seasonal or cyclical trends. It should also be possible to identify both primary and secondary target markets.

4. *Barriers to market entry*. Are there any barriers likely to block the entry or expansion of the business into selected markets? Also, are there any barriers that might prevent other firms from encroaching into your selected market segments? The range of things that need to be considered here include: technology and capital, start-up costs and time, the need for personnel, intellectual property (IP) protection, competition and substitutes, R&D, regulations, tariffs/quotas, marketing/advertising, brand recognition, transport, and economic factors.
5. *Market penetration***.** How much market share does the business anticipate it can achieve in any particular market segment? This should be quantified in terms of a percentage of the market and also total sales that might be made. These estimates should be justified by quantifiable evidence and not hopeful expectations.
6. *Pricing and margin targets***.** How price sensitive is the market? It is important that a detailed assessment be made of the pricing strategy, profit margins and sales targets that the business is seeking, or needs to secure for its products to make the business strategy work.
7. *Marketing channels***.** Consideration also needs to be given to how the business will get its products or services sold into the market, how customers will find them, and any problems that might arise over delivery and after-sales support and service. Attention should be given to the possible use of media for advertising and the cost of this.
8. *Primary research and sales data*. Unless the business already has a well-developed customer base, the owner-manager will need to commence building a database that can be used for future market research and sales management. This should include: the names and phone numbers of existing and potential customers, a summary of any market research surveys conducted, and a summary of results (e.g. the willingness to purchase, acceptable price levels, other needs your product/service fills, etc.).
9. *Ability to deliver*. Once the market opportunity has been fully assessed, attention must be given to determining whether the business has the capacity to deliver it products and services on time, on cost, and on quality. Important issues to determine include: the lead time required for filling orders, volume purchase plans, delivery logistics, and after-sales service plans.

4.13 Knowing the Rules of the Game

Every industry has its particular structure, business cycle and ground rules. For an owner-manager to be fully in control of their business, it is important that they examine their industry and monitor its trends and cycles. Many small businesses suffer from cash flow problems caused by slow trading during down turns in the industry business cycle. This can be of particular concern to firms engaged in tourism sectors or the building industry. Experience is often the best teacher for learning how a particular industry operates. However, there are several key issues that should be considered. Among them are the rules of the game operating within the industry. One way to examine this is via the PARTS framework (Brandenburger & Nalebuff, 1995) that contains five elements, i.e. the **P**layers, **A**dded value, the **R**ules, the **T**actics and the **S**cope.

1. *The players*. The first of these elements is that of the players or participants that make up the game. The main players in the industry might include customers, suppliers, competitors and 'complementors' (i.e. firms or organisations that might help the business). Owner-mangers should get to know who these players are and how they can harm or help their business.
2. *Added value*. The second element is the added value that each player can bring to the game. Those with most value to add should have more power or influence over the game. If a business can find ways to neutralise or reduce this value add, it can reduce the relative power of the other players. This is particularly the case in the way supply chain relationships work (supply chains are discussed in more detail later). Each member of a supply chain must offer added value to the network to not only keep its place there, but to enhance its position in the industry.
3. *The rules*. The rules of the game denote the structure of the industry that a business is operating within and the conventions of that particular industry. As there are no universal rules in business, these rules can be shaped and changed by the players. (Ethics and government regulations can also set guidelines.) In some industries there is a rule that ensures one price is charged by all players. This forces companies to accept the market price or risk becoming engaged in a fierce price war. The owner-manager needs to learn what the 'unwritten ground rules' are within their industry. In some sectors there are interpersonal relationships that are used to secure business deals and these can be highly anti-competitive. However, in many industries these 'rules' have emerged to allow complacency and poor practice to occur, often to the detriment of good service or quality to customers. Breaking the rules is often how a small firm gets ahead, although this can be risky. Note, also, that breaking the industry rules is *not* the same as breaking the law.
4. *The tactics*. The tactics employed in the game can involve a variety of moves and countermoves designed to gain a competitive position. For example, the concept of 'judo economics' is one way in which new entrants are dealt with. Here, the market leader in an industry might lower prices to squeeze out a new entrant who may then be forced to either exit the industry or match the major player's market price. If this occurs, the dominant player raises its prices and things settle down, with the smaller player agreeing to remain in a subservient position. This is common in many industry sectors.
5. *The scope*. Finally, the scope of the game is where the boundaries or limits lie. For example, during the 1980s, Sega challenged Nintendo's game market via a 16-bit processor. Nintendo allowed Sega to gain a position in the 16-bit market while it consolidated the 8-bit market. However, once Sega –

the new competitor – had built up the 16-bit market (while taking all the risks), Nintendo then launched its own 16-bit technology. Nintendo, the dominant player at the time, felt confident enough to allow Sega first mover advantage in the new technology because Nintendo (a) already controlled a superior market share and more importantly (b) controlled the rights to the more popular games titles. New technology is always a risk, and in this case, Nintendo was happy to let Sega take most of the risk and then jump into the market later with leap frog technology once the new 16-bit systems had been proven.

This framework also takes into account what Brandenburger and Nalebuff (1995) described as the 'value net', formed by the firm's customers, suppliers, complementors, and substitutors with which the business engages in a variety of competitive and cooperative relationships. These relations are described as 'coopetition' and have to be developed with caution due to their often-ambiguous nature (Dagnino & Rocco, 2009; Nalebuff & Brandenburger, 1997).

4.14 Analysis of Industry Structure

Lewis (1999) has outlined what he describes as a practical guide to the analysis of industries when undertaking environmental reviews. Three phases are described: the first involves an analysis of the key forces influencing the level of competition within the industry; the second involves examining trends taking place in the industry over time; while the third involves a degree of future forecasting and scenario building.

4.14.1 Phase 1 – Analysis of the Current Industry Structure

During the first phase of an industry analysis, attention needs to be given to the five forces that determine the level of the industry's competitiveness (Porter, 1980). Specific attention should be given to answering the following important questions:

- How many competitors are there and how saturated is the sector?
- Do these competitors follow a set of rules that you can understand? How will they react to your moves?
- Are you able to find a point of competitive difference in this market where your business can offer superior value adding?

Porter (1980) has provided a useful framework for the assessment of competitors as well as the industry environment. The framework shown in the following diagram illustrates this process. As noted by Lewis (1999), the diagram suggests that competitors need to be examined in terms of their response profile. This is essentially a SWOT analysis of the competitor that seeks to determine: how

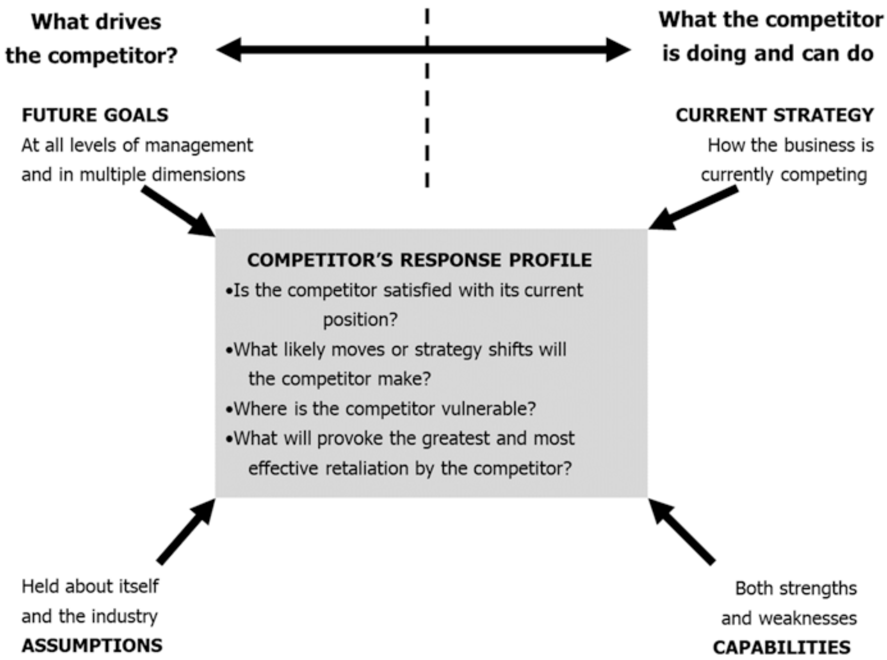

Fig. 4.4 Competitor analysis
Source: Lewis (1999)

vulnerable they are to attack, where they can strike you, and the most likely action that they may take when faced with a market challenge (e.g. price cutting, new aggressive promotions, new products, legal action). Figure 4.4 illustrates this process.

This analysis should aim at understanding the motivational forces driving the competitor. All organisations have their own unique culture, and past history will frequently demonstrate patterns of behaviour that can serve as a clue to future action. The analysis should develop a profile of the management team of key competitors, i.e. who makes up their board of directors, or what is the background of their general manager and his/her key management team?

While sometimes the competitor will reveal their behaviour – e.g. via media announcements, comments by senior executives, feedback from customers or suppliers – it is frequently difficult to know as much about the competitor as you would like. Privately-owned companies are often more difficult to gather information about because they are not required to produce regular public reports. In these situations, more subtle approaches are required. Most businesses have some public profile, and a review of past media records (the internet is good for this) can reveal a lot about the company and its owners.

4.14.1.1 Threats of New Entrants

With respect to the threat of potential new competitors entering the industry, it is a good idea to consider how easy or hard it would be for a new competitor to enter your industry. Often, changes to government regulations, e.g. extended retail trading hours, can allow new entrants to move into a market and challenge the existing *status quo*. The opening up of markets to increased competition is a key policy for governments.

4.14.1.2 Threats of Substitution

Another consideration is the likelihood that new technologies can challenge the existing players within the industry by introducing new substitutes that make existing products or services redundant. When considering substitution threats, a key question to ask is:

4.14.1.3 How Easy Is It for a Customer to Switch from You to Another Supplier?

This is not just about going to another competitor, but actually substituting your product or service with a completely new one. New technology is often the cause of such substitution threats. For example, the ability to use online internet communications for long distance telephone calls may threaten existing telecommunications services. Small business owners should monitor trends in technology to keep alert to substitution threats. This has been the case in the film industry where Kodak has seen its business under threat as digital cameras and home computers allow consumers to substitute wet film cameras and Kodak processing centres with home-based production and printing facilities.

4.14.1.4 The Power of Buyers and Suppliers

While the customer plays a significant role in most small businesses, it is important to consider the bargaining power that they – and your key suppliers – have. An important question to ask is:

> How much power do your customers or suppliers have over your firm's capacity to control price?

In most cases the small firm is a price taker; you can only get into a non-price competitive position by value adding. Successful small business operators build strong partnership-like relationships with their leading customers and key suppliers, ensuring that they can avoid 'price-only' reasons for doing business together.

4.14.1.5 Determine the 'Rules of the Game'

As noted above, the owner-manager should try to determine the rules of the game in their industry and its local context. Look for the unwritten ground rules as well as what is publicly stated. Excellent radar for owner-managers involves getting into professional and social networks where they can find out what the real rules are and can better monitor industry trends.

4.14.2 Phase 2 – Analysis of Key Changes Within the Industry Structure

During the second phase of the analysis, it may be wise to undertake an historical review of the industry to map out how it has changed over time. Of particular importance is the identification of the key forces that have driven change within the industry. Key political, economic, social and technological (PEST) forces need to be examined. For small business owner-managers this might involve reading the business press to monitor trends and talking to others within the industry with more experience of the sector and its trends.

With such data gathered, an initial set of possible scenarios can be developed and scrutinised for plausibility. A set of scenarios that offer a clear pattern of past behaviour or action should be drawn up. If sufficient data is available, these scenarios can be turned into quantitative models for assisting decision-making. To better understand the current structure of an industry requires the owner-manager to look closely at the changes taking place within that industry. A PEST analysis of Political, Economic, Social and Technological changes can help outlines the areas that require consideration.

A Guide to Industry Analysis

Phase 1 – Analyse the current industry structure

- Identify existing competitors in the industry.
- Are there any potential new entrants?
- Are there possible substitution threats from new technology?
- How much power do customers and suppliers have?
- What are the 'rules of the game'?

Phase 2 – Analyse the key changes within the industry structure

- What key political or regulatory issues are likely to impact?
- What is the economic outlook for the industry?
- Are there any social trends likely to influence customers?
- What is the likely impact of technology on the industry?

Phase 3 – Analyse the future industry structure

- Define the geographic or market boundaries of the industry.
- Identify and list all key players within the industry.
- Identify and list all key trends likely to impact the business.
- Identify and list all major areas of uncertainty.
- Develop likely scenarios and assess their plausibility.
- What gaps exist in your knowledge that should be answered?
- Prepare a list of likely options.

Source: Lewis (1999).

4.14.2.1 Political or Regulatory Changes

Are there likely to be changes to the government rules – e.g. retail trading hours – that can impact upon the business in either a positive or negative manner? Reading the newspapers and trade or industry journals, attending public information sessions and networking via your local chamber of commerce and industry (CCI) can all be means of keeping in touch with such developments.

4.14.2.2 Economic Change

How regularly does the industry go through business cycles? One way to keep alert to this is by looking for leading economic indicators. For example, if the business is a supplier to the building industry and there is a change in bank interest rates, this can flow onto the business and lead to a downturn.

Key suppliers or leading customers, if they are from large national firms, can be an excellent source of market trend information. Banks might also supply such information as might the local chamber of commerce and industry.

4.14.2.3 Social Changes

If the business is involved in selling a product or service that has a social or psychological impact on the market or is influenced by such things, it will be necessary to monitor this. For example, the trend within Australia is toward smaller family units, often a couple with no dependents.

Such family units are generally dual income and have high disposable incomes but are time poor. They are interested in a range of lifestyle products and services as well as things that can enhance already well-serviced households.

4.14.2.4 Technological Change

As mentioned above, the impact of technology creating substitution threats to existing industries is significant. It is necessary to keep alert to the way technology is trending so that the business can take advantage of it and can be on the right side of any new technological revolutions. Keeping up to date with technological trends is not always easy but can be monitored by regular attendance at trade or industry shows, by travelling overseas, or by simply using the internet to review the latest developments in products and systems.

4.14.3 Phase 3 – Analysis of the Future Industry Structure

Finally, the owner-manager should look to the future and try to analyse the way that their industry might look in 5–10 years' time, e.g. the impact of digital technology on such areas as printing, graphic design, and a host of other sectors. The ability for people and business to purchase relatively low-cost and user-friendly computer software programs to do work that once could only be done by a professional service has made many industries redundant. However, such new technologies have not completely replaced these services because many people either lack the time or the skills to do this work to the required professional standard.

4.14.4 Key Stakeholders

Key stakeholders can also be of importance and have a crucial influence on the evolution of the industry. Figure 4.5 illustrates the various stakeholders likely to surround the business and who the small business owner-manager may need to consider when seeking to develop strategy or undertake projects (Freeman, 1984). Key forces that can determine the extent to which particular stakeholders may impact on the business are their legitimacy, power and urgency (Agle et al., 1999). For example, customers generally have legitimacy, power and urgency thereby commanding the attention of the small business owner. This may also be the case for financial institutions such as banks and employees, although they may have less power. For many small businesses the legitimacy of such groups as unions or interest groups (e.g. social or environmental) may be challenged (Table 4.4).

Harrison and St John (1996) propose a matrix of power and interest that can be used to assess the potential influence of stakeholders in the firm. Where the stakeholder has high levels of power and a high level of interest in the firm's activities (e.g. shareholder, lead customer), it is appropriate to see the stakeholder as a key player, or even a strategic partner. However, where the stakeholder is powerful but has only a low level of interest in the activities of the business, or has high interest

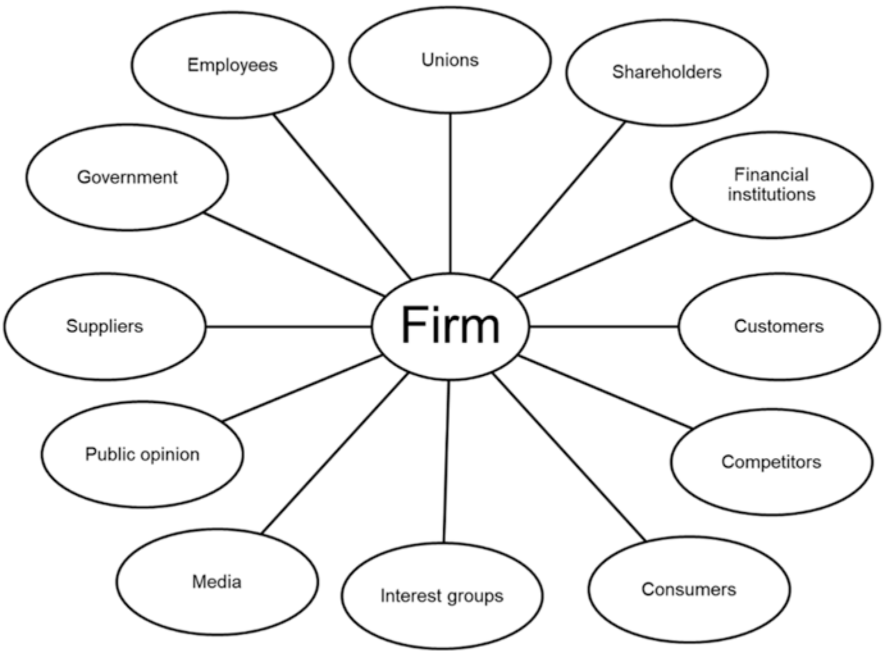

Fig. 4.5 Stakeholders surrounding the firm
Source: Freeman (1984)

Table 4.4 Matrix power and interest

	Level of stakeholder interest		
Stakeholder power		**Low**	**High**
	Low	A expend minimal effort	B keep stakeholder informed
	High	C keep stakeholder satisfied	D stakeholder is a key player

Source: Harrison and St John (1996)

but limited power, it is appropriate to just keep them informed. Yet where the stakeholder has both low power and interest, the business can effectively ignore or expend little effort on them.

4.15 Conducting a SWOT Analysis

One of the most well-known models used in strategic planning is the strengths weaknesses, opportunities and threats – or SWOT analysis – model. It is a useful framework for examining strategic options available to an organisation and usually precedes any detailed strategy formulation. Figure 4.6 illustrates a SWOT analysis framework.

Using the SWOT analysis framework within the strategic planning process requires a careful consideration of both the internal and external factors surrounding the company.

- *Threats*. The main threats facing the company from external sources, particularly those addressed by the PEST model, i.e. the political, economic, social and technological threats.

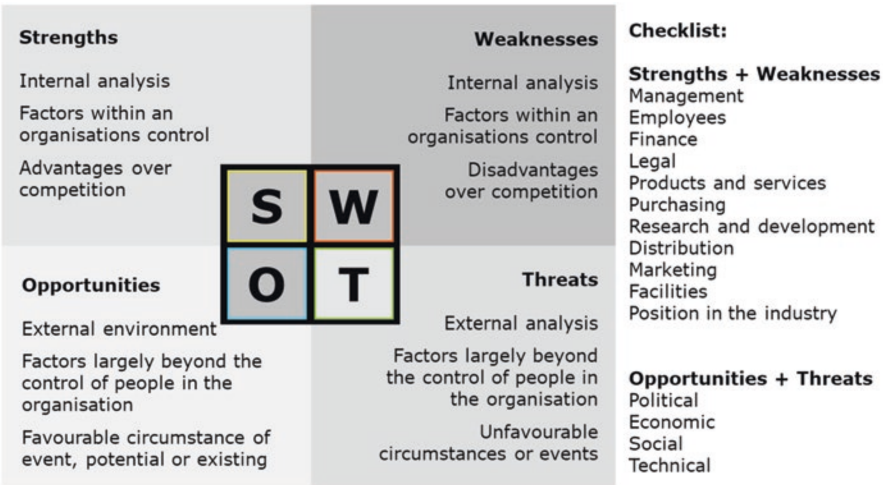

Fig. 4.6 SWOT analysis

- *Opportunities*. Major opportunities including growth in the organisation's markets, and how the organisation might develop a competitive advantage in those markets through configuring existing resources.
- *Weaknesses*. These are predominately internal issues and relate to areas of weakness in relation to the threats facing the organisation, and its ability to follow its opportunities. These can include financial, human, market, technological or physical resource limitations.
- *Strengths*. An assessment of the company's key strengths identified in terms of those things that give it competitive advantage in its chosen markets. These can include resources that allow it to perform better than its competition or potentially exploit a future opportunity.
- *Strategic options*. Analysis of the issues identified by the four key areas of the SWOT model allows the analysis team to generate strategic options that the company may potentially follow. These can then be examined in the future for their feasibility.

Proctor (1997) points to the value of approaching the process via a TOWS matrix in which the threats and opportunities are considered first, and then matched against the organisation's weaknesses and strengths. Environmental impact considerations can be better assessed using this approach. Once a TOWS matrix has been completed, the organisation is in a good position to formulate a range of strategic options for further evaluation and assessment. It is important in undertaking a comprehensive SWOT/TOWS analysis that the owner-manager considers all issues including both internal as well as external environmental influences.

Competitive Analysis

Compare your business with its key competitors in the following areas, listing relative strengths and weaknesses as viewed by the customer:

- *Products or services* – quality, features, brand names
- *Pricing strategies* – about the same, lower or higher?
- *Quality* – better or worse than your products?
- *Stability* – high turnover of employees, managers?
- *Experience* – how many years in the industry?
- *Company reputation* – well known and held in high regard?
- *Location* – are their operating locations better or worse?
- *Appearance* – signage, buildings, uniforms, streetscapes
- *Sales methods* – direct, professional, aggressive?
- *Credit policies* – can you offer competitive terms?
- *Image* – use of publicity, media exposure, word of mouth
- *Advertising* – use of formal advertising and branding.

4.16 Finding Your Competitive Advantage

It is generally impossible for a small firm to be successful in all market segments and across a wide range of industries. Porter (1991) suggests that a firm can effectively compete on only two levels:

1. *By being the lowest-cost producer*. A firm that can produce its products or services at a lower cost to its competitors can either sell them cheaper or at the same level, but with a higher profit margin. This gives it a competitive edge.
2. *By differentiation*. A firm that can add value to its products or services can charge either a premium price or sell at the market rate but attract the customer because of its superior features. This also provides a competitive advantage.

Whichever strategy a firm chooses depends upon its market and possibly upon its products. In a market where the customer is only interested in the lowest price, there is little opportunity for or point in attempting to add value and differentiate. This is the case in commodity markets such as agriculture and mining. Here the successful business must lower its internal cost structure to be competitive.

In most consumer markets – and in industrial markets where sophisticated products are sold – the price paid by the customer is not usually the only criteria. Customers are frequently interested in value for money. Under these conditions the successful business can differentiate its product by adding value. If successful, it can ask a higher price and customers will still buy the product. For example, consider branded goods, e.g. Nike jogging shoes, as compared to Dunlop joggers. These two generic strategies of lower cost and differentiation can be adapted for niche markets in what is termed focus. These are illustrated in Fig. 4.7.

Most small firms will need to follow either a focus cost leadership or a focus differentiation strategy. A firm following a cost leadership strategy runs the risk of not being able to maintain lower operating costs than its competitors. Competing on price is generally risky unless the firm can guarantee that it can maintain the lowest operating costs over a long time period. This is usually difficult for small firms as they lack economies of scale and scope.

A business that seeks to follow a cost leadership strategy will need to ensure that they maintain continuous lower costs either by vertical integration (not usually possible for small firms) or by the application of technological process innovations and learning effects to ensure that it has sufficient economies of scale (again, something not many small firms can achieve) (Murray, 1988).

For firms following differentiation strategies, the risk is that competitors will imitate their product or service offerings and then customer will find it difficult to discern any competitive advantage between industry participants. This is a challenge facing many firms such as retail banks, fast food outlets and manufacturers of consumer goods. Configuring the firm to compete via differentiation can result in the company being unable to retain sufficient cost controls to easily shift back to a cost leader strategy. Further, in highly saturated and competitive markets, the ability

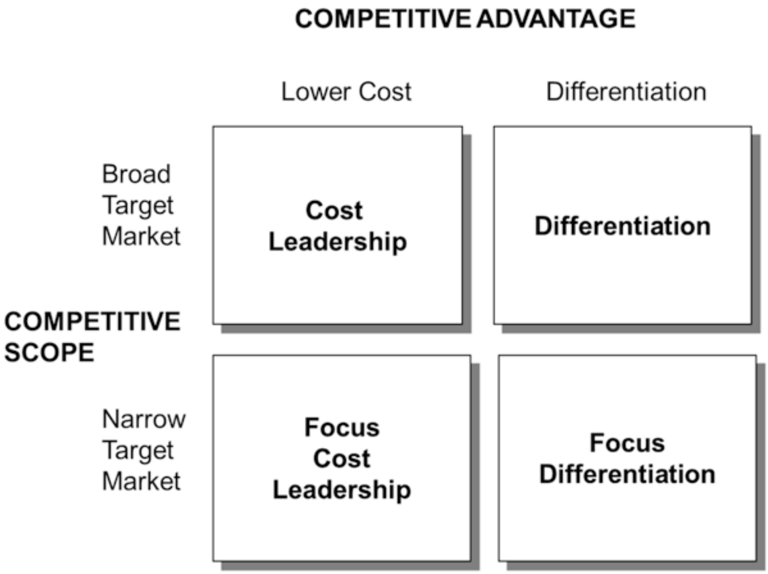

Fig. 4.7 Generic positioning strategy options
Source: Porter and Stern, 1999

of niche players to secure competitive advantages against larger competitors through specialised focus differentiation strategies is a major challenge (Peters, 1993).

To secure a sustainable differentiation strategy, a business must have customers who view price as less important than product or service attributes when making purchase decisions. Furthermore, they will need to be able to use continuous innovation to create new or improved products and services (Murray, 1988).

Finally, for firms seeking to follow focus strategies – either cost or differentiation based – the key risks are that competitors will seek to imitate the strategy or that the niche segment becomes unattractive over time. Larger competitors can easily move into the niche seeking to offer similar products or services, or smaller players can continue to dissect the segment into sub-segments, thereby eroding the focus strategy (Peters, 1993).

Focused strategies require the identification of market niches into which the small firm can position its products or services and maintain a competitive stance without risk of customers leaking across into other segments (Murray, 1988).

4.17 Building on Distinctive Competencies

Competitive advantage is developed from the resources, skills and assets found within the firm. These can be people, products, brand names, technologies or processes – or even the location of a store – which provide the business with the basis for building a competitive advantage. These resources or assets are the distinctive competencies – or the foundation – of a firm's competitiveness (Selznick, 1957).

To provide the basis of a sustainable competitive advantage, such distinctive competencies should have the following attributes known as the VIRO model (Barney, 1991), or what Barney and Clark (2007) have classified as the RIVAL model:

- *R (Rare)*. They should not be commonly possessed by your competitors or potential competitors.
- *I (Difficult to imitate)*. They should be difficult for your competitors to copy or duplicate.
- *V (Valuable).* They must be able to either reduce costs or add value in such a way as to encourage customers or potential customers to choose you over competitors, or even to pay a premium price. They should enable your firm to exploit opportunities or neutralise threats.
- *A (Attached strongly to the firm with no strategically equivalent substitutes)*. They should not be easily matched by competitors with substitutes that can perform a similar function.
- *L (Long lasting)*. Consumer preferences are not going to change soon so it is worth developing these assets and investing in them in order to maintain the competitive advantage.

A survey of CEOs in the US and the UK that asked them to identify their own distinctive competencies identified such things as: company and product reputation, employee know-how, culture, networks, databases, suppliers, distributor know how, and specialist physical resources, e.g. plant and equipment (Aaker, 1992; Hall, 1992b). Of critical importance in sustaining a competitive advantage was the time it might take to replace these assets. The majority of British CEOs, for example, ranked company reputation as most important. They estimated that on average it had taken them 11 years to develop their existing reputation. By comparison, product reputation was rated as being second in importance. However, this could be replaced in about 6 years (Hall, 1993).

What is Your Basis for Competitive Advantage?
- What do you consider to be your firm's two main distinctive competencies, and how many years would it take to replace them if lost?
- They must have the following four elements in combination:
- Customers will value them or they might be used to lower operating costs.
- These assets are not currently available to competitors and will remain so for a reasonable period of time.
- These assets cannot be easily copied by competitors.
- Customers will not be able to easily substitute this resource or asset by using an alternative technology or solution.

4.18 Strategic Planning Responses

Mintzberg and Waters (1984) have suggested that there are three main types of strategy process:

- *Planning* – where the manager is seeking control, standard results and carefully structured and timed implementation;
- *Entrepreneurial* – where the main focus is on following a vision and using past experience and 'gut feelings' to formulate strategy and implement it; and
- *Learning by experience* – where strategy is evolutionary and follows a pattern of trial and error.

Each of these three strategic processes can be found within small businesses. However, it is more common to find the entrepreneurial or learning by experience approaches. The development of strategy within a business can be explained in terms of the response its management makes to the level of uncertainty in the task environment and the level of complexity within its organisational configuration (Tidd, 2001). Mazzarol and Reboud (2009) suggest that there are four generic strategic planning types that are appropriate responses for a given set of conditions. These are illustrated in Fig. 4.8.

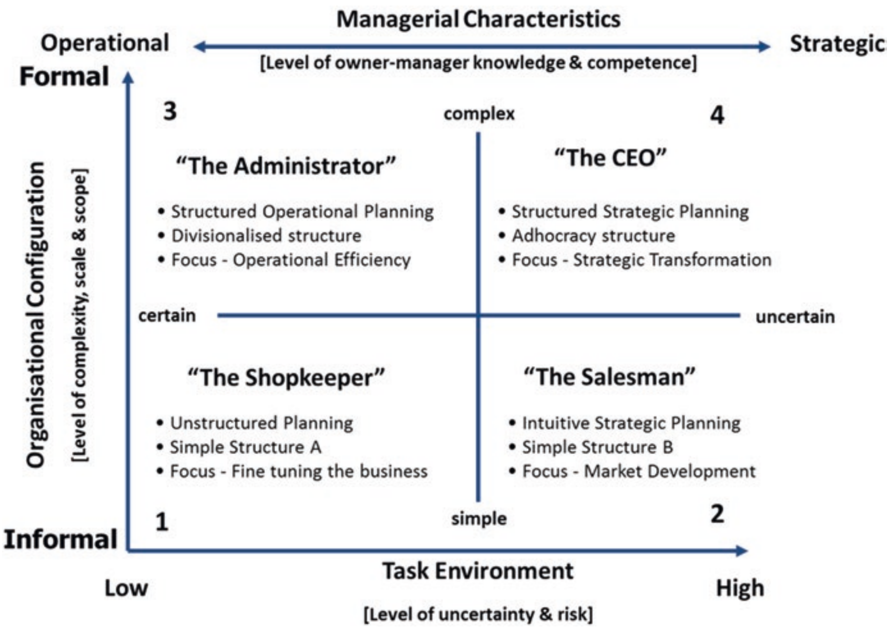

Fig. 4.8 Four strategic planning responses
Source: Mazzarol and Reboud (2009)

Each of the four strategic planning types is a response to the level of uncertainty found within the task environment and the level of complexity found within the firm's organisational configuration. The firm's *task environment* is made up of the environment surrounding the business that impacts on its goal setting and goal attainment. The firm's *organisational configuration* refers to the formal and informal structure of the business (D'Amboise & Muldowney, 1988). These conditions also determine and are determined by the characteristics of the firm's management, with a focus on either operational or strategic issues as a priority. The four types are described below.

4.18.1 The Shopkeeper

Where the task environment is certain and the organisational structure is simple, the appropriate planning response is that of an informal or unstructured planning process. The focus in this situation should be more operational than strategic – or 'fine-tuning the business.' This planning response has been referred to as the *shopkeeper*. Some of the key areas of focus for this type of planning are to improve either the flow of management information to assist financial control and reporting, or the operational systems associated with information technologies and process capabilities. A *shopkeeper* planning response is appropriate where there is a steady market, few competitors, established customers or long-term contracts, a standard product technology, and guaranteed suppliers.

4.18.2 The Salesman

Where the task environment is uncertain but the organisational structure or product/process technologies are simple, the appropriate planning response is that of an intuitive strategic planning process. This planning response is that of the *salesman* and the focus is primarily on market development. *Salesman* strategy involves a high emphasis on marketing and networking. The key areas for attention are marketing and sales activities, developing customer delight programs, and building up the level of strategic networks and alliances. Most of these are designed to help the firm access new markets or widen its existing market share. A *salesman* planning response is appropriate where there are well-organised markets with some competitors, and where customer behaviour is uncertain with fluctuations in orders. Suppliers may not be guaranteed, although product technology is largely routine and not radical.

4.18.3 The Administrator

Where the task environment is certain but the organisational structure or product/process technologies are complex the appropriate planning response is that of a structured operational process. Here the emphasis is on operational efficiency and cost control. This planning response is that of the *administrator* with a primarily internal rather than external focus. The primary focus for this planning response is on quality and operational control. An *administrator* planning response is appropriate where the product or process technology is complex but with a predicable pathway to market. Also, where there is limited competition within diversified markets, this type of planning is appropriate.

4.18.4 The CEO

Where the task environment is uncertain and the organisational configuration or product/process technologies are complex, the appropriate planning response is structured and strategic in nature. This response type is the *CEO*, and the focus is on strategic transformation. It typically involves taking new product technologies into new markets, and needs a systematic approach to planning within R&D, new product development (NPD), and operational controls. High levels of innovation and technological complexity combined with uncertain markets are the domain of the *CEO*.

4.18.5 The Four Planning Responses and Risk

These four planning responses are a means by which the owner-managers of small firms may seek to deal with the risk that increases as the level of complexity and uncertainty increases within their task environment and organisational configuration. As illustrated in Fig. 4.9, the *CEO* planning response, which is structured and strategic, is most appropriate for a Type D Market that has both uncertainty of the market but a complexity in the product (Type IV). This is the highest risk scenario, and any small firm that is seeking to enter a new market with a new product is going to need to plan carefully and systematically because they will not have any past experience of the customer or market to draw upon and even the new product will be unknown. By comparison, the risk is low in the simple-certain Type A market where the product and market is well known (Type I) to the small business owner. Here the more informal, mainly operational planning response of the 'shopkeeper' is appropriate.

It is important to note that the experience and skills of the owner-manager or leadership of the small business play a key part in determining these planning responses. Where the owner-manager is highly experienced in a given product or market, the perceived level of complexity and uncertainty will be reduced. As such, they are less likely to see the need for formal strategic planning such as is appropriate for the *CEO*. However, a problem for many small business owners is that they are not often able to judge well their own level of knowledge and skill about either the product or the market. This is particularly likely amongst the more entrepreneurially-oriented owners who tend to approach opportunities using a

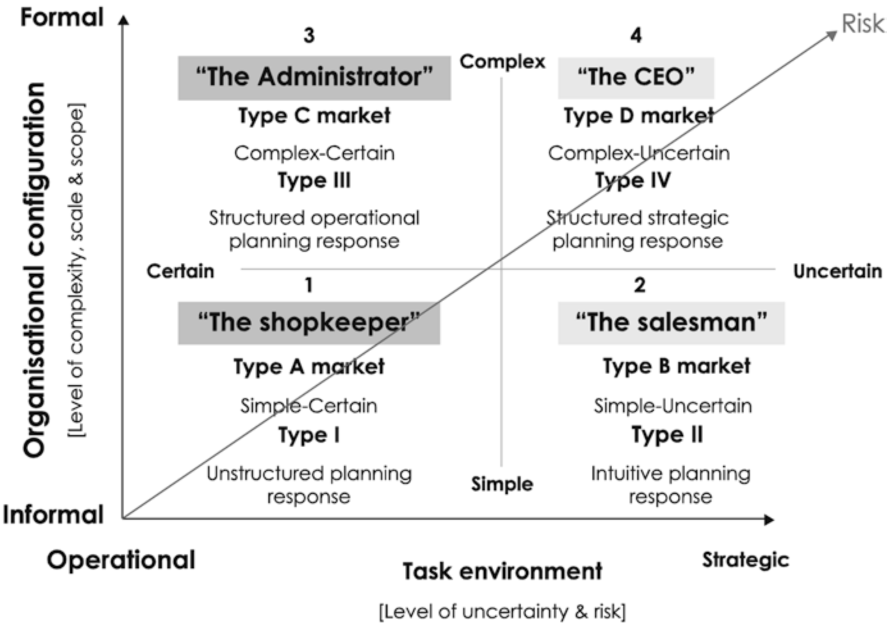

Fig. 4.9 Four strategic planning responses and risk
Source: Mazzarol and Reboud (2009)

combination of biases, heuristics and the *law of small numbers* in which they rely on the opinions of a few lead customers, family or friends to make strategic investment decisions (Simon, Houghton, & Aquino, 2000).

4.18.6 Areas of Focus Within the Four Planning Responses

While the four planning responses are idealised scenarios representing the best options under given conditions for a small business owner to choose, they can be translated into areas of potential action. Figure 4.10 shows the four planning responses and the main areas of focus that the owner of a small business might address when engaging in these particular planning behaviours.

4.18.6.1 Planning Response I – Shopkeeper

The primary focus of the *shopkeeper* is operational issues such as the fine tuning of accounting and financial cost control systems, setting up the firm's information and communications technologies (ICT), and mapping out appropriate key performance indicators (KPI). These are all areas in which many small firms have weaknesses. However, by finetuning the business in this way, the owner-manager can help to boost their profitability and in turn set up their firm to be a well-managed, efficient and more sustainable venture.

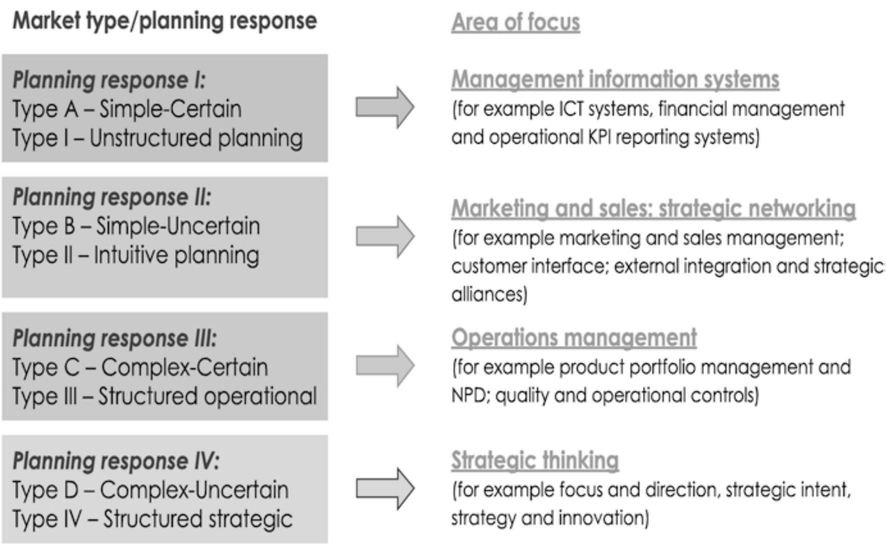

Fig. 4.10 Four strategic planning responses areas of focus
Source: Mazzarol & Reboud, 2009

4.18.6.2 Planning Response II – Salesman

For the *salesman*, the primary focus should be on the areas of marketing and sales management plus strategic networking. The owner-manager who knows their product or service well, but is seeking to enter and exploit new market opportunities, must invest in building an effective sales and new business generation system. We examine this in more detail in later chapters, but the small firm that is hoping to expand within new markets and create new customers must have a strong sales management team. There is also a need for the business to invest in customer relationship management (CRM) system software and support processes. For many firms, consideration should also be given to the longer-term process of building up the corporate and product brand reputation.

4.18.6.3 Planning Response III – Administrator

Faced with a high level of complexity in the production of a product or the delivery of a service, the *administrator* is best served by focusing on the operational management functions, and taking a formal and systematic look at how these should be configured. This may involve the formal structuring of a new product development (NPD) process and the associated systems for R&D management; or, it may involve formal quality assurance and cost control systems being implemented across the firm's production and operations areas.

4.18.6.4 Planning Response IV – CEO

For the *CEO*, the entry into new markets with new products or services is usually part of a major growth strategy. Small firms that engage in this type of activity are often seeking to launch new innovative products, and they are in need of a more structured and sophisticated planning approach that will take a systematic strategic view. Formal market research and analysis with careful attention to building a viable business case, and the acquisition and allocation of resources, will all be part of this planning.

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Creating Customers

5

5.1 Introduction

> If we want to know what a business is, we have to start with its *purpose* … There is only one valid definition of a business purpose: *to create a customer* (Drucker, 1954, pp. 37).

Large corporations have substantial resources to devote to marketing, and frequently have many levels of marketing management with responsibilities for national and regional operations, or different product lines (Webster, 1992). A feature of the large corporation is its use of formal planning processes to guide its marketing activities (McColl-Kennedy, Yau, & Keil, 1990). By contrast, most small business proprietors find the marketing of their businesses a complex and difficult task. Unlike larger firms, the small business lacks both the resources and the expertise (Carson, Gilmore, & Rocks, 2004).

5.2 Marketing the Small Business

While the large corporation can afford a dedicated team of trained marketing specialists, the small business owner-manager is forced to carry the burden of being responsible for sales, marketing, personnel, publicity, production and financial matters. In most cases these duties are performed by the owner-manager without any formal training. Marketing knowledge and skill among small business proprietors is generally low, and many consider marketing to be little more than selling or advertising (Gold, 1993).

This lack of marketing skills among small business owners has been highlighted by past research which has identified an absence of formal planning, inadequate customer knowledge, an absence of market research and poor or ineffective use of

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promotional tools (Carson & Cromie, 1990). Small business owner/managers are also restricted in their marketing activities by a lack of financial resources to undertake market research, promotions or employ specialists (Weinrauch, Mann, Robinson, & Pharr, 1991).

Marketing is frequently viewed as a kind of *magic bullet* that can be fired at customers to enhance a firm's success. It would be wonderful if this were true, but alas the reality is somewhat different from the popular perceptions. There are no *magic bullets* that a small business can get. The process of marketing involves the development of strategies and plans which can integrate all elements of the firm's activities to enhance customer satisfaction and maximise sales. It should involve the firm focusing upon the needs of its markets, and then developing or shaping its product or service offerings to satisfy these customer requirements. This marketing concept remains an integral aspect of good marketing practice in all successful businesses (Clark, 1987; Kruger, 1989; Payne, 1988). Marketing is also something that must involve all members of the firm, and not just those with a designated marketing function (Gummesson, 1991; Piercy, 1991).

Small business marketing activities are heavily influenced by the perceptions of their owner-managers who are often close to their customers and frequently follow intuitive approaches with little formal planning (Carson, 1990). Unlike management of large corporations, the small business proprietor is likely to view marketing expenditure as a non-essential cost. Use of professional selling is also avoided by many small firms due to its cost and complexity. Most small firms lack specialist marketing expertise and sufficient financial resources to make a significant impact on the market via promotion or distribution strategies (Carson, 1985). This lack of expertise and resources distinguishes the small firm from its larger counterparts in terms of marketing activity (Davis, Hills, & LaForge, 1985). Despite this lack of marketing skill and application within the small business sector, the importance of marketing to small business success is strongly highlighted in the literature (Boag, 1987; Merrilees & Nuesink, 1992).

According to Carson (1985) the small business moves through a four stage evolutionary cycle in its marketing activities. In stage one the firm commences initial marketing activities and is frequently focused on product related issues. Product quality, pricing and the establishment of reliable distribution channels are a dominant concern. In stage two, the firm is involved in *reactive marketing*. This is driven by increasing customer demand and the firm is frequently engaged in reacting to this demand. By stage three the firm has grown both in market share and experience, and the owners are usually willing to attempt new strategies in something of a *do it yourself* marketing approach. Finally, stage four finds the firm adopting more sophisticated marketing techniques involving *integrative and proactive* strategies. This can incorporate such things as relationship marketing, customer tracking, and coordination of all the elements within the marketing mix to deliver a fully customer-oriented marketing structure (Kau & Ch'ng, 1990).

5.3 Small Business Marketing Success Factors

Understanding what customers need and want, how they make their buying decisions, and how they use products or services is an important first step in the process of developing an effective marketing strategy. Once these customer needs and wants are identified, the firm can either develop or modify its product or service to meet customers' needs and specifications.

Once the business has generated suitable products or services, its next challenge is to sell them into the market and communicate via promotion and advertising the existence and relative merits of these products or services. If the small business owner has managed to identify points of difference based on its distinctive competencies, they should clarify what these *unique selling propositions* (USPs) are, and build appropriate communication strategies – e.g. promotion via advertisements, publicity or selling – to inform customers about them. They must then be prepared to keep on improving.

This can be viewed as part of the reflection around the Business Model of the small firm. Using the Business Model Canvas approach (Osterwalder & Pigneur, 2010) leads to identify 9 blocks, including: a value proposition, a target customer and key resources and competences (see chap. 4). A strong link between those three components helps to gain a higher legitimacy perceived both by the targeted customers and by the employees. Osterwalder, Pigneur, Bernarda, and Smith (2015) suggest that the analysis of the customer's needs should include:

- A better understanding of the customer's jobs,
- An observation of the pains encountered by the customer when actually doing these jobs,
- An understanding of what is considered as important in terms of the quality expected by the customers (the gains)

These observations help the firm to design a value proposition incorporating "pain killers" and "gain creators".

Marketing Within the Small Business

Marketing within the small firm is a four-stage process:

1. Identify customers' needs and wants.
2. Develop or adapt products and services to meet customer needs.
3. Communicate to the customer the product or service highlighting your unique selling points.
4. Continuously improve the product or service and innovate in response to customer feedback.

Marketing in the small business is different from that of larger organisations because the owner-manager frequently has:

- a much greater degree of personal knowledge of the business' position in the market;
- greater direct contact with customers;
- the ability to be responsive and flexible in meeting customer needs;
- a wide range of informal methods to collect market intelligence; and
- greater benefit from word of mouth referrals rather than the formal use of promotion.

Research undertaken into the factors associated with successful small business marketing shows that the most important source of promotion for these firms is word of mouth referral. A study of the marketing practices of 113 small businesses in Australia found that success – measured by profitability, growth in sales and employees, and growth in assets – was associated with above average levels of formalisation in the marketing process, rising market share and a greater level of sales generated by word of mouth referral (Mazzarol & Ramaseshan, 1998).

This research highlights the need for owner-managers to adopt a systematic and formal approach to marketing, sales and service. From this research, success was also associated with:

- regular use of customer surveys to identify customers' needs and wants;
- systematic branding of products and services and the development of their corporate image;
- possession of a formal marketing plan that is reviewed regularly;
- formal customer tracking and recording;
- staff training in customer service skills;
- regular product reviews following market feedback; and
- formal market research before a new product launch (Mazzarol & Ramaseshan, 1998).

5.4 Everyone Is Responsible for Marketing

Marketing is a strategic process that requires senior management to set the overall direction in which the firm moves. A carefully considered marketing strategy needs to coordinate decisions regarding which products are sold and into which markets. However, marketing should not be entirely left up to management to implement. The implementation of the firm's marketing effort is something in which all employees must participate. Everyone needs to have a clear understanding of the overall vision and goals for the business, and how they can implement the firm's marketing strategies through their own work efforts.

Whenever a customer contacts a business – or is in contact with its staff or its products – they are assessing the firm's capacity and reputation. Such 'moments of truth' should result in customers being so impressed with the firm's performance that they are delighted and are willing to provide word of mouth referral to others. However, if they have a bad experience, this word of mouth will be negative and the damage to the business will be immeasurable.

5.5 Creating Customers Via '*Customerising*'

The key to any marketing process is to generate sales. This requires the small business to create new customers and retain those that have already purchased from the firm. For most small businesses, the process of marketing is closely associated with both selling to and networking with the customer to ensure that their needs are fully understood and met. Hall (1992) suggested that the term *customerising* was a more suitable term to use when describing small business marketing. The concept of *customerising* relates to the ability of the business to continually delight the customer by understanding his or her minimum expectations and then exceeding them. Hall (1992) identified five key elements that make up the customerising process:

- *Customer commitment*. This is the willingness to consider the likely impact on the customer of any decision or action that is taken.
- *Networking*. This involves actively working with those who can influence the business. This may include competitors from time to time.
- *Problem seeking/problem solving*. The business that views itself as a problem seeker and solver rather than a mere product peddler is likely to be more successful. Customer problems become opportunities for future product or market development.
- *Customer delight*. The ability to surprise the customer with added value to products or service and continually exceed their expectations.
- *Market development*. It is important that the small firm owner-manager is able to focus on the core skills they and their firm possesses when seeking to develop future business strategies.

Achieving successful *customerisation* requires the small business owner-manager to develop a coherent approach to three key elements: i) achievement of customer delight; ii) strategic networking; and iii) the development of a business generating system. Each of these three elements is examined in the following sections.

5.5.1 Creating Customer Delight

For a small business, the development of delight in customers is critical to future success. The generation of truly satisfied customers requires a concerted and long-term strategy that starts from the owner-manager's commitment to quality and service. Listening to the customer and being responsive to their needs rather than simply trying to sell products or services is a key hallmark of customer delight. It is important to keep close to customers, to seek to understand the differences between their minimum levels of expected and acceptable service, to explore the trade-off between quality and cost, and to better identify what customers really desire.

In seeking to fully delight the customer, the small business needs to view the need to listen to the voice of the customer as a regular part of its product or service development process (Griffin & Hauser, 1993). Understanding what customers want and then finding ways to deliver it beyond existing industry benchmarks of speed, quality or performance can help ensure not only delighted customers but also competitive advantage.

Customer delight is measured in terms of the level of unsolicited repeat business and the word of mouth referrals that the business receives. Customers should regularly be heard expressing delight or pleasant surprise as to the speed at which a problem was solved or a request responded to. Owner-managers of small firms should be able to provide at least six good examples of customer delight and a similar number of clear examples of how their business has demonstrated its commitment to customers from the recent month's business activity (Hall, 1992).

A customer-oriented business will have frontline sales or service staff who are aware of the importance of customer delight, and are trained and committed to achieving it. Customers should find it easy to do business with the company. In addition, the business needs to be ready to adapt its products or services to respond to major market opportunities if required as well as having a core range of tried and tested products or services.

Loyal Customers Make Business Easy

If you are a small business owner, consider the following important questions:

- What percentage of your customers are repeat customers?
- What is your customer's buying cycle?
- How much is a loyal customer worth to your business?
- How much time do you spend winning new customers versus nurturing existing ones?

Most small business owners understand the concept of 'good will'. This is the intangible asset that frequently adds value to the balance sheet. Loyal customers represent a cushion of potential sales that, if retained, are almost like having a healthy bank balance to draw upon. They are in essence the firm's good will.

Loyal customers are valuable. For example, the Domino's Pizza chain estimates that a loyal customer is worth about $5,000 over the ten-year life of a franchise. The Ford Motor Company estimates that a loyal customer is worth $142,000 over their life.

(continued)

Many business people spend much of their time trying to win new customers. While this is a necessary activity, it is usually three to five times more expensive getting a new customer to purchase as it is to get a repeat purchase from an existing one. For this reason, the loyal customer is valuable and deserves more attention than the prospective customer.

The aim of any small business owner should be to widen their range of leading customers in order to avoid becoming overly dependent on one or two key accounts. They should also have a clear understanding of what combination of price, product quality and service will lead to delight among customers. There also needs to also be a well-established system for problem solving within the firm.

5.5.2 Strategic Networking

Small businesses that actively seek strategic alliances with customers, suppliers and third party support agencies – e.g. accountants and banks – are likely to enjoy more success than those that don't (Ostgaard & Birley, 1994). Owner-managers from small businesses can use strategic networks to secure new business opportunities, defend existing market share or acquire access to resources that might otherwise be outside their reach (Jarrett, 1998).

Unfortunately, many small business owners don't fully appreciate the importance of strategic partnerships and are often reluctant to engage in strategic alliances out of a fear of losing valuable information, or out of a desire to remain independent. Others either don't see the value of strategic networking, or see other firms as untrustworthy (Dean, Holmes, & Smith, 1997).

The owner-manager must recognise that networking is a strategic responsibility and one that they need to allocate time for. For most small firms, the best time spent is that devoted to networking with leading customers (Mazzarol, 2003, 2004). Networking needs to be discussed and planned on a regular basis at management meetings within the business. All members of the firm need to understand the importance of networking and how it impacts on the success of the company.

The capacity of the owner-manager to form strategic partnerships with customers, suppliers, employees and business advisors has been identified as important to successful growth in small firms (Mazzarol, 1999b).

5.5.3 Developing a Business Generating System

Networking is one means by which new business opportunities can be created. However, the successful small business owner needs to develop a systematic means of new business generation. The ability to listen to the voice of the customer and adopt a problem seeking, problem solving approach to managing customer relationships will also greatly enhance new business development.

Building a Business Generating System

Creating customers requires understanding of the customer buying cycle. This is the sequence of stages through which your customers move prior to and after they actually make a purchase.

In order to generate new business, you need to find out the following things about your customers:

- What motivates them to buy your product or service?
- What search process do they go through to find a supplier?
- How did they learn about your business?
- Why did they choose to buy from you?
- What was their level of satisfaction during and after purchase?
- What made them buy again if they are repeat purchase customers?

Knowing these things can help you turn suspects into prospects, prospects into customers, and customers into advocates who sell your business for you – all of which can help to make running your business a little easier.

Research into successful small businesses highlights the importance of possessing both key data awareness and a business generating system (Mazzarol, 1999a). Being key data aware refers to a situation in which the owner-manager knows how they win their business and what information they need to gather to monitor their customers. Such information includes knowing: who buys, why they buy, and how they buy (frequency and search patterns). The owner-manager should possess key data on their customers to ensure they understand the minimum set of expectations that they need to fulfil.

Key Data Awareness

Successful small business owners need to know how business is won and what information is needed to answer the questions:

- Who buys?
- Why do they buy?
- How do they buy, e.g. what is their buy frequency and search behaviour?

Successful small business owners need to possess key data on customers to ensure customer delight takes place regularly. For example:

- Are customers satisfied?
- What are their complaints?

This process has strongly evolved a lot over the last decade due to the technological evolution and the digital transition. Most of the firms, including many small firms, have developed agile methods (Sukwadi, Wee, & Yang, 2013; Zhang, 2011) and rapid customer testing of "Minimum Valuable Product" (MVP) (Racolța-Paina & Andrieș, 2017). This process enables to stick to customer needs and to test almost continuously that the features provided correspond to the minimum requirement of the customers.

Customer delight can only be achieved if customer satisfaction levels are monitored and if any complaints are addressed. The essence of a new business generating system is to have a clear strategy that targets well-defined market segments within primary markets that have been researched and that offer excellent long-term growth potential. All employees within the firm should be able to view themselves as sales people and effectively communicate the company's vision and mission to the customer or prospective customer.

In successfully developing any market, the small business owner-manager should avoid competing purely on price. Avoiding being 'price driven' will require value adding to products or services by the small business, which will in turn enable customers to buy for reasons other than price and may help justify any premium prices charged (Mazzarol, 1999a).

5.6 A Marketing Framework

Figure 5.1 illustrates a marketing framework for a small business. It comprises five key elements that need to be considered by the small business owner-manager when seeking to develop a systematic approach to the way the business is marketed (DUBS, 1995). These five elements and their various considerations combine to make up a marketing framework that can guide the development of an effective small business marketing strategy.

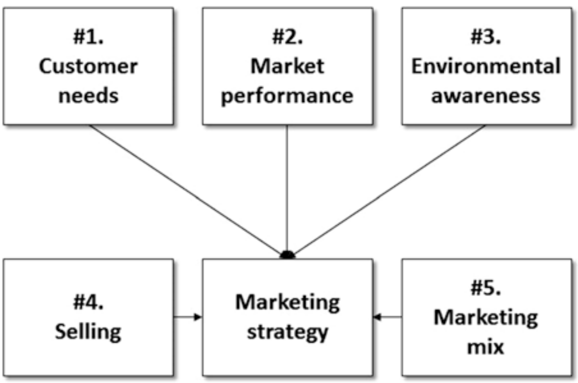


Fig. 5.1 Small business marketing framework. (Source: DUBS, 1995)

1. *Understand the customers' needs*. Market research is essential to the owner-manager fully understanding their customers' needs and wants. This does not have to involve formal market research conducted by professionals, but it does need to be systematic. Focus groups, surveys, and interviews with customers can teach a lot about the business and its products.
2. *Assess the firm's market performance*. The owner-manager should look back at the firm's past track record in the market, how each product has contributed to the profitability of the firm, and how sales have been trending for each product or product group.
3. *Maintain good environmental awareness*. The owner-manager should seek to be kept fully informed of any trends or changes taking place in their industry and any likely to impact on their business – from government regulations to the activities of competitors.
4. *Develop a coherent sales strategy*. In business, selling is where 'the rubber meets the road'. The small business owner-manager must have a well-considered sales strategy to assist them with new business development and the retention of existing customers.
5. *Develop a marketing strategy based on the marketing mix*. The marketing plan is built around a framework known as the 'marketing mix' which will be discussed below.

5.7 Identifying Customers' Needs and Wants

> **Consider the following statement:** … Customers buy hopeful expectations not actual things (Theodore Levitt, Harvard Business School).

Have you ever wondered why people buy perfumes and after-shave lotions? In many ways, much of what we as customers spend our money on is to fulfil specific desires or to solve problems. We are frequently seeking the solutions offered by these products and service rather than the products themselves. Therefore, it is important to focus on the *customer* and not the product. This has several important consequences:

- *Research the customers' needs and wants*. Ask: 'Why do my customers buy my products? Why do they buy them from me? How do they make their buying decisions?'
- *Segment the market*. Not all people are the same, but customers can be grouped into identified segments by various characteristics, e.g. age, income, education, geographic location, lifestyle, etc. Get to really understand which segments are truly valuable to your business and can offer the best long-term potential.
- *Adapt the product or service to the customer*. Few customers will adapt themselves to suit your product. Shape it to best fit the needs of the customer, and be flexible enough to modify it quickly to adapt to changing tastes or individual needs if required.

- *Seek competitive advantage by value adding not cost cutting*. While some industries may be suited to low-cost competition, most are not. Add value, charge a premium price, and compete by differentiation.

5.7.1 Conducting Market Research

An important element of understanding the market place is to undertake regular market research. This need not be expensive. Asking customers what they like and don't like about a product and debriefing distributors, agents and sales representatives can also tell you a lot about the way the product is performing. However, it is important to remain open minded and objective (Hamlin, 2007). Examining sales figures and tracking customer-buying patterns can also be undertaken via internal procedures. Don't forget that nearly 90% of what you need to know about your industry is probably already in print in government reports, newspapers, magazines and journals. Some 'desktop' research could prove extremely cost effective for future management decision-making.

Techniques for Focus Groups and Interviews

Ensure that the objectives of the study are clearly outlined and understood.

Work from a prepared discussion or interview guide that maintains the overall structure of the questions and keeps the interview or focus group on track.

Ask open-ended questions to evoke responses that allow the customer to talk about the things that they like or dislike about the *status quo*. Avoid questions that encourage 'yes' or 'no' answers.

Do not allow the interviewer's opinions or biases to dominate or influence customer responses.

Have interviews or focus groups facilitated by trained or experienced market researchers and who are not directly associated with the company.

Ensure interviews or discussions are recorded, ideally using audio recording device, but inform all participants and make sure that you have their consent.

5.7.2 Focus Groups and Interviews

The process of gathering data to identify customer needs can involve a range of market research techniques comprising both qualitative and quantitative methodologies. One of the most popular methods is the focus group where 8–12 people are guided by a facilitator through a discussion lasting about one to 2 h. This technique has been in use since the late 1940s and is useful for circumstances where it is desirable to have people share their opinions or views on a subject, as this can help elicit information less likely to emerge in one-on-one interviews (Hines, 2000).

5.7.3 Focus Groups Versus Interviews

An advantage of focus groups is their ability to draw together a relatively large number of customers in a single meeting and to provide a large amount of data fairly quickly. Focus groups often stimulate participants' thinking and can elicit information that could otherwise be missed in surveys or one-on-one interviews. However, the focus group needs to be facilitated by an experienced researcher to get the best outcomes. An alternative is to conduct one-on-one interviews with customers. This is more time consuming and therefore more expensive, but can be just as revealing. Evidence suggests that two interviews can yield as much information on customer needs as one focus group, and that 20–30 interviews can generally produce about 90–95% of the customer needs information required (Griffin & Hauser, 1993).

5.7.4 Surveys

Other research methods can be used to examine customer needs. Quantitative techniques usually involve undertaking surveys and then analysing the data with statistical software packages. There are at least two types of research study that you might use: descriptive studies and causal research. Descriptive studies provide an overview of how the market looks, while casual research seeks to understand the relationship between one variable and another. Assistance with quantitative market research should be sought from specialist market researchers who can be found in the universities or the private sector. In simple terms, the two main types of quantitative techniques that might be used to assess future markets are surveys and experimental designs.

Survey techniques require a representative sample that is statistically valid. The size of the sample may depend on the nature of the study to be undertaken, but the minimum sample size for statistical validity is around 40 responses. It is preferred that samples be larger than this and most market research studies involve samples of between 100 and 500 responses.

Principles of Good Questionnaire Design

- Use simple, everyday language.
- Keep questions short and avoid 'double-barrelled' questions.
- Avoid the use of double negatives in questions as this may lead to the response being reversed.
- Use plenty of white space, a consistent font and clear instructions to guide the respondent through the survey.
- Ensure the respondent understands what is being asked of them and that they can make a reliable, meaningful comment on the question.
- Use appropriate data recording methods, e.g. Yes/No, rating scales like 1 = strongly disagree, 5 = strongly agree).

(continued)

- Ensure question items flow logically and don't conflict with each other. General questions should normally precede specific ones.
- Allow sufficient room for respondents to answer questions.
- Avoid too many open-ended questions, particularly in telephone surveys.

Source: Peterson (2000). Questionnaire design methods

Care should be taken when developing questionnaires so that question items are written clearly and in plain language. It is not appropriate to have a telephone survey lasting longer than 15 min, and professional assistance with such surveys is recommended. Ambiguity in question item wording can be overcome by careful piloting of the questionnaire before undertaking the full survey. This may involve taking a small number of customers, getting them to complete the pilot survey, and then obtaining feedback on what they understood or did not understand in the questionnaire (McColl, Jacoby, Thomas, & Soutter, 2002).

5.7.5 Sampling Issues for Surveys

The size of the sample, rather than of the population, is what determines the precision of survey results. This means that just as big a sample is required to accurately represent a small population as a large one. Three factors determine how large a sample must be:

1. the desired level of accuracy (conversely, the margin of error that is acceptable);
2. the desired level of confidence that results are actually within the level of accuracy; and
3. the variability of key variables.

The greater the variability of key variables, i.e. background and behavioural characteristics or attitudinal positions, the larger the sample size needs to be. To investigate the perceptions of a sample population on a range of issues relating to individual attitudes, we must assume maximum diversity (variability) in responses; that is, the entire population cannot be homogenous in perceptions or characteristics.

However, the desired level of sampling error (e.g. plus or minus 2% of survey results) and the probability that those results are within that (4%) error margin (e.g. with 95% confidence) need to be determined in order to select a sample size. These are subjective decisions dependent on the purpose of the research and the resources available. Most national surveys specify a 3% margin of error with a 95% confidence level (Table 5.1).

Table 5.1 How many people do you need in a random sample?

Desired accuracy level	Desired confidence level .01 (99%)	Desired confidence level .05 (95%)
1%	16,587	9604
2%	4147	2401
3%	1843	1067
4%	1037	600
5%	663	384

Source: Corbett (1991)
Note: The table assumes maximum variability for a binomial variable

The table above shows the relationship between the desired accuracy level, the desired confidence level, and the sample size. For example, a 3% accuracy level with a 0.01 confidence level (meaning that we can be 99% confident that a result which lies within 3% is not random) would require a sample size of 1843 respondents. Large samples are expensive to gather and therefore a compromise is often required. Market research studies using around 400 respondents are common and are usually quite accurate.

5.7.6 Data Collection Methods

Survey data collection is now primarily undertaken using online survey methods, usually facilitated by consumer panels managed by professional market research firms (Callegaro et al., 2014). Online panels comprise respondents who have agreed to participate in regular consumer surveys for a small remuneration, typically based on the number of questions they are asked to complete.

Some online market research panels are large and have been screened by the research firm to enable them to be segmented into different demographic groups depending on the nature of the research project. When selecting an online panel provider, it is important to ask questions about the size and demographic mixture of the respondents in the panel. Most panels will comprise a cross-section of the general population, but if specialised samples are needed (i.e. particular age groups, ethnic groups or occupations) it may be difficult to collect sufficient numbers of respondents.

In this case the telephone survey might be necessary. Data can be gathered most easily by telephone survey, although customers might also be sent questionnaires in the mail or even via email. Telephone surveys offer a fast way of capturing survey data, and can ensure that target sample sizes are obtained, e.g. the surveyors keep calling until quotas are filled. However, telephone survey work is best done by professional agencies and may not always capture data in the depth required. These agencies will also use computer assisted telephone interview (CATI) systems making it more.

An increasing problem with telephone surveys is that many people no longer have a fixed line telephone and make exclusive use of mobile or VOIP systems such as Skype. The telephone directory is often not able to reliably provide a cross-section of the population as it once did. Professional market research firms with call centres should be consulted and it may be necessary for you to purchase a database or list of respondents, however, the reliability of these lists may not be guaranteed.

Mailed surveys are becoming much less common today and will require that you have a reliable mailing database to work with. Mailed surveys allow for more in-depth questions but suffer from lower response rates. It is usual for mailed surveys to return around 10–20% response rates. This means that large numbers of letters must be sent out to get a reasonable sample size back. The mail survey may also suffer from sample response bias where only those customers who are either positive or negative will respond.

For many small business owners, a lot of market research data can be collected via social media. For example, firm's that have company Facebook, LinkedIn, Google+ or Twitter accounts can use these to track customer engagement and feedback. Company website traffic can also be monitored using online analytics provided by Google or web hosting services. Small surveys can be run using such social media tools at little or no cost. These sites can also be used as online Apps to capture customer or consumer feedback via mobile platforms such as smart phones (Mahajan, 2015). Once again, this type of data collection is often best undertaken with the assistance of a professional market research company.

5.7.7 Boosting Response Rates

To get a better response rate from surveys, consideration should be given to the saliency of the questionnaire in the mind of the customer. If the survey is not viewed as important, they will often ignore it or refuse to participate. A well-considered covering letter or telephone script is essential to boost responses. In some cases, respondents might be pre-notified of the survey, in which case you would call them by telephone, seek their participation and then send them the questionnaire in the mail. It may also be useful sometimes to follow up a mailed survey with a telephone call to confirm receipt of the questionnaire and participation in the study. Such techniques are, however, quite costly and may be viewed as annoying to customers if you don't have a well-established relationship with them.

A small incentive can boost response rates. For example, focus group participants are usually offered a small sum of money (e.g. $70) to compensate them for their time. Lottery tickets or theatre tickets have also been used to boost response rates. Explaining in your covering letter why the study is being undertaken and any potential benefits to the respondent may also boost participation. Finally, ensure that the questionnaire is not too long and that it is easy to complete.

5.7.8 Data Analysis

Quantitative data analysis is best undertaken by specialist market researchers who can be found via universities or professional market research agencies. There are many different statistical methodologies that might be used to analyse quantitative data; this textbook is not able to examine these in any detail. However, most statistical analysis involves either bi-variate or multivariate techniques. Bi-variate analysis examines the relationship between two variables and employs such statistical measures as chi-square or t-tests; while multivariate analysis examines the relationship between one or more dependent variables and multiple independent variables. Such techniques as multiple regression, factor analysis, conjoint or discriminant analysis are typically used (Holbert & Speece, 1993).

Qualitative analysis can include a process of archetyping customers. Building consumer archetypes consist in personifying the typical consumer. One of the techniques developed is based on "personas", a concept coming from anthropology (Adlin et al., 2006) and this is more and more used as an alternative method for representing and communicating customer needs.

> **For example,** … by using a narrative, picture, and name, a persona provides product designers with a vivid representation of the design target (Miaskiewicz and Kozar (2011).
>
> **Furthermore,** … this can be enormously helpful in keeping everyone's thinking focused on the emotional connection to consumers. The archetype can be a real person or a composite creation (Lojacono and Zaccai (2004) (p. 77).

5.8 Assessing Your Market Performance

The findings from the market research are used to guide a process of strategic market assessment that examines the current structure of the industry or market that the small business finds itself in, how this market is changing, and what its future directions are likely to be. Also, of importance is to assess how your business has been trading over time – usually a period of about 3 years.

5.8.1 Classifying Customers for Performance

A part of the segmentation process is to classify all customers or customer segments according to their value to the business. There are various ways that a customer might be classified. One suggestion is to apply various customer classification methods (Naylor & Greco, 2002):

1. *Cash flow*. One method is to use a debtor matrix and classify customers according to how regularly and reliably they pay their invoices. Customers that are willing to pay up front, on time or even in advance are going to have a positive

impact on the firm's cash flow. By contrast, those customers that are slow to pay or unreliable will only harm the firm.

2. *Investment portfolio*. Customers can be viewed as investments. Review the customer base as an investment portfolio, look for the customer relationships that have good long-term profitable growth potential and focus on these. For those customers that are not performing, the owner-manager should take steps to remove them from the customer portfolio.
3. *Image enhancement*. This approach sees the customer as an opportunity to secure positive image benefits for the firm. It is not appropriate for all types of firms, but where the owner-manager sells business-to-business, they are often judged by the quality of their clients or customers. The owner-manager should therefore seek high profile customers who can enhance their company image and use these relationships for self-promotion.
4. *Compatibility*. Another approach is to select customers according to their ability to fulfil the firm's mission. Too often small firms take on many different types of customers just to make money without asking whether this type of business is really compatible with the mission and purpose of the firm. If a customer does not fit the firm's profile of the type of person or business that the small firm wishes to do business with, the owner-manager should consider whether they really want this type of relationship.
5. *The 80/20 rule*. The truth in most firms is that 10–20% of all customers generate around 80–90% of sales and profits. The owner-manager should calculate each customer or customer segment in terms of how much they contribute to their firm's sales turnover and how much they might contribute to profits. Being overly dependent on one or two customers is risky, but a small business must be sure that it looks after its key customers.

These approaches to classifying the customer base are part of a strategy to ensure that the small business focuses its limited resources on the right customers for the right reasons. Securing large market share and multiple market segments is generally difficult for small firms. Thus, it is important that they monitor trends and develop suitable metrics to gauge the benefits of their marketing activities.

5.8.2 Key Trends and KPIs

For most small firms, the data that is held in the business's records should be sufficient to undertake a preliminary analysis of the key trends taking place within your customer and product base over the past 3 years. You should be able to draw from your sales records: data on the amount of sales generated, the value of these sales, and the profit margins generated by different products or market segments. Each firm should develop its own set of marketing KPIs (key performance indicators). It is important to set clear goals within the marketing plan and try to work toward achieving these over the designated time period.

Keeping KPI figures is important not only to guide activities associated with the implementation of the marketing strategy, but also to ensure that corrective action can be taken if goals are not achieved. It may be difficult for start-up businesses to know what performance benchmarks should be set in advance. This can be assisted by examining the performance benchmarks of other firms within the target industry, although such data may not be easy to obtain. Realistic benchmarks should be set that keep the business moving along at a pace that is desirable, but that also allow the management team the opportunity to deal with unexpected developments.

5.9 Developing a Sales Strategy

The ability of the business to sell its products and services to customers is essential to its overall survival and success. Without a coherent and effective approach to selling, it is unlikely that a small business will have success in its marketing. Key questions that the owner-manager should ask about how selling takes place in their business are (DUBS, 1995):

- Who does the selling in the company? Is it the owner-manager or a sales team?
- How well organised and briefed is the sales team to allow them to sell the benefits of the firm's products or services and to highlight its distinctive competencies?
- How does the firm measure sales performance, e.g. conversion rates, new business created, selling the range, call rates?
- How effective is the feedback on customers, competitors and the environment?
- Within most small businesses the most important sales person is usually the owner-manager.

Suggested Marketing KPIs

Sales and profitability KPIs*:*
- Number of sales over past 3 years.
- Average gross profit over past 3 years.
- Average net profit over past 3 years.
- Gross profit contribution for each individual product (expressed as a % of total sales).
- Average annual growth performance for each product group.
- Gross profit contribution for each individual customer or market segment (expressed as a % of total sales).

Customer and market share KPIs*:*
- Average annual growth performance for each customer or market segment.
- Customers' sales, profitability and growth.

(continued)

- 80/20 ratio measures to rank customers.

Sales channel KPIs*:*
- Gross profit contribution for each sales channel (expressed as a % of total sales).
- Average annual growth performance for each sales channel.
- Capital expenditure costs as a % of sales.

Marketing cost KPIs*:*
- Promotional costs as a % of sales.
- Average time taken from initial customer contact to sales closure.
- Production costs as a % of sales.
- Distribution costs as a % of sales.
- After-sales service costs as % of sales.
- 80/20 ratio measures to rank customers.

Income recovery KPIs*:*
- Debtor matrix listing each customer by days payable, e.g. 30, 60, 90 or 120.

However, it is important to get all employees within the business to see themselves as sales people. The sales role is often ignored by firms and left to chance when it should be planned, goal oriented and focused on providing mutually beneficial outcomes to both the buyer and the seller.

A key question to ask is: … Do your meetings with customers leave them better off?

It is a good idea to remember that in sales '*you only get one chance to make a lasting first impression*' (Brooksbank, 2002). All staff – particularly those that have contact with customers – should be aware that they are essentially frontline sales people and should be well trained in how to deal with customers, how to explain the benefits of the company's products or services, and how to close a sales deal.

5.9.1 Developing a Sales Platform

The sales platform technique is designed to keep up a high level of sales activity to ensure that your business does not run out of sales. It helps you to prepare future sales forecasts, and to determine the overall level of sales activity that you need to undertake to keep your sales turnover on target (Table 5.2).

There are at least three broad types of relationships that a small business can develop with its customers during the sales process:

Table 5.2 Use the following calculations to prepare your own sales platform

Step	*Item*	*Source of data*
1	Annual sales target	Business plan targets
2	Average order size	Previous orders
3	Orders needed per year	Step 1 divided by step 2
4	Orders needed per month	Step 3 divided by 12
5	Conversion rates of quotes to sales	Market research or past experience (1 in _____)
6	Number of quotes needed each month	Step 4 x step 5
7	Conversion rate of leads to quotes	Market research or past experience (1 in _____)
8	Leads required each month	Step 6 x step 7

Source: DUBS 1995, Making the Most of Your Business, NatWest UK
This provides a monthly guide for planning your sales activity

1. *The supplier*. In this relationship the role of the sales person is to solve a logistic problem such as shipping, billing or replacing damaged goods. This type of sales relationship is common to most retailing or motor vehicle sales and is found where the customer knows what they want and the type of service they need to solve their problem.
2. *The counsello*r. In this type of relationship, the sales person is viewed as having expertise in a given area and seeks to match solutions to the customer's needs and to develop a deep understanding of the customer's goals and objectives. In this type of sales relationship, the customer places high value on personalised service. The customer also needs help to solve complex problems that the sales person has the capacity to assist with due to their expertise. This type of relationship is common among accountants, real estate agents and financial consultants.
3. *The systems designer*. This type of sales relationship is common in the fields of computer sales and management consultants. In this environment, the customer is uncertain of how to perform a function. They want a total solution to their problem and need a sales person who can design and implement a systematic approach. Their relationship may include designing the system, implementing it, and then providing upgrades and the opportunity to work with the customer to optimise its efficiency.

Each of these types of sales relationship requires different levels of expertise. The simplest of these is that of the 'supplier', where complexity is low and customers have good knowledge of what they are looking for. By contrast, the 'counsellor' and 'systems designer' relationships are more complex and require the sales person to build up trust and credibility with the customer before any sale can be made.

5.9.2 The Sales Track

How a business sells can be as important as who does the selling. To create effective selling, it is advisable that the business develop a sales track that all sales staff can use. A sales track is a systematic plan designed to guide the sales presentation. It seeks to enhance the probability of a customer agreeing to purchase a product. It gives structure to the sales presentation and reduces the chances of poor delivery. The key elements of a sales track include the following guidelines:

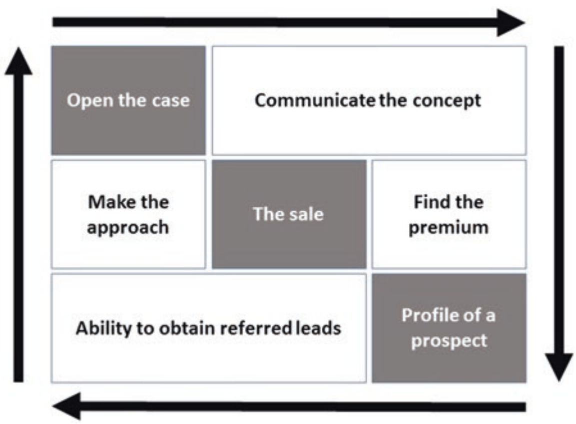
- It should focus of the customer's needs and wants, not on the product or service.
- It should involve a question and answer technique designed to guide the customer towards acceptance of the need for the product or service.
- It should get the customer to say 'yes' as often as possible; this is usually achieved by asking questions that have a 'yes' answer.
- Keep the message simple but focus on offering benefits or solutions to the customer's needs rather than the features of the product or service.

A sales track needs to be well thought through and rehearsed until it can be delivered much as an actor might deliver his or her lines in a play. It is important that this sales track be delivered in a natural manner, supported by a genuine belief in the product or service being a solution to the customer's problems.

5.9.3 The Sales Cycle

The process of selling has been likened to a cycle involving a continuous process of identifying prospective customers, making initial contact, communicating the concept and making a sale, then following up with after sales service and support. The sales cycle model shown in Fig. 5.2 illustrates one version of this process. An initial

Fig. 5.2 Sales cycle model



starting point is the profiling of a prospective customer through market research. Where possible, the small business owner-manager should be identifying these customers either by word of mouth referral or from referred leads provided by existing satisfied customers.

Where the sales environment requires direct personal selling – such as in business-to-business markets – the owner-manager and their sales staff will need to determine the most effective way to make an initial approach to the prospect. Cold calling is difficult and usually produces low conversion rates along with a good deal of stress. However, it is always advisable to prepare and rehearse any telephone scripts to be used, or to think carefully about lead letters that might be sent out prior to a sales call.

Once a sales appointment has been secured, the next stages are to open the case and communicate the concept. Opening the case requires a well-considered sales track that might involve a problem seeking/problem solving approach. Rather than seeking to sell the prospect a product or service, it is usually better to build up a good understanding of the problems facing the prospective customer, and what needs and wants they have. By exploring the prospect's problems and listening to their voice, it is possible to identify how best to configure existing products or services to provide solutions. The time spent in listening to the customer will allow the benefits and unique selling points of the firm's products and services to be fully communicated.

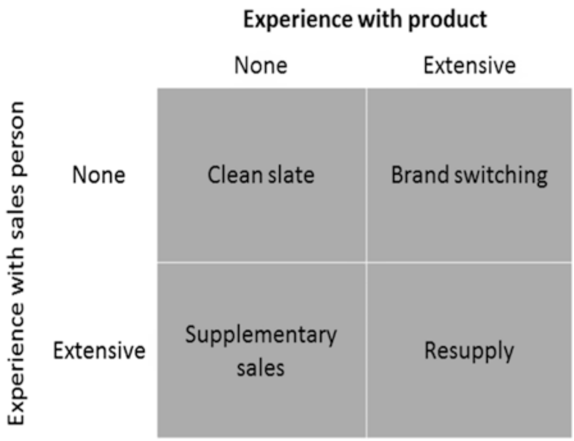
In many sales environments the price paid by the customer is not set. This is particularly the case in business-to-business markets where there is frequently room for some process of negotiation over price and/or credit terms. Once the sales cycle has moved to the point where the prospective customer is interested in making a purchase, the negotiations should focus on finding a suitable price or *premium*, and it is here that the firm should have clear policies relating to how much discounting can be offered and what credit terms are available. Too many small firms cut prices to win sales only to find to their dismay that they have made no profit.

5.9.4 The AIDAS Model

One approach that has been used to guide the development of a sales track is the AIDAS model. Although this is not a complete solution it can provide a useful framework. The five key elements of the AIDAS model are:

1. *Attention*. Why should you be listened to?
2. *Interest*. What can you offer the customer?
3. *Desire*. What problems can you solve or want can you satisfy?
4. *Action*. How can the customer make use of what you have to offer?
5. *Satisfactio*n. What can you do to ensure that the customer remains happy with your product?

Fig. 5.3 Customer contact matrix. (Source: Li Brizzi, 2001)



5.9.5 The Customer Contact Matrix

The type of sales approach adopted will depend on the nature of the relationship between the customer and the business. Figure 5.3 illustrates the customer contact matrix. It can be seen that there are four possible situations depending on whether the customer has some experience with either the product or the sales team. Where the customer has neither, the situation is that of a 'clean slate'. In this case the owner-manager must adopt the role of the 'counsellor', building trust and educating the customer in both the product or service and their firm's ability to supply it (Li Brizzi, 2001).

By contrast, where the customer has past experience of both the owner-manager and the product, the situation is one of *resupply*. In this situation, the relationship is routine and the firm plays the role of *supplier*. The situation of 'brand switching' is where the customer is familiar with the product but is seeking to switch to a new supplier. Here the main focus is on building trust and credibility for the firm. Finally, selling new products to existing customers is *supplementary sales*. In this situation the owner-manager already has a good relationship with the customer but needs to educate them to the benefits of a new product or service.

5.9.6 Use 10/30/60 Formula

In developing an effective sales strategy, the owner-manager should follow the 10/30/60 formula of *top-of-mind* marketing (Naylor & Greco, 2002). This suggests that they target about 60% of their marketing and sales effort at existing customers. They are the most likely to have knowledge of the business and to feel positive toward its products or services. It is also more likely that they will buy from the firm again. The next 30% of sales efforts should be targeted at new customers who are well suited to the firm's mission and fit the profile of a target customer. If market

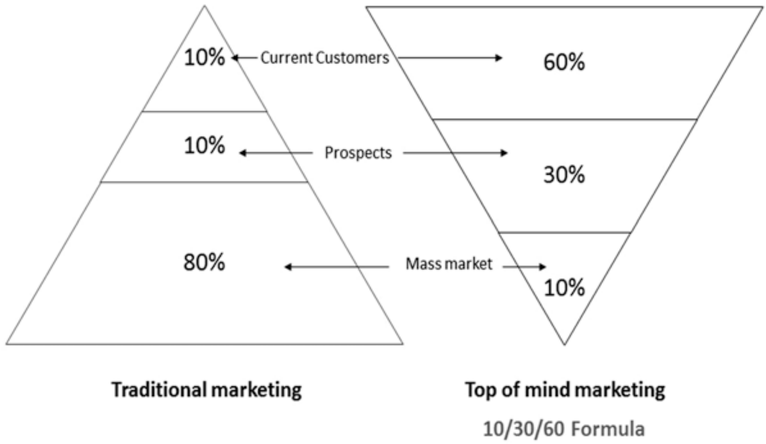


Fig. 5.4 Top of mind marketing and sales approach. (Source: Naylor and Greco, 2002)

research has been completed the owner-manager should have a good idea of who these potential customers are, how they make buying decisions and where they can be reached. Finally, the last 10% of any marketing and sales efforts should be spent on the general community or mainstream market as a form of image building exercise. The owner-manager should not expect to get too many new sales from this last 10%, but they might get lucky. Figure 5.4 illustrates this model.

5.9.7 Monitoring Sales Activity

Selling is a systematic process that requires discipline and is best approached with a quantitative means of measuring performance. The owner-manager should keep track of all marketing and selling activity with a view to determining its impact on their total sales revenues. For example, they might set up a process of distributing direct mail or letter box drops, placing media advertising, directory adverts, telemarketing or participation in trade shows.

Each dollar spent on these activities should be matched against sales generated during the period it was undertaken. If the firm makes direct sales calls to customers, it should log each sales call and calculate conversion rates. Keeping a track of sales activity and how much effort is required to generate a certain level of sales can help to determine if the sales team or sales track is working.

5.9.8 Handling Objections

A major challenge sales people have to face is customer objections to the sales pitch. However, customer objections should be viewed as an opportunity not an obstacle. In most cases the customer is seeking more information rather than making a strong objection. Common objections are that the product is too expensive, the quality is poor for the price, the customer has been satisfied with their existing products or services, they don't really need it right now, or they will buy it next time. View every objection as an opportunity to provide the customer with more information about the product or service and how the firm can help them solve their problem.

5.9.9 Closing the Sale

Many people are afraid to close a deal, but without closure there can be no sale. It is a good idea to adopt the policy, close early and close soon. This allows an assessment of how ready the customer is to buy, and avoid wasting time. There are many approaches to closing a sale. Among them are the following:

- *Alternative close*. This approach involves giving the customer a couple of choices, e.g. 'Would you like the red or the blue?' It is getting them to pick their preference thereby closing the sale.
- *Summary close*. This method involves summarising the benefits of the product or service to the customer. A study by Xerox found this to be 75% effective (Loutfy & Belkhir, 2001).
- *Assumptive close*. In this approach you assume the sale is agreed to, e.g. 'How would you like to pay for this, credit card or cheque?'
- *Special concession close*. This involves offering the customer a special deal if they decide to go ahead with the sale, e.g. 'If you buy today you can get a discount.'
- *Standing room only close*. In this approach the customer is informed that they might lose the opportunity to buy if they don't act quickly as there are other buyers waiting, e.g. 'I have three other customers waiting.' This is common in real estate.

5.10 The Marketing Mix

The market mix has been described as the 4-Ps comprising: product, price, placement, and promotion, around which any marketing plan should be developed. For service firms these four elements are complemented by a further three: process, people and physical evidence (Berry, 1980). Each of these seven marketing mix elements needs to be considered and a strategy developed for it within the overall marketing plan. Figure 5.5 illustrates the marketing mix and draws together a series of elements (shown in the outer circle) that are strategic considerations, which need to be addressed prior to developing strategies in each of the 7-Ps of the marketing mix.

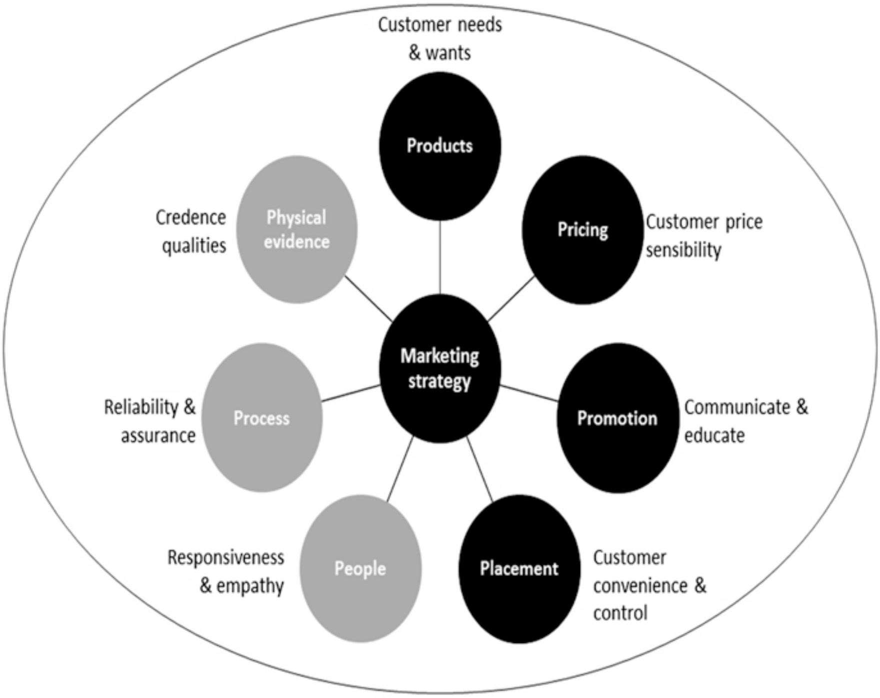


Fig. 5.5 The marketing mix as marketing strategy

In the following sections each of the elements in this marketing mix model are discussed with a view to their role as building blocks of a marketing strategy for the business.

5.10.1 Targeting Customers – Market Segmentation Strategies

Because all people are not the same it is essential that target market segments are identified. This involves dividing a heterogeneous group of buyers or potential buyers into more homogeneous groups with relatively similar product needs. Market segmentation is important as it improves a firm's understanding of the target market, its composition, and buyer behaviour by allowing attention to be given to a small range of customers. Using customer feedback from market research, segmentation highlights different marketing opportunities within those segments that are not being well satisfied by existing products or services and therefore serves to identify potential new buyers. It also allows a more concentrated marketing effort and more efficient use of resources, particularly for small firms that lack the ability to cover multiple segments. This focusing or concentration of effort also enables more effective strategy formulation as knowledge of segments, and segment potential, aids forecasting and assists budget allocation. Segmentation is also useful in assessing and countering competition as it allows you to achieve a better competitive positioning for new products.

5.10.2 Requirements for Segmentation

For a segment to be worthwhile it must be sufficiently large to provide good sales volume over a long time period and from customers willing and able to pay a price able to produce strong profit margins. The accessibility of the targeted market segment is also important as is their ability to respond to your new product offering. There is little point in targeting customers who are too far away or who have legal contracts that bind them to existing suppliers.

Reasons for Segmentation

- Improves understanding of the target market – you can focus on fewer customers and really get to know and understand them.
- Highlights marketing opportunities – a better under-standing of your particular market segment will enable you to identify new opportunities.
- Allows efficient use of resources – less time wasted on chasing poor prospects.
- Enables more effective strategy formulation – focused effort and resources.
- Aids forecasting and assists budget allocation.
- Useful in assessing and countering competition – allows better competitive positioning for existing brands (minimises cannibalisation).

Customers are usually segmented according to criteria related to their demographic profile or psychographic characteristics. Demographic variables include such things as age, income, gender, family structure, geographic location, occupation, ethnicity and education for people and size, turnover, industry type and management structure for organisations. This demographic data is readily available from the Australian Bureau of Statistics (ABS), INSEE, EUROSTAT, or other equivalent statistical institutes, or from market research surveys. Psychographic variables are the values, attitudes, beliefs and lifestyles of the customers. These are more readily obtained either from dedicated institutes (like the CREDOC in France) or from focus groups or interviews and can be associated with demographic variables (e.g. people over 65 years are likely to have different values, attitudes and lifestyles from people less than 20 years).

5.10.3 Market Positioning – Finding Your Niche

Positioning is about where a firm is placed within the market. The larger the market the more specialised the firm may need to become if it wishes to maintain a competitive edge. It is important to understand that in marketing perceptions are really what make or break the business. How customers and potential customers perceive the business is frequently an outcome of the positioning strategy that has been adopted.

Even the largest firms cannot easily serve all potential market segments. Smaller firms are unlikely to be successful in attempting to diversify into a broad range of market segments. Highly competitive markets appear to favour smaller firms that follow a niche marketing strategy. Small to medium sized firms that can successfully exploit a market niche frequently achieve high growth (Harrison & Taylor, 1996).

An important starting point for successful market positioning is the development of a positioning statement. This is a short statement designed to articulate to the market what the business is all about and become that single word in the mind. Some famous examples of positioning statements used by large firms are:

- Oh, what a feeling – Toyota
- Life’s Good – LG
- Solutions for a Small Planet – IBM
- Just do it – Nike

The development of successful brands is a key ingredient in market competitiveness. A study of 20 product categories found that most of the leading brands had been established as market leaders from the early 1920s onwards (Ries & Trout, 1997). The future will probably see two types of brands existing in the majority of markets. At one extreme will be the ‘mega brands’ of the large companies. This includes the likes of Coca-Cola, Kellogg’s and Gillette. At the other end will be the specialists in the niche markets.

5.10.4 Branding – Avoiding the Middle Ground

> The brands that are going to have the most trouble are the ones in the mushy middle (Ries & Trout, 1997).

The development of a brand name for a business or its products is one of the most important things that an owner-manager can do as part of their marketing strategy. It is likely to require a good deal of time (perhaps 5–10 years) and a significant investment to build a brand. However, money spent on branding is an investment not a cost. The future of most consumer markets will be increasing specialisation with niche marketing becoming the key to success (Kotler, Burton, Deans, Brown, & Armstrong, 2013). Brand development in such an environment needs to have the objective of creating a brand name and image that is viewed by the customer as having no substitute. The brand name must be carefully nurtured and supported with all the elements of the marketing mix to ensure that it is positioned in the mind of the customer.

The brand development process is not something that can be achieved overnight. Successful brand development is achieved only after years of sustained effort. However, the process will be achieved if the firm is able to establish the correct market positioning and build upon its distinctive competencies using these to communicate to the chosen market segment its unique selling points.

5.10.4.1 Five Steps to Brand Name Development

The following five-step process has been used successfully by marketing companies when generating brand names (Sandhusen, 2008):

1. *Establish brand name criteria*. It should be compatible with the product's image and marketing mix (e.g. indicate prestige or economy). It should be distinctive and suggest something about its features or benefits. It should be easy to recognise, recall and pronounce. It should also be easily translated into other languages and compatible with other products sold by the firm.
2. *Create a list of potential brand names*. Some advertising and marketing companies will generate a list of names if you first produce some key words. Computer programs are now available to do this.
3. *Screen the list to select the most appropriate for further testing*. Match the names against the criteria.
4. *Obtain consumer reactions to the remaining names*. Run focus groups or interviews with customers within the target market.
5. *Conduct a trademark search*. This is possible via IP Australia online at www.ipaustralia.gov.au. This contains the Australian Trade Mark Search online tool that offers quick access to all registered trade names and trademarks in Australia.

5.10.5 Products and Services

The first element to consider in the marketing strategy is the product or service that will be offered to the target market. Prior to offering any product or service into a market you should undertake market research to determine whether there is a need and whether this product has the features or benefits customers are seeking. A total product concept approach should be followed that recognises that the product comprises three primary elements (Kotler & Armstrong, 2010):

- *The core of the product*. This is the primary benefit(s) offered to the customer that ensures they achieve satisfaction of basic needs. An example might be Qantas which as an airline offers a core product of time critical transport services. This is largely undifferentiated from other airlines.
- *The tangible elements*. The physical things that encompass the product are the tangibles and in the case of Qantas might include the type of aircraft flown, seating layout and the Qantas Club. Where one product seems to offer enhanced

tangible elements, a differentiation strategy can be developed to secure customer loyalty and command a premium price.
- *The augmented elements*. While tangible elements are most noticeable, they can easily be benchmarked. For example, Qantas aircraft and customer lounges may be similar to those of other airlines reducing their relative benefit. It is in the area of augmentation that maximum customer benefit can usually be offered. This might include branding, priority check in or frequent flyer schemes.

It is important that new products be developed with a view to the total product concept. The core, tangible and augmented elements of the product should be identified and matched against customer needs and competitor offerings.

5.10.6 Pricing

One of the most important goals for any marketing strategy should be to secure a premium price within the target market. In assessing the customer's needs it is important to determine how price sensitive they are. The ability for a product to secure a premium price will depend on whether the firm can follow a differentiation strategy rather than one of cost leadership. As discussed above, the ability to follow a differentiation strategy will depend on the customer's willingness to place product attributes over price when making a purchase decision. It is important therefore to seek out leading customers who value the firm's products and services and are prepared to pay a premium price for these benefits. Offering benefits that are not attractive to customers or seeking to compete on price alone is unlikely to be successful.

Pricing strategies can follow one of two general approaches: market penetration, or market skimming. A market penetration strategy involves pricing the product at a low level and seeking to gain rapid market share. By contrast a market skimming strategy involves placing a premium price on the product and seeking to recoup the cost of R&D within the first few years. The majority of new technologies follow a price skimming strategy. For example, when the IBM Personal Computer first came onto the market in 1981, it sold for about US$5455 and offered relatively limited functionality and features. By the end of the 1980s the product's price had fallen to around US$1500 and its features and functions had increased significantly.

5.10.7 Placement

How a product is placed into the market and distributed to the end-user customer is a key strategic decision that must be addressed in any marketing plan. The distribution of the product is referred to as the *marketing channel,* and the configuration of this channel structure is a critical issue. The main strategic issues that need to be considered are how much market coverage can be achieved for the product, thereby offering customer convenience of purchase, versus the level of control the producing firm has over the product. Control over the product once it is offered into the market is often critical to its ultimate success. However, small firms are often faced with the dilemma of having to distribute their products via one or more larger firms, some of which may carry multiple brands. As a general rule, it is important to maintain as much control as possible over the product throughout the marketing channel and keep the line between the end user customer and yourself as short as possible.

5.10.7.1 E-Commerce Strategies for Placement

An important aspect of placement for SMEs is whether or not to use e-commerce strategies. The term *e-commerce* is somewhat poorly defined; however, it is usually associated with the use of information and communications technologies (ICT) to sell goods and services online via the internet (Mazzarol, 2015). It is an important placement strategy as it can offer the small business a way to sell goods and services without the cost and complexity of having to rely on bricks and mortar retail shop front premises, or the intermediaries who might capture some of the profit margin.

A study of 678 SMEs in the United Kingdom found that four types of e-commerce activity was taking place. The first group, described as *Developers* were firms that were not fully engaged in e-commerce and mainly used emails for transacting with customers and suppliers, and a company website for promotion and branding. A second group, labelled *Communicators*, were actively engaged in e-commerce and had set up their online systems to actively exchange information with customers and suppliers. However, they were not using them to transact the orders. The third group, labelled as *Web Presence*, were doing everything that the second group were, but instead of just communicating they were using their websites and online systems to take purchase orders. The final group, the *Transactors*, were transacting business online and using online systems for payment. These groups suggest a four-stage evolution of small businesses developing their e-commerce capabilities (Daniel, Wilson, & Myers, 2002).

The use of e-commerce strategies by SMEs is growing but it remains quite low. For example, in 2016 an estimated 93% of Australian small businesses were connected online and 61% had a company website with 43% possessing a mobile App or website optimised for mobile platforms. However, only 22% were using their websites to undertake e-commerce transactions (Sensis, 2017). While not all small businesses will need to trade online, the trend amongst consumers is to use websites to make purchasing decisions and to place orders. For many people this is being undertaken using smart phones and tablets, and they are interested in the convenience and ease of online shopping. There are technical issues that SMEs will have to deal with, and the risk of cyber-attacks and other security threats associated with e-commerce (Rahman & Lackey, 2013). However, it is important that small business owners adapt to this technology if they wish to remain relevant and visible to the modern consumer.

Table 5.3 The promotions mix

Advertising mix	Personal selling mix	Sales promotion mix	Publicity mix
Newspapers	Consultative selling	Packaging	Media release
Magazines	Route selling	Point-of-purchase	Feature stories
Radio	Counter sales staff	In-store promotion	Speeches
Television	Telephone sales	Brochures	Press conferences
Outdoor	Word of mouth	Samples	Image management
Transit		Coupons	Online blogs
Directories		Competitions	Social media
Online		Trade shows	

5.10.8 Promotion

One of the most publicly visible elements of the marketing mix and frequently the costliest is promotion. Promotional strategy needs to consider two important issues:

- *Message strategy*. This is what you will say about your firm and its products and services. It should seek to capture your firm's market positioning or unique selling points and should make a clear offer to the customer.
- *Media strategy*. This is the means by which you will get your message to the customers. It involves making use of appropriate media channels such as print, radio and TV, direct selling or the internet.

How you will communicate and educate the customer to the benefits offered by your firm's products or services is of importance. A *promotions mix* is often used as a framework for developing a promotion strategy. This usually incorporates the elements shown in Table 5.3.

How much weight is placed on any one of these promotional mix elements will depend on the nature of the product and market. Promotional activities will comprise a major cost to any new product launch and few small firms will have the budget to launch a mainstream advertising campaign in the mass media. It is most likely that direct selling and trade show demonstrations supported by a well-considered publicity strategy will get the best results. However, one of the most effective sources of promotion for the small firm is likely to be word of mouth referrals generated by customers who have experienced the new product and wish to advocate it to their family and friends (Mazzarol & Ramaseshan, 1998).

5.10.8.1 E-Marketing Strategies for Promotion

As noted above in relation to placement strategies, SMEs should consider making use of digital media and websites for e-commerce. In order to support an effective e-commerce strategy, the small business will need to develop an *e-marketing* plan and the capacity to implement it. The concept of *e-marketing* refers to the use of

ICT systems, in particular websites and social media, to engage in advertising and marketing communications (Mazzarol, 2015).

The cost of website development and its ongoing support is now relatively low. In 2016, around 61% of SMEs in Australia used a company website to promote their business, and a further 28% were promoting their business via third party websites (Sensis, 2017). SMEs that make use of e-marketing have experienced better than average new business generation and reduced costs of goods sold. This has boosted their bottom line profits and enhanced their brand image (Eid & El-Gohary, 2013).

Social media should also be considered within any e-marketing strategy. Key considerations in developing such a strategy should be the fostering of an online community (i.e. customers, potential customers), as well as the support that your social media strategy provides to existing marketing and sales strategies. In this respect, it is important to integrate the social media strategy into the company's customer relationships management (CRM) system. Consideration need to be given to how information is captured and used (Harrigan & Miles, 2014). The protection of customers' data and their trust in the social media sites the firm engages them through are all very important factors to consider. The importance of data protection has dramatically increased over the last few years with a series of scandals. As a consequence, media and public opinion in certain countries to become very vigilant and government have developed regulation system (e.g. in the EU the "General Data Protection Regulation" (GDPR) law implemented in 2018, which requires from any firm dealing with personal data to organise their storage and protection).

It is interesting to note that in 2016 less than half (48%) of Australian SMEs used social media. Of these the most common use was via Facebook (88%), Twitter (25%), LinkedIn (23%) and Google+ (10%). Only a very few firms (4%) had a blog and the same proportion made use of YouTube to post corporate promotions. There was only a relatively low level (34%) of SMEs that made use of paid advertising via social media networks, and the majority did not actively maintain their social media. For example, only 23% updated their social media on a daily basis, and 24% each week (Sensis, 2017). This suggests that less than half of SMEs are using social media for e-marketing, and less than half of those are actively engaging with social media once they have established a company presence there.

Using social media can be a time-consuming process and it may be difficult to see direct cause and effect of any activity a business might undertake. However, in many consumer markets the use of social media is a potentially effective way to build and maintain relationships with customers. As discussed earlier, it can also offer a way to undertake market research and even trial ideas with loyal customers.

A rule of thumb with social media use is the *99/10/1 Rule*, which states that for any social media event out of 100 people 1 person will post up and article, 10 people will comment on it or "like" it and the other 99 people will simply watch. However, these 99 people are not ignoring the communication. Good social media coverage is valuable to a small business as it forms an electronic word-of-mouth (e-WOM) communication that can be very beneficial to the positive image of the business (Lee & Youn, 2009).

5.10.9 Process

For service firms, but also for firms with a tangible product, it is important to consider the way the operational processes will be undertaken and how they will be so configured as to ensure that quality is maintained and customers are delighted. It is important for customers that any product or service can demonstrate its reliability and assurance. Reliability is usually measured in terms of how dependable the product or service is and whether it performs accurately against expected standards. Assurance is less easily measured, but relates to the overall competence, courtesy, credibility and security offered by the firm that is providing the product or service. Quality assurance management systems (QAMS) should be used to ensure that the product is able to perform to standard, but attention also needs to be given to training staff, agents and even suppliers who are associated with the product to conduct their activities in such a way that customers feel assured.

5.10.10 People

Assurance can be demonstrated to customers by staff courtesy and ability to answer their questions and instil confidence in the firm and its products. It is for this reason that most small firms rely heavily on the owner-manager to deal directly with customers, particularly new customers. This highlights the need to take care when selecting sales people or selling agents who are going to represent the product (and the company) to the customer.

To create a credible market profile, it will be important to take care in the selection of key personnel and also strategic alliance partners, including your customers. The quality of people is often measured by how responsive and empathetic they are to customers. Responsiveness is associated with a willingness to help customers when they experience difficulties and to respond promptly in correcting faults or addressing customer concerns. Keeping customers fully informed and up to date on the way a service is performed, when it will be performed or when a product will be delivered is also part of this process. Empathy toward the customer can be demonstrated by the degree of personal attention shown and how well the firm's employees appear to understand the specific needs of the customer. This is where good market research of customer needs can be beneficial and where focusing on servicing the needs of a small segment of the market may be better than trying to cover too many customers at once.

5.10.11 Physical Evidence

The image of a company is critical to its ability to win acceptance and gain customer support. How the firm manifests its image to the market is contingent on what are called credence qualities (Parasuraman, Zeithaml, & Berry, 1988). These deal with the perception of the firm as a quality provider with credible capabilities. Small firms seeking to enhance their credence qualities should take care to ensure that their image is carefully controlled to project the best possible impression. Brochures and marketing materials should be professionally developed and the product's presentation and packaging should be designed to provide an image of quality and functionality. Use of professional industrial and product design services and graphic designers to help shape the company image are all part of this process.

5.11 The Building Blocks of Increased Business

For the majority of small firms, the best form of marketing is to offer excellent service and to deal with customers in a manner than generates repeat business and positive word-of-mouth referrals. This raises the issue of how might a small business owner ensure that they can continuously provide high quality service and thereby engender customer loyalty?

To address this, we turn to some of the foundations of service quality and services marketing. This will apply equally to firms that manufacture as to service providers – even though these concepts have been developed for services marketing. The reason for this is that the small business owner, even if they are a manufacturer, will be working closely with a few lead customers, and it is their ability to service these accounts that will most likely secure them the desired outcomes.

5.11.1 Service Quality Framework

Parasuraman et al. (1988) proposed a model for measuring customer service quality. Known as the SERVQUAL scale, it consists of 22 question items, grouped into five dimensions, that deal with: i) empathy; ii) responsiveness; iii) reliability; iv) assurance; and v) tangibles.

The dimension 'empathy' refers to whether the customer perceives that the firm understands their needs and wants. 'Responsiveness' relates to whether the customer feels that the firm's employees respond to them in a timely manner, and 'reliability' refers to the firm's ability to consistently and faithfully deliver on its promises. 'Assurance' refers to the ability of the firm to make the customer feel comfortable with their services, and that they will not make mistakes or errors. Finally, 'tangibles' refers to those things that a customer can see such as the firm's buildings, staff uniforms, vehicles and marketing materials including logos and brand names.

Figure 5.6 shows these five SERVQUAL dimensions and how they relate to the three key services marketing strategy areas of people, process and physical evidence as part of an overall service quality framework. It can be seen that empathy and responsiveness are the key elements that need to be attended to when considering service enhancement strategies built around employees within the business. Key process issues are reliability and assurance, and the key considerations for physical evidence are the firm's tangibles and what is referred to 'credence qualities', which

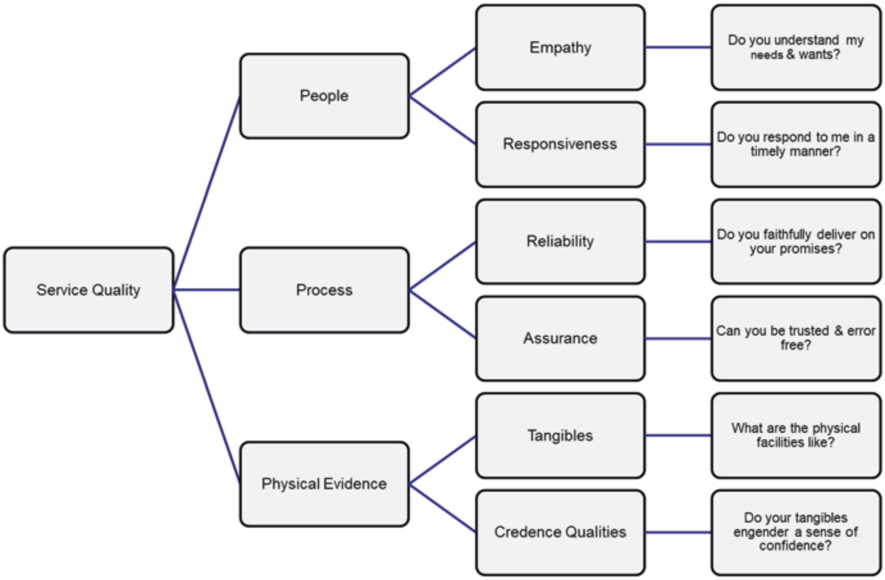


Fig. 5.6 Service quality applied

relate to the customer's perception that the firm has quality and can render a good outcome due to its corporate reputation (Nayyar, 1990).

A small business owner seeking to develop best practice in customer service would need to focus their attention on all these elements, making sure that their staff understand customer needs and wants and are able to respond promptly to requests. They should also make sure that their firm's operational processes ensured reliability and error-free outcomes. Formal quality assurance systems can play a key role in this, although it should be approached as part of a strategic management process and not as an end in itself (Nwankwo, 2000). Also, by ensuring that the business builds up its branding and corporate image with appropriate attention to how it looks, the overall physical evidence presented to the customer will be good.

5.11.2 Business Building Blocks

Finally, we can conclude this chapter with what can be described as the building blocks of increased business. This concept is outlined in Fig. 5.7, where it can be seen that to achieve increased business – as measured by growing sales and repeat business – the small firm needs to develop five areas as building blocks.

The first building block is service quality, which has been discussed above. Satisfied and loyal customers are the product of service quality that is above average. If service quality can be excellent, it is most likely that the customers will be satisfied. Customer satisfaction can and should be monitored, and action taken if it is not up to standards. Where customers are satisfied, there is the greater likelihood

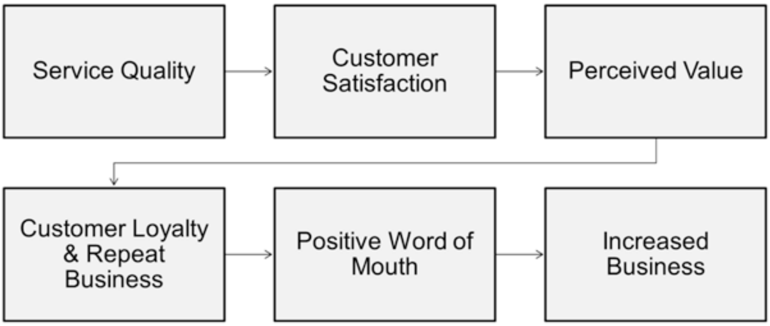


Fig. 5.7 The building blocks of increased business

of them perceiving value in the firm and its products or services. Perceived value is a process of trading off the cost of a product or service for the benefits it provides, and good service will help to add value (Zeithaml, 1988).

Customers that perceive value in a service or product will be more likely to remain loyal and repeat purchase (Sweeney & Soutar, 2001). They are also more likely to offer positive word-of-mouth referrals (Mazzarol, Sweeney, & Soutar, 2007; Sweeney, Soutar, & Mazzarol, 2008). This word-of-mouth referral is the best form of marketing communication a small firm can get, and therefore attention should be given to these antecedents.

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6 The Process of Growth in the Small Firm

6.1 Introduction

> Not all businesses that survive grow to be large businesses. This is due either to the nature of their industry or simply the personal desires or ambitions of the owner-manager (Scott & Bruce, 1987, pp. 45).

Small business growth is a goal that would seem desirable for all owner-managers. However, relatively few small business start-ups develop into large firms (e.g. with over 250 employees) (OECD, 2002, 2010). Many disappear along the way, either due to external factors beyond the control of the owner-manager, or more commonly due to internal factors over which they do have control. Perhaps it may come as a surprise to know that the majority of small business owner-managers choose not to grow their businesses (McMahon, 1998). This appears to be as a result of their lack of understanding or skills in how to achieve growth, as well as a conscious decision to restrict expansion and thereby maintain a business of a size that they can easily control (Nightingale & Coad, 2014). In Chap. 4, the three generic strategic options facing the small firm were outlined. These comprise *stasis*, *exit* and *growth*. As was noted, all three strategies are viable and demanding ones for a small business to follow. However, the *growth* strategy is probably the riskiest and most demanding. This chapter looks at the nature of small business growth and the challenges facing growing small firms.

6.2 The Growth of Small Firms

In Chap. 1 the growth cycle theories of small firms were examined. It will be recalled that research into the growth of small firms has indicated a series of stage-models in which the business moves through a number of defined stages as it grows (e.g. Barnes & Hershon, 1976; Churchill & Lewis, 1983; Greiner, 1972; Scott & Bruce,

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T. Mazzarol, S. Reboud, *Small Business Management*, Springer Texts in Business and Economics, https://doi.org/10.1007/978-981-13-9509-3_6

1987; Steinmetz, 1969). Most of these models were built on the idea of the business lifecycle and previous research dating back to the work of Penrose (1952, 1959). An underlying assumption of these models was that most firms will follow the same trajectory from one stage to the next.

While various models identify different numbers of stages, these models generally suggest that the business is initially conceived in the mind or minds of its founders (pre-start-up), is then established (start-up) and passes through several additional stages as it grows into a mature large firm. These additional stages might encompass a period of survival while the firm struggles to achieve sustainable profitability, growth (sometimes divided into early and late stages) in which the firm takes on employees, wins new markets and introduces new products. Once it starts to grow it will either plateau off, or enter a further stage of expansion in which it transitions from a small to a medium, or even large firm, before reaching maturity (Scott & Bruce, 1987). While the actual growth of individual small firms may not be as linear as such theoretical models suggest, they provide a useful framework against which to analyse the experiences of particular firms.

At each stage of the process the small firm can grow, plateau or even die. In the initial stages of formation and survival the owner-manager is largely focused on keeping the business alive and must find new customers and maintain sufficient cash flows to pay running costs. The owner-manager is likely to be the most important asset the little firm has, providing all its managerial skill, direction and financial capital. It is common for many small firms to plateau and remain quite small with limited resources and local horizons (Reedy & Litan, 2011). This capped-growth is usually the result of a conscious decision by the owner-manager to restrict the firm's expansion out of a desire to avoid risk, uncertainty and the general problems associated with hiring more employees, winning new markets, developing new products or securing new capital investment (McMahon, 1998).

There may also be a lifestyle decision involved in which the owner-manager chooses not to grow the firm due to satisfaction with a small-scale operation that delivers low stress and an easier life. Such abandonment of the desire to grow by the owner-manager may take place in the relatively early stages of development where the firm has fewer than 10 employees and sales revenues of less than US $0.5 million (usually associated with the lifestyle decision), or it may take place later when the firm has grown to about 25 employees and a sales turnover of about US $2 million (a capped-growth decision) (Hanks, Watson, Jansen, & Chandler, 1993).

Headd and Kirchoff (2009) conducted a longitudinal study of small firms in the US over the period 1992 to 2002. They used a large sample from within the national census database. The study found that most firms do not grow very much post start-up. A small number of firms grow and increase their employment, but this growth is not constant. After a period of rapid growth, they tend to revert back to the mean. While some industry sectors are more volatile than others, on balance the survival rate of small firms was found to remain constant over a period of 30 years. This research has been replicated in later studies (i.e. Davila, Foster, He, & Shimizu, 2015; Reedy & Litan, 2011).

The factors influencing growth in small firms include age, size, industry sector, legal structure, location and ownership (Storey, 1994). As firms age, they tend to slow their rate of growth. Smaller firms also tend to grow faster than larger ones as they are often younger, although this issue is complex. Different industry sectors are also more prone to growth than others. This can include those within high-tech areas, or those with access to export opportunities. There are different rates of growth found amongst manufacturing and service firms. The legal structure of the firm can also impact on growth. For example, limited liability company structures will grow faster than partnerships. Location is often important, as some regions experience better market conditions. Finally, the ownership is critical.

An analysis of Swedish data undertaken by Davidsson, Kirchoff, Hatemi, and Gustavsson (2002) found support for all these influences on growth. In particular, they highlighted the importance of industry sector. Some sectors were experiencing higher rates of growth than others. Also, of importance was the role played by mergers, acquisitions and spinoffs. Interestingly, higher growth rates were found where a previously independent firm was acquired by another, yet the opposite was the case where the firm had subsidiaries. Spinoffs also led to a decline in growth of the spun-off venture.

6.3 Learning to Manage Growth

Should the firm move successfully into a growth or expansion phase the owner-manager will be required to increase the scale and scope of its operations. Part of this expansion will involve hiring additional employees, and increasing the overall complexity of the firm's activities. It is likely that the need for greater levels of professional management will be required to operate the firm, along with the need for enhanced planning and the introduction of systems to support the new levels of complexity. The transition from a small, owner-managed firm to a large systems-managed business will require the development of a team-based management approach with greater specialisation within the management team. Corporate governance is also likely to change as the growth cycle takes place. As it grows, the business will become more formalised in its accounting, management and other systems. The need for greater quantities of capital is likely to lead the business towards equity finance. As new equity partners are taken into the company the original owner-managers may find their level of control diminished. The larger the firm becomes the more likely its management structure will become decentralised with greater separation between the owner and the firm in terms of operational and financial matters.

Steinmetz (1969) was one of the first to identify the need for owner-managers of small firms to consider the managerial challenges that they would face when seeking to undertake an expansion of their firm. Figure 6.1 illustrates, in a conceptual form, the critical phases of management through which the small firm is likely to move. As can be seen, the small business with fewer than 30 employees are able to

Fig. 6.1 The critical phases of small business growth
Source: Steinmetz (1969)

be managed with direct supervision. In this type of business, the owner-manager is typically the centre of the firm's activities. All employees are easily supervised by the owner-manager who can continue to make all key decisions within the firm.

If the business grows in size to a medium size (e.g. 20–250 employees), the managerial challenges increase. The additional scale and scope of operations require the owner-manager to employ more team leaders or front-line supervisors. The shift is from direct control to delegation. New management skills will be required, particularly human resource management and higher-level financial control skills. Leadership and strategic planning in a formal sense also become more important. By the time the business has grown beyond the 250-employee mark, the firm is likely to be so large that the owner-manager is unable to exert direct supervision over its operations. They will be depending increasingly on their own team of front-line supervisors and managers to keep things under control. A board of directors may have been formed and the company will be moving (by Phase 3) into a large corporate model, with divisional structure and increasingly formal management and corporate governance systems.

6.4 Managing Growth Profitably

For many firms, growth is painful and requires change in management style and structure. As firms grow, they invariably have to take on more employees and management staff. These managers are frequently specialists in fields such as marketing, accounting or production. Increasing the size of the management team without developing the teamwork within this team can result in inefficiencies. Many firms grow larger only to retrench once they find their productivity and efficiency levels are falling. This is a growth barrier that must be managed through. The business will become less efficient and even less profitable during various stages of its growth cycle. It can only grow through this barrier with careful planning and team effort. This is shown in Fig. 6.2.

In essence the ability to grow in a sustainable manner is likely to depend on the owner-manager's ability to develop management systems and business models that will allow the business to grow in scale and scope without suffering from the collapse of profitability that typically takes place when additional overheads are imposed on the firm. For many small business owners, the risks associated with growth are too much. As previously discussed in Chap. 4, research into small business growth suggests that small business owners are typically faced with one of three strategic options: *stasis*, *exit* and *growth* (Mazzarol & Reboud, 2009).

A longitudinal analysis of the interrelationship between profitability and small business growth using a large multi-country sample found that profitability was a stronger foundation for future growth than a 'growth first' strategy (Davidsson, Steffans, & Fitzsimmons, 2009). This highlights the importance of building growth on firm foundations. The small business owner must ensure that they possess products or services that can command good profit margins and retain this position within chosen markets. Another longitudinal study of SMEs in Spain over the period 1998 to 2012, found that a critical factor in facilitating growth was the firm's ability to manage a sufficient buffer of cash in order to maintain the *working capital* or liquidity required to fund expansion (Martínez-Sola, García-Teruel, &

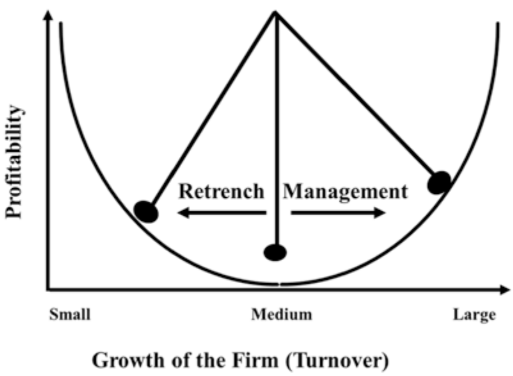

Fig. 6.2 The profitability trade off in growth
Source: Snaith (1997)

Martínez-Solano, 2018). In fact, the speed with which these small firms were able to adjust their cash reserves in the context of their growth strategies was an essential part of their success and/or ability to avoid failure.

The option of growth requires a focus on market opportunities and these must be supported by good levels of innovation within the business. As noted above, sustained growth will require the business to launch products into markets that have above average profits and returns to investment for the business. The option requires the owner-manager to possess visionary leadership and the ability to set clear strategy and implement it. For example, the growth option requires a clear market opportunity, the ability to apply sufficient resources within the business, good management systems for human and financial control, a clear point of innovation, access to strategic network support, and a means of funding expansion (Mazzarol, Reboud, & Olivares, 2006). However, growth also requires the small business owner to take on the managerial challenges of increasing complexity and risk as their company expands its markets, range of activities, turnover and human resource base. This growth process has been likened to a series of crisis points through which the owner must manage.

6.5 Managing Through Crisis Points

Greiner (1998) proposed a five-stage model of organisational growth with similar features to that of Scott and Bruce (1987) (see Chap. 1). However, this model is more applicable to explaining the change process facing organisations of all kinds, not just those in the small business sector. According to Greiner's (1998) model the firm grows via a series of evolutionary and revolutionary cycles. Revolution or 'crisis' usually precedes a transition to a new phase where more evolutionary growth can occur. Five distinct phases are identified during the growth cycle, Fig. 6.3 illustrates these.

The first phase is that of *Creativity*, which accords with the typical small business model. In this phase, the characteristics found within the firm are those of informal communication and control structures, and a premium on managerial leadership – usually from the owner-manager. However, once the firm grows to a scale and complexity that cannot be easily managed by one or two persons, the firm experiences a crisis of leadership and must establish a team of professional managers. This phase is called *Direction*, and features the introduction of systems to ensure control and coordination.

However, once the scale and scope grow too large, the firm experiences a crisis of autonomy whereby sub-units within the firm seek greater independence from central control. This forces the firm to enter the next phase of *Delegation*. Here, the firm is structured into divisions with devolution of managerial control pushed down to the sub-unit level. Senior management is focused on coordination of their strategic portfolio, with only indirect control mechanisms. If diversification becomes too great, the firm experiences a crisis of control and the firm enters the next phase of *Coordination*. Here, the senior management seek to regain control via formal

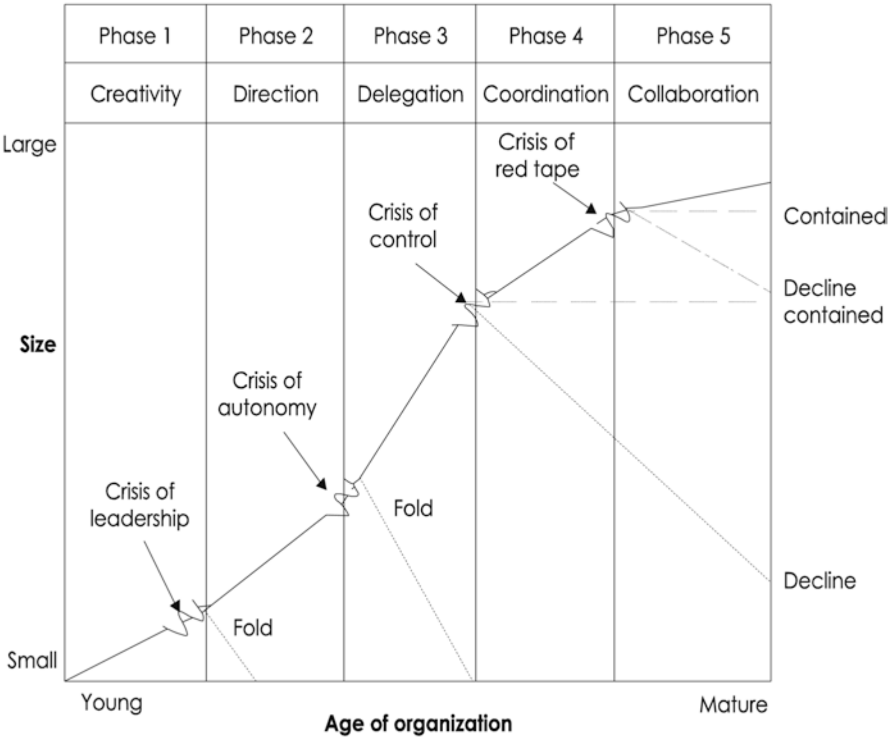

Fig. 6.3 The crisis stages of growth
Source: Greiner (1998)

portfolio planning and divisional configuration. Divisional managers must regularly conform to performance benchmarks (e.g. ROI, ROCE measures).

Finally, the firm experiences a crisis of red tape and enters the *Collaboration* phase, where senior management is more flexible and sophisticated in its control measures. Interdisciplinary team-based structures emerge, and shared values within the organisation are critical to maintaining cohesion and unity.

According to Greiner (1998), the managerial practices to be found in most firms at each of the five phases of the growth cycle can be broadly mapped as shown in Table 6.1. For managers seeking to understand the most appropriate approaches to strategic management, consideration of these growth phases is important. Strategy may be easy to formulate, but its implementation will be complicated by the dynamics of organisational culture existing within the firm during each stage of growth. Further, the manager may find that a strategy suitable for one phase will not work during another phase.

Kroeger (1974) identified the main roles of the owner-manager along the path of growth and complexity within the firm. In the initiation or creation stage, the owner's role is primarily that of contributing ideas. They are the originator and inventor. However, as the business is established and begins to develop, their role shifts to

Table 6.1 Organisational practices in the five phases of growth

Category	Phase 1: creativity	Phase 2: direction	Phase 3: delegation	Phase 4: coordination	Phase 5: collaboration
Management focus	Make & sell	Efficiency of operations	Expansion of market	Consolidation of organisation	Problem solving & innovation
Organisational structure	Informal	Centralised & functional	Decentralised & geographical	Line staff & product groups	Matrix of teams
Top-management style	Individualistic & entrepreneurial	Directive	Delegate	Watchdog	Participative
Control system	Market results	Standards & cost centres	Reports & profit centres	Plans & investment centres	Mutual goal setting
Management reward emphasis	Ownership	Salary & merit increases	Individual bonuses	Profit sharing & stock options	Team bonus

Source: Greiner (1998)

more one of a planner and organiser. During the growth stage, if the business moves in that direction, the owner-manager's primary role is that of a developer and implementer. Once the business is mature, their role shifts to that of administrator. If the business begins to decline, the owner-manager must focus on succession planning and restructuring. Each growth phase requires different types of managerial skill.

During the creativity phase, the firm is highly dynamic, and strategic management needs to be flexible and not too prescriptive. The entrepreneurial leader (owner-manager) of the firm is usually the focus of any strategic thinking, and all decisions need to consider the personal objectives of the entrepreneur as well as those of the firm itself. As the firm becomes more complex and formal – in the direction and delegation phases – a greater emphasis is required on the design and implementation of systems, with attention paid to identification of core competencies (Prahalad & Hamel, 1990). Expansion into new markets or the development of new products during such phases can severely stretch the limited resources of the firm, as well as diluting the firm's overall strategic intent.

As the firm shifts toward the coordination and collaboration phases the most important element is likely to be the organisational culture or shared values inherent in the company. If the fully developed collaboration model is to be achieved, it is essential that the firm possess an internal culture that is built around dynamic, multidisciplinary teams with participative management style that develops a learning organisation approach involving the regular transfer of strategic tacit knowledge (Senge, 1990). It is obvious that this is much easier to develop conceptually than it is to actually implement.

D'Angelo and Presutti (2018) examined the international growth of 170 SMEs in Italy. They examined the firms' growth over the 10-year period from 2015 to 2015, and the influence of *entrepreneurial orientation* (EO) and *learning orientation* (LO) on growth, plus the moderating effect of the founder-CEO's previous experience. Their study found that both EO and LO had a significant and positive influence on the international growth of these firms. Further, the more experience that the founder-CEO had in relation to growth and industry-specific management, the more likely that successful growth was achieved. While this is unsurprising, it confirms the importance of the owner-manager being strategically focused on growth, willing to learn and adapt, and knowledgeable about the challenges that growth is likely to generate.

6.6 Small Business Growth Is Not Always Linear

Mount, Zinger, and Forsyth (1993) have examined the growth process of small firms and suggest that while the stage models as described above are useful, they do not always accurately describe the reality of how small firms grow. The management structure of a small firm may or may not follow the well-defined frameworks outlined above. In some cases, the business may leap forward and be formed with a more advanced managerial structure despite its modest size. As noted earlier, much may depend upon the industry environment in which the firm is operating. Environments that are highly dynamic and turbulent may see the business moving rapidly through these development phases. Furthermore, the business may have some of its functions (e.g. marketing, finance, operations, and human resources) move at different speeds in terms of how they are professionally managed within the firm.

Small business growth is therefore not necessarily a linear process and is likely to depend upon the managerial learning of the owner-manager. For example, Macpherson (2005) found that growth within small firms is not linear but a more iterative relationship between the external environment, the internal resources and systems of the firm, and the owner-manager's ability to learn and adapt. The findings indicate that, rather than sequential crises, these firms were dealing with a number of crises concurrently, and solutions were significantly dependent upon existing experience and systems of organising, a manager's perception of the crises, and access to relevant knowledge. In these firms, growth was dependent on idiosyncratic solutions rather than on any prescriptive approach suggested by traditional growth models (Macpherson, 2005).

Navarro, Casillas, and Barringer (2012) examined the growth process of 89 high-growth SMEs in Spain over a 5-year period from 2001–2005. They identified four 'clusters' of firms that they labelled: *innovators*, *locals*, *adventurers*, and *tourists*. These findings are summarised in Table 6.2. It will be seen that the growth these firms engaged in was driven by many factors that included whether their focus was international or domestic, based on innovation and new product development, or market penetration and new customer acquisition. The strategic importance of growth also varied as did the people who were engaged in the growth process.

Table 6.2 High-growth SMEs clusters

	Domestic expansion	International expansion
Innovation	*Innovators:* Domestic growth using a high degree of innovation and new products.	*Adventurers:* International growth using a high degree of innovation and new products.
	Growth driven by innovation and new product development. Usually mid-sized firms with growth as a priority and all employees involved.	Growth is driven by innovation via new or enhanced products, plus new customer acquisition overseas. These firms are sales focused and all employees are engaged.
Penetration	*Locals:* Domestic growth using existing products targeted at new customers.	*Tourists:* International growth using existing products targeted at new customers.
	Growth is focused domestically and on new customer acquisition using existing products. Firms are larger and growth is a priority. The main employees engaged in this process are sales and marketing staff.	Growth is moderate and focused on launch of new products into international markets. Firms are larger and growth is not a priority. Senior executives are the main people involved.

Source: Adapted from Navarro et al. (2012)

In summary, the growth process of a small firm can be understood in terms of a series of managerial challenges brought about by increasing levels of scale and scope. The firm may not always move through the clearly defined stages as described by some researchers, but might move back and forward between stages, and may see some elements of each stage being addressed at different times within different parts of the business. The way the firm undertakes its growth is likely to depend upon the capacity of the owner-manager to deal with the challenges imposed by growth.

6.7 Owner-Manager's Influence on Growth

Although successful growth within the small business sector is contingent upon many factors, the most important is arguably the attitude of the owner-manager. The decision to grow is a risky one that many entrepreneurs choose not to make. As discussed above, the majority of small business owners are not interested in growth (Davidsson, 1989; Gundry & Welsch, 2001; Storey, 1994). Growth in the small business is strongly associated with the personality, attitudes and behaviour of the owner-manager (Perry, Meredith, & Cunnington, 1988). The decision to grow is often a personal one associated with internal motivations not linked to the more rational economic considerations of government (Moran, 1998; Wiklund, Davidsson, & Delmar, 2003). For those that seek growth the two key factors are owner related and business related.

1. *Owner related factors* – their ability to set business goals and their skills at handling the operational, technical and managerial issues involved with running a business. Strategic planning skills are also critical for growth.

2. *Business related factors* – the financial resources, personnel, planning and control systems and process technologies.

Of these two areas, the most important by far are the owner related factors.

The reasons why so many small business owner-managers should not desire growth are numerous. Concern over having to go into debt is a deterrent to many, particularly women (Taylor, 1986) who have been reported as more "risk averse" than men (ABS, 2015). Growth can also represent a loss of personal control by the owner-manager who may dislike the idea of passing the responsibility of running the business over to professional managers (Gibb & Davies, 1992).

It is important to realise that the problems associated with growth in the small business are just as difficult as those confronting much larger firms are. Effective growth strategies require careful planning and most small businesses lack the resources needed to undertake this (Shuman & Seeger, 1986). For many small business owner-managers the decision to grow is fraught with problems (Bosworth & Jacobs, 1989). Inadequate management skills, particularly in strategic planning, can serve as a deterrent (Scase & Goffee, 1985).

Access to finance has also been identified as a major impediment to small business growth in firms requiring it for R&D (Jones, 1992; OECD, 2016). The inability of the small business to seek out sources of information and technology needed for growth has also been found to act as a potential barrier (Rothwell & Beesley, 1989). According to Jones (1992), the majority of barriers to small business growth are found inside the business. These include a lack of technical and managerial skill, inadequate organisational adaptability, and ability to acquire or use technology. Alpander, Carter, and Forsgren (1990) in a study of 526 small early stage firms found similar results with the majority of problems being solved by logical decision-making and management skills.

Research into the reasons why owner-managers from small firms might make a conscious decision to grow their business has focused in part on their psychological or personality characteristics (Moran, 1998). Some evidence exists to support a link between growth focus and the strategic orientation and the entrepreneurial character of the owner-manager (Kotey & Meredith, 1997). For example, a link appears to exist between the owner-manager's need for achievement and their growth orientation (Perry et al., 1988).

A study of 340 Australian small business owners undertaken by Weber, Geneste, and Connell (2015) identified four types of owner-manager in relation to their orientation towards growth. The study examined the owners' strategic orientation using a modified measure based on the strategic typology originally developed by Miles, Snow, Meyer, and Coleman (1978). This identified large firms as falling into one of four types in relation to their corporate strategy:

1. *Defenders* – a strategic type where the firm's senior managers focus on defending their existing markets by selling a limited range of products within defined and relatively limited customer segments. Any growth is via market penetration rather than innovation.

2. *Prospectors* – a strategic type where the firm's focus is on high levels of innovation and the launching of new products across a wide range of market segments. This type of firm is generally willing to take risks to secure growth through new product-market combinations.
3. *Analysers* – a strategic type where the firm's focus is on modest, calculated risks that yield the best profit or returns to investment. Rather than launch into new product-market combinations, this firm typically waits to see what success has been achieved by the *prospectors* before launching its own products.
4. *Reactors* – a strategic type where the firm's focus is mostly reacting to market trends rather than seeking to lead them or systematically exploit them. Such firms are often indecisive and slow to act, or find they exist within "a state of almost perpetual instability" (Miles et al., 1978, p. 557).

Figure 6.4 illustrates the findings from Weber et al.'s (2015) study, where it can be seen that the four strategic types of small business owner have been mapped on a matrix in which their preparedness for growth and perception as to how successful and/or attractive, their firms might be in pursuing growth, are used to delineate the four groups. It can be seen that the four groups also match the four types from the Miles et al. (1978) typology. According to Weber et al. (2015), these four types of small business owner are not only fairly typical of those found across most SME communities, they also require different approaches in relation to how they might

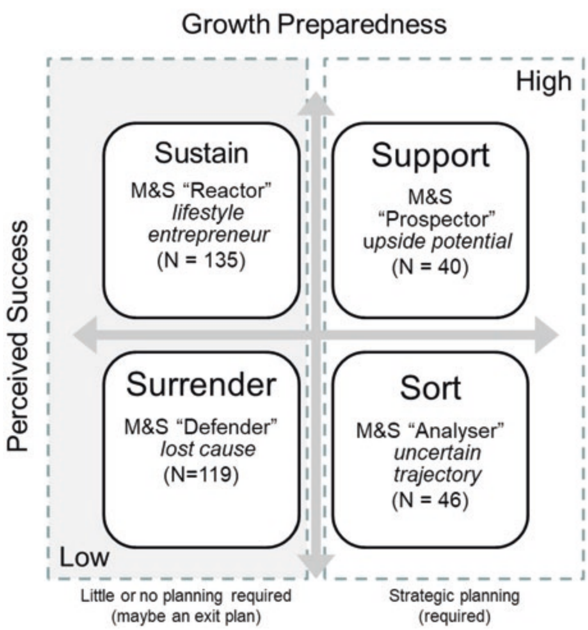

Fig. 6.4 The growth and success strategic group matrix
Source: Weber et al. (2015)

be supported by government policy in relation to the much-desired growth. As shown in Fig. 6.4, there are four recommended policy responses for each of these four types of SME, which are discussed below.

- *Support* – the *prospector* like small firms comprised 11.8% of the total, and demonstrated both a high preparedness for growth and a strong perception (based on past success) that future growth would be desirable. For this type of owner-manager, there was a lot of 'upside potential' for the firm to successfully pursue growth, and as such they would be a good candidate for any support.
- *Sort* – the *analyser* like small firms comprised around 15% of the total. They had not had as much success as the *prospectors*, but were positively oriented towards future growth. Here the level of support was recommended to be one of 'picking winners', or screening those that might have the best chances of success.
- *Sustain* – the *reactor* like small firms comprised around 44% of the total. They generally have no desire to grow their businesses and don't view growth as a pathway to success. In this case, the recommended policy assistance is to leave them alone and ensure that they are given sufficient support allow them to sustainably continue.
- *Surrender* – the *defender* like small firms comprised around 39% of the total. These firms were located in niche markets and focused on defending their existing customer or market position. They were risk averse and not interested in growth. In cases where these firms were trapped in declining industries or facing competitive challenges, the recommended policy support was to assist them to plan for a controlled exit.

Overall these strategic types are relatively common across the small business community. As was discussed in Chap. 1, relatively few small businesses actively seek growth, and this is reflected in the findings from the study by Weber et al. (2015), where at least 83% of the firms studied were not growth oriented. Much of this reflects the owner-managers' perceptions of the merits of growth, and their own past experience of success in growth activities. In essence, this points to the critical role of the managerial competence of the owner-managers.

The importance of managerial competence as a key factor in the capacity of small firms to grow has also been highlighted in the literature (Watson, 1995). Also important is the firm's ability to adapt and change as threats and opportunities emerge. A particular strength of small firms is their ability to flexibly adapt, with their organisational culture being adaptable due to their small size and openness. Firms with too much rigidity and formalisation or those with no structure or rules are less likely to succeed than those that can strike an effective balance (Stoica & Schindehutte, 1999).

6.8 Stages of Strategic Change in Owner-Manager Thinking

Hofer and Charan (1984) have identified seven distinct transition stages through which the owner-manager or entrepreneur is considered to move when developing their business. These can be linked to the growth cycle of the small firm in terms of the owner-manager's decision to grow.

- *Entrepreneur strongly wants change*. The entrepreneur or owner-manager is motivated to grow due to a desire for change to their existing task environment.
- *Increase participation and associated decision-making*. The day-to-day organisational decision-making processes must be changed as the business expands or the owner seeks change. This is usually where the initial stages of delegation begin.
- *Institutionalise key operational roles*. A desire to delegate to employees and managers leads to the owner-manager having to formalise organisational tasks and roles. This is the point at which the first tentative steps towards a strategic human resource plan can be seen.
- *Develop middle managers*. Delegation of tasks, particularly complex managerial duties forces the owner-manager to begin development of middle management or front-line managers. Team building and team leading functions are commonly part of this process.
- *Review business strategy*. There is a strong link between structure and strategy. Once the company begins to move in a new strategic direction – in order to grow – there is usually a need to review the existing business strategy.
- *Formalise structure and procedures*. In conjunction with the development of larger organisational forms, the owner-manager must begin to formalise the structure and procedures for managing the company. Once a management team is in place the owner may establish a company Board of Directors and manage remotely through this.
- *Appoint professional directors*. The end point for many owners is to develop their company to a point where it can sustain a full-time executive management team. They can then sit on the Board and appoint professional directors to assist with the planning and general administration.

According to Hofer and Charan (1984) the transition process through these seven stages is likely to take the owner-manager (entrepreneur) about 42 months. Figure 6.5 illustrates the process and time taken to move from the first to the last stage. It can be seen that some phases are likely to take longer than others. There is also a degree of overlap in these actions. What these tasks represent is a transition in the sophistication of the management within the firm. This move from rudimentary to sophisticated management is necessary to the firm's ability to grow (Berman, Gordon, & Sussman, 1997).

The need for the owner-manager to adapt their management style and thinking to meet the challenges of growth is particularly important among firms that experience rapid growth. A study of firms experiencing rapid growth rates found that the firms

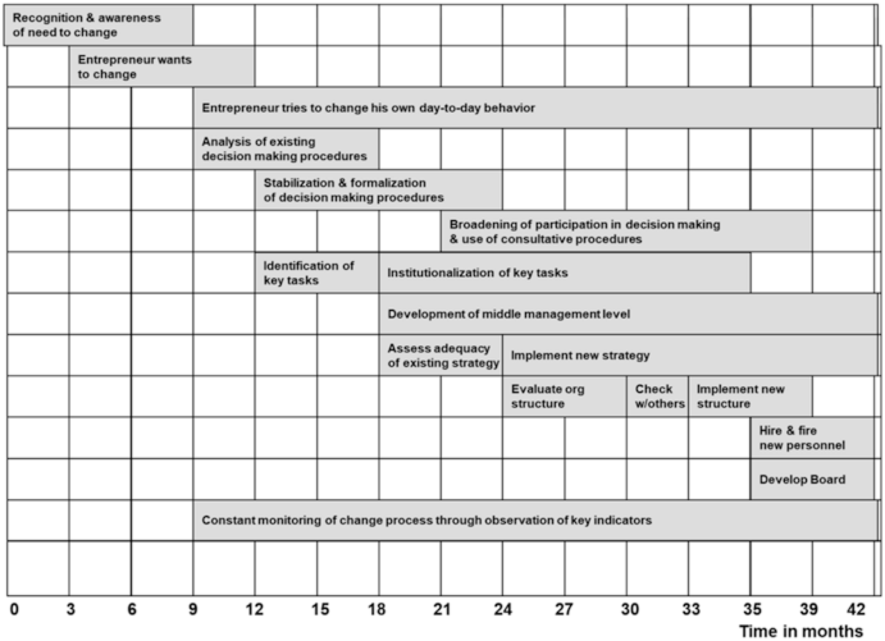

Fig. 6.5 The transition process over time
Source: Hofer and Charan (1984)

which successfully made the transition from small to large were characterised by owner-managers who could create a vision of the firm as a larger entity. These firms recruited a management team in their early years that was capable of taking the business forward to a higher level. The vision of the firm was 'constantly and zealously reinforced'. The business also adopted the same systems and processes found among much larger firms, while keeping hierarchy to a minimum. Finally, these firms gave their employees a financial stake in the business (Hambrick & Crozier, 1985).

6.9 Models of Small Business Growth Management

Various models have been developed to help explain the process of growth in small firms, and how this growth might be managed. Gibb and Davies (1992) examined the growth process of small businesses in the UK. This analysis adopted a resource-based view of the firm (see Alvarez & Busenitz, 2001; Barney, 1991), and focused on the base potential for development inherent within the firm.

Growth was contingent upon the financial, physical and human resources available to the owner-manager as well as their own experience, leadership, ideas and control base. Combinations of external and internal factors need to be considered by small business owner-managers seeking to grow their firm's operations. Figure 6.5 shows their growth model, which is discussed in more detail in the following section.

Issues in Growth Management
The challenges of seeking to manage growth are:

- lack of capital;
- internal resistance to change (ossification);
- increasing demand on resources;
- shifting control of managerial functions;
- devolving decision-making;
- cost vs. quality;
- flexibility vs. formalised strategies; and
- bureaucracy vs. decentralisation.

6.9.1 Growth via Product-Market Development

In this model the opportunities for the business to follow in seeking its growth path are generally numerous and the owner-manager is faced with the dilemma of deciding which option they should follow. Their ability to grow is likely to depend upon their capacity to identify a vehicle for growth which is typically a combination of products and markets where the best opportunities lie. This product-market combination is referred to as the growth vector (Ansoff, 1965), and is applicable to both small and large firms.

As shown in Fig. 6.6 the ability of the small firm to successfully develop this vehicle for growth, will depend on the base potential that the business has for growth (e.g. its resources, skills and capabilities), the degree of change required to move in the new direction, the internal and external factors enhancing or impeding the process, and the time available to achieve the goals. Gibb and Davies (1992) suggest that the key elements which should be examined in reviewing the base potential of a small firm that is considering future growth include five 'bases' which comprise the resources upon which the business's growth can be built. These are the resource, experience, control, ideas and leadership bases. Each of these is explained in more detail below.

6.9.1.1 The Resource Base

Attention should be given to the firm's financial resources, particularly its cash reserves (e.g. working capital). The firm's plant and equipment and its state of repair also need to be reviewed, along with its products or services, to determine if they are able to offer sufficient lifecycle to support growth. In addition, the firm's employees (e.g. numbers, skills, attitudes) and management team all need to be examined. Finally, there should be evidence that the business has state of the art technology to allow it to operate as efficiently as possible.

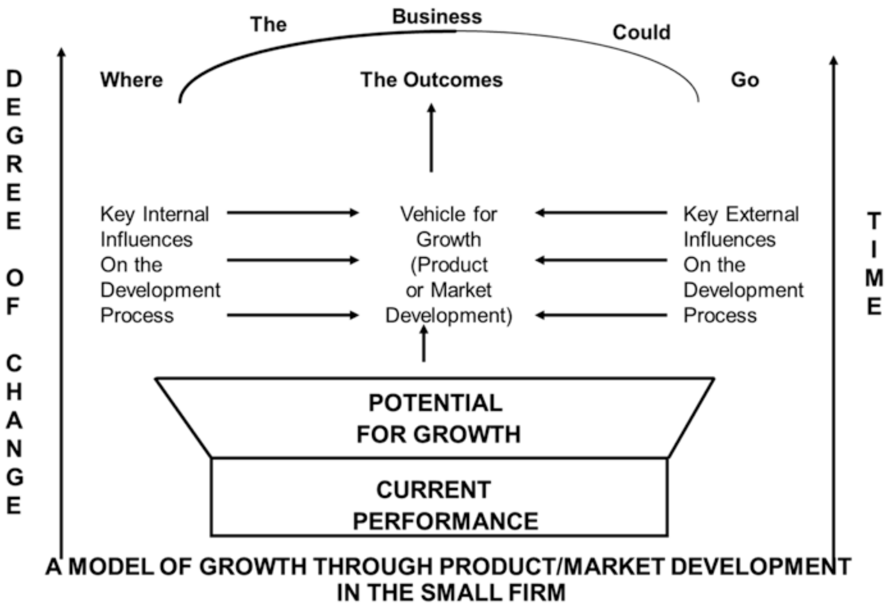

Fig. 6.6 A model of growth in small firms
Source: Gibb and Davies (1992)

6.9.1.2 The Experience Base

The experience base of the business relates to its corporate knowledge of doing business in a given market or markets. How long has the firm operated in this industry and does it have a management team with experience of borrowing money, raising capital, moving locations, opening new sites, exporting, developing new products, or managing growth? Obviously where the management team has some past experience of managing in the areas being chosen for future expansion, the likelihood for future success will be greater.

6.9.1.3 The Control Base

Control within the firm is likely to occur as a result of the ability of the management team to secure reliable information, and then to use this data to make decisions. Attention needs to be given to how adequate the firm's data capture and reporting is, and degree of professionalism and responsibility of the management team. The owner-manager's ability to develop business plans and prepare workable budgets will be important. Also, of importance is likely to be the owner-manager's capacity to delegate authority to staff within the firm.

6.9.1.4 The Ideas Base

Growth within a small firm will require innovation, either the development of new products and services, or the development of innovative approaches to new markets or marketing methods. Attention should be given to the firms' capacity to undertake R&D and new product development, and whether the business has a track record of generating new ideas and implementing them. How does the owner-manager deal with innovation and is there evidence of market research prior to new product development?

6.9.1.5 The Leadership Base

The ability of the small firm to undertake a process of sustained growth is also likely to depend upon the potential of its owner-manager or management team to provide effective leadership. Key issues that should be examined here are the age, education and family influences of the owner-manager. What are their personal goals for the firm and their motivation to achieve their goals? Is there evidence of the owner-manager behaving in a professional manner and being a good negotiator, people manager and communicator? The owner-manager's management style and personal attitude toward change is therefore important. Also important is the owner-manager's degree of strategic awareness and their understanding of the environment in which the business is operating.

6.9.2 A Framework for Entrepreneurial Growth

Mazzarol (2005) outlined a framework for understanding the process of growth within a small firm that comprises five key elements. Figure 6.7 shows this framework, which is built around the basic entrepreneurial process of opportunity recognition, resource accumulation and capacity building. It also assumes that sustainable growth is measured by turnover, employees, assets/equity, market share and profitability. The model is consistent with previous research that highlights the importance of strategic, resource and growth orientation within entrepreneurial firms (Brown, Davidsson, & Wiklund, 2001), as well as the important role played by the firm's leadership and its ability to identify product and market development strategies for growth (Smallbone et al., 1995). The model was used as a framework for a study of strategic management behaviour in small firms undertaken by Mazzarol and Reboud (2009) in which these elements were tested against two databases comprising 316 small firms.

6.9.2.1 Entrepreneurship

The first of these elements is the role of the owner-manager within the business. As discussed above, the majority of small business owners do not seek growth and are more content with a lifestyle strategy. Growth requires an orientation that is entrepreneurial. This is aimed at maximisation of profits, expansion into new markets and a willingness to take risks. It is important to look at the characteristics of the owner-manager and see how well they profile in terms of the entrepreneurial qualities of creativity, achievement drive, desire for autonomy, calculated risk taking and internal locus of control (Caird, 1993). In essence the mental attitude of the owners of the business can determine how well the firm is likely to perform in the future.

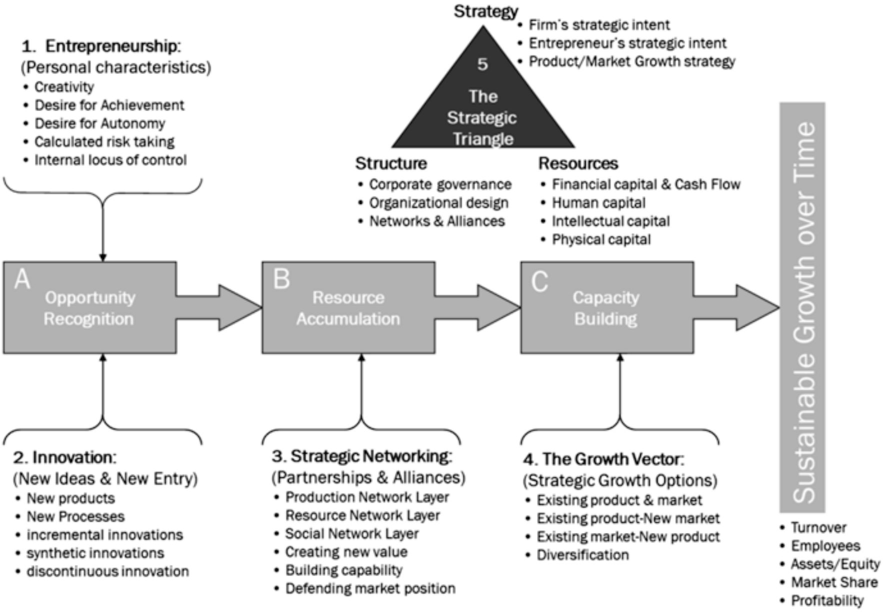

Fig. 6.7 A framework for entrepreneurial growth
Source: Mazzarol (2005), Mazzarol and Reboud (2009)

6.9.2.2 Innovation

The second element that is important within the framework is the ability of the owner-manager to employ innovation to secure a clear point of differentiation within chosen markets. Any business that does not continuously seek a competitive edge through value adding to products, services or processes is unlikely to achieve much sustainable growth. Such innovation can be radical and leading edge as is common with high technology firms. However, many small firms succeed to maintain a lead within their selected markets by continuously innovating in a more incremental manner. It is also common for small firms to adapt ideas and technologies from other industries or markets into hybrid or synthetic innovations that can provide a unique solution to a particular problem and thereby secure a market lead (Tushman & Nadler, 1986).

Innovation within small firms is typically contingent on the owner-manager's ability to set direction and provide leadership. A study of the innovative behaviour of 137 small business owner-managers found that the factors relevant to encouraging innovation within their firms were: the ability to form strong partnerships with their employees, the ability to define quality for their staff, and the willingness of employees to accept change. Also important was their use of formal quality assurance methods to benchmark performance (Mazzarol, 2002).

6.9.2.3 Strategic Networking

The third element of the framework relates to strategic networking. Because small firms lack the resources needed to undertake all the work, they need to do to achieve their goals it is necessary for them to form strategic alliances with other organisations. Such alliances are most commonly with leading customers who may even agree to co-invest in the development of new products or key suppliers that can help the firm lower input costs or maintain quality. However, there may also be alliances with firms that lie outside the production network (e.g. supply chain relationships), into what is termed the resource network, including providers of finance such as banks or venture capital firms or professional groups such as accountants and lawyers. Such networks are usually held together by social networks between the owner-manager and the managers of these other organisations (Holmlund & Tornroos, 1997). Most of these alliances are designed to provide the small firm with either access to resources and markets or the defence of existing market position (Jarrett, 1998). Strategic networks can be beneficial in assisting small firms to expand their geographic market extension and long-term objectives (Havenes & Senneseth, 2001).

The small firm and its owner-manager are engaged in a web of important stakeholders with whom the firm must interact in order to secure its future. Jennings and Beaver (1997) suggest that the small firm operates within a network or stakeholder web comprising both internal and external actors. Figure 6.8 illustrates this web of stakeholders.

Within the firm are the employees who are seeking a variety of benefits or outcomes from the owner-manager, including their job security, job satisfaction, career development and overall day-to-day satisfaction with their working environment. To establish and grow, a successful firm requires the hiring, retention and development of a competent and dynamic team of employees. Surrounding the firm is a range of other stakeholders including financial institutions, customers, suppliers, local government authorities and government. Each of these places demands and expectations on the small firm and its owner-managers.

The general range of pressures that might be placed on the small business owner-manager by this stakeholder web can be quite diverse. However, the successful entrepreneur can also leverage this network to secure support, finance and market access and market intelligence. Partnering with customers, employees, suppliers, financial institutions and government agencies is the hallmark of successful small firms and has been associated with growth in such firms (Mazzarol, 1999a). This partnering involves developing mutually beneficial relationships that can enable the small firm to leverage resources and improve its competitiveness (Hall, 1992).

6.9.2.4 Growth Vector

The fourth element within the framework is the growth vector initially identified by Ansoff (1965). As discussed above this suggests that growth is achieved by a combination of matching products to markets. To achieve growth requires offering new products into established markets, taking existing products to new markets or diversifying into brand new product-market combinations. While diversification is a

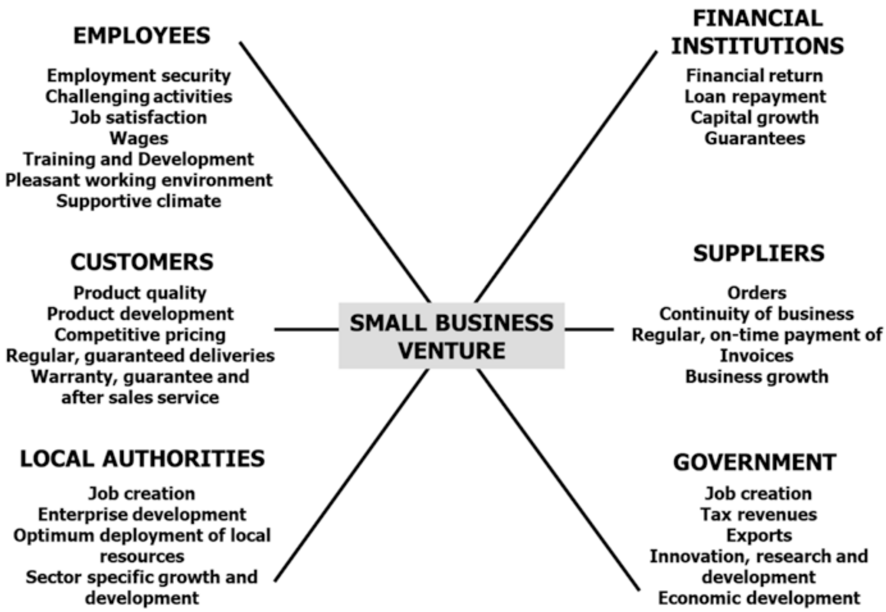

Fig. 6.8 Stakeholder web of the small firm
Source: Jennings and Beaver (1997)

common – and necessary strategy – among large corporations seeking growth, most small firms will find diversification overly risky and a potential overstretch of their resources. Figure 6.9 shows a model of the growth vector.

As shown in Fig. 6.9 the opportunity to grow is contingent on the firm being able to find product and market combinations that will allow sufficient sales to fund the business and allow expansion. Most firms commence trading within a given market segment with a specific product or service. Future growth within this existing product market space (e.g. quadrant 1) will depend on how large this segment is. If the segment is mature the business will need to consider one of three options.

1. *Market share growth*. This involves taking the existing products or services to new markets, which may involve opening new outlets, selling interstate or even exporting. This option involves a risk factor that may be four times that of the existing product market combination. The level of risk is proportionate to the experience of the firm in each of these new markets.
2. *New product development*. This option involves the firm developing new products or services that can be offered to the same customers or market segment. To follow this growth strategy the business will need to have a good level of innovation capability and invest in new product development and R&D. The risk level associated with new products is typically eight times that of the existing product-market combinations.

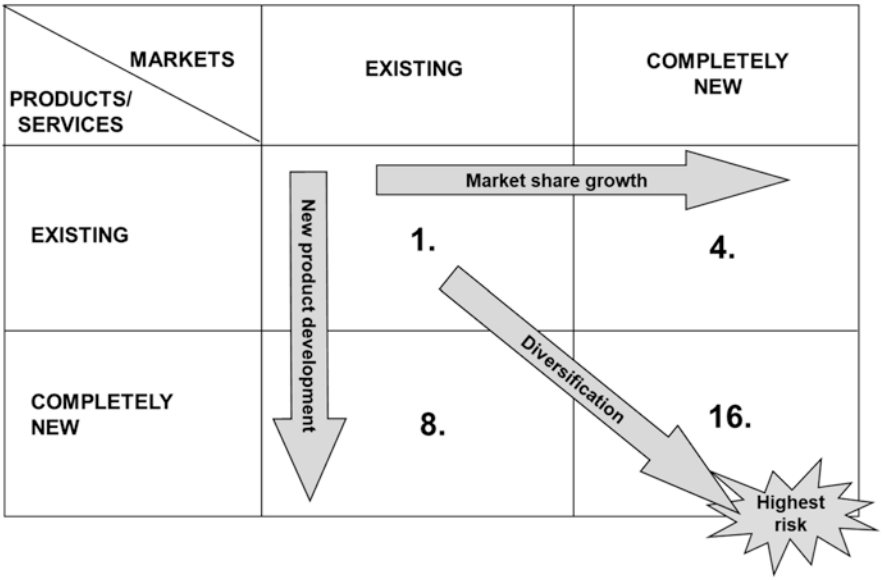

Fig. 6.9 The growth vector framework
Source: Ansoff (1965)

3. *Diversification*. The combination of new products and new markets involves a diversification strategy that may see the business moving outside its experience base. For this reason, the risk factor associated with diversification could be as much as 16 times that of the existing status quo. Small firms should consider diversification strategies with care, as they will face a situation in which their experience in both product and market is weak.

In considering which option to follow within the growth vector, the small business owner-manager should consider their base potential across the key areas of resources, experience, control, ideas and leadership as defined by Gibb and Davies (1992). It is particularly important to review the overall business model that is to be used as the growth vehicle. This should be assessed in terms of the key factors associated with opportunity screening and business strategy and planning as outlined in Chaps. 3 and 4.

6.9.2.5 Deliberate vs. Emergent Strategies

Research into small business strategy formulation using the Ansoff growth matrix framework has suggested that owner-managers are likely to follow emergent rather than deliberate strategies, and are likely to follow adaptive, opportunistic approaches to strategy in which growth in the small firm is linked closely to the owner-manager and how they perceive their strategic options (Watts, Cope, & Hulme, 1998).

Mintzberg and Waters (1984) identified that the reality of many strategic management environments was a climate of uncertainty. Managers were usually operating with incomplete information and making decisions that did not always guarantee a known outcome. Under such conditions there was a distinct difference between the *intended* strategy the firm wished to follow and the *realised* strategy that eventually occurred. Deliberate strategy may take place in which the plans that were intended all work out and the realised strategy is the same as the intended. However, many strategies fail or must be abandoned or changed. These are unrealised strategies, and offer important lessons for managers who are willing to learn. Frequently, a number of emergent strategies surface that were not considered when the original planning took place. It is important not to ignore these opportunities. For most small firms, the need to adapt and change to external market forces creates a climate of *emergent* strategies rather than more *deliberate* ones.

6.9.2.6 The Strategic Triangle

Finally, the framework includes the balancing of the strategic management triangle comprising the three elements of strategy, structure and resources. This strategic triangle recognises that the process of strategic management requires the harmonisation of three key elements:

1. strategic direction;
2. organisational structure; and
3. allocation of resources.

The balance between strategy and structure is recognised as of critical importance to effective sustained growth (Chandler, 1962). Any change to the strategy of a firm must be associated with a change in the firm's structure. If these two elements are not in harmony the implementation of any strategy will be difficult. The inclusion of the third element of resources is of key importance as small firms are characterised by resource scarcity. Managing the small firm requires the entrepreneur to keep strategy and structure in harmony with the firm's resources. Resource allocation is of key importance for identification of core competencies that may be configured to achieve competitive advantage (Penrose, 1959).

Figure 6.10 illustrates the strategic triangle. It suggests that the owner's attention should focus on keeping a balance between the three elements. Strategy requires the owner-manager to clearly define the future vision they have for both the firm and themselves. Their strategic intent and the product-market growth vector they feel needs to be followed should be determined. In doing so they need to ensure that they have undertaken adequate market research and prepared a business case.

Once the strategy is clear, the owner-manager needs to review their structure and determine if they have an appropriate organisational design to allow them to pursue the strategy they have chosen. The managerial governance of the business should be considered. As Hofer and Charan (1984) have shown, the owner-manager may need to work through the seven stages of professional managerial development eventually appointing a Board of Directors to assist them to manage the business. For many small firms the lack of internal resources is likely to require them to form strategic alliances to allow them to access management and operational skills and resources that they cannot afford to own directly.

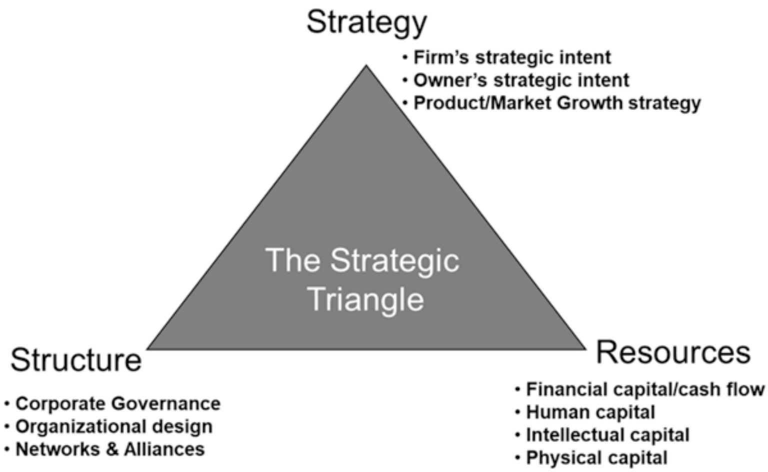

Fig. 6.10 The strategic triangle
Source: Mazzarol (2005)

6.10 Key Considerations for Growth

Given the central importance of the owner-manager in determining whether or not a small business follows a growth strategy, it is useful to understand the factors likely to motivate owner-managers to seek growth, and the considerations they make when doing so. Research into the factors motivating growth among small business owners suggests that contrary to economic theory, the desire to achieve financial gain from the growth process is not always the primary motivator. Other considerations include the desire to maintain control over the business, to maintain independence and to manage through the crises likely to be faced in any expansion process. Owner-managers may be concerned that growth will have a negative impact on their firm's workplace culture (Wiklund et al., 2003).

To gain an insight into the thinking associated with small business owners and growth, a study was undertaken using a series of focus groups comprising 50 small business owners who had enrolled in university management development program. These individuals had indicated a desire to enhance both their management skills, and the growth potential of their business. As group, they were therefore a useful test case for understanding the perceptions of small business owner-managers toward growth. The focus groups were facilitated using a 'group support software' (GSS) that captures individual responses via a computer terminal allowing both confidentiality and rapid data analysis and comparison. The focus of these discussions was upon the way growth might be measured within the small firm, and the means by which growth might be achieved.

6.10.1 Reasons for Growth

An initial question asked of the respondents was: 'Why grow?' This question was received with a range of responses the majority of which were focused around personal issues. As can be seen from Table 6.3 the responses grouped into three broad categories. The first related to internal motivators and included things associated with the owner-manager's sense of self or desire for personal advancement. The second category related to external motivators and included things external to the business that required the owner to respond to through a growth-oriented strategy. Finally, the third category related to altruistic motivators that included employment creation and general benefits to the wider community. These findings support the research of Perry et al. (1988), which found that growth motivations among small business owners were significantly associated with achievement drive. It is also consistent with other research suggesting that owner-managers see growth as not just about making money, but also about maintaining independence and their sense of purpose (Kazumi, Sato, Nishikiori, Kurose, & Sato, 1996; Wiklund et al., 2003).

Table 6.3 Motivations for growth

Internal	External	Altruistic
Financial security	Grow to sell the business	Generate employment
Personal challenge	Response to market pressures	Benefit others in the community
To improve lifestyle	Take advantage of an opportunity	
Ego	Grow or die	
To increase wealth		

Measuring Growth

Growth is frequently measured by annual turnover, or number of employees. However, a measure of the firm's growth can be calculated using the following formula:

$$\text{Growth factor} = \frac{\text{This year's figure} - \text{Last year's figure}}{\text{Last year's figure}}$$

e.g. This year's profit = \$900,000 and Last year's profit = \$750,000

$$\text{Growth factor} = \frac{900{,}000 - 750{,}000}{750{,}000} = +20$$

From this calculation, it can be seen that a business can determine the speed of its growth by looking at its profit growth year by year. Obviously, a business that grows to double its size in only a few years and continues to grow at this rate will pose substantial challenges for the owner-manager seeking to manage the business.

6.10.2 Measuring Growth in the Small Firm

An important issue in the management of growth is how to measure it and whether or not the rate of the firm's expansion is controllable. Numerous attempts have been made to create measures of growth. These approaches typically use quantitative measures such as numbers of employees, annual sales turnover and assets, but can also include market share and even internal variables such as the tenure of senior executives and age of firm (Weinzimmer, Nystrom, & Freeman, 1998).

For small business owner-managers, the physical size of their business (e.g. its structural quantity) may be of less importance than the overall sustainability and functional quality of the firm. This was indeed the finding from the focus groups. As shown in.

Table 6.4, the measures of growth identified by the respondents can be broadly grouped into financial, marketing and management areas.

The financial issues were more commonly reported as measures of growth than the management ones. These findings are similar to those gathered by Mazzarol and Ramaseshan (1998) in a survey of 113 small businesses. This study found that profit growth rated significantly ahead of other factors as a success measure among small business owners. Growth in sales and growth in assets were rated in second and third place while growth in employee numbers was viewed as being of low importance to measuring success.

6.10.3 Means of Achieving Growth in the Small Business

In examining how growth in their own business might be achieved the respondents in the focus group sessions were tasked to list as many potential factors as possible. A substantial list was produced that was ranked in order of priority. Twelve key areas were identified as shown in Table 6.5. It can be seen that the most important – from the owner-managers' perspectives – were profitability and management skill.

6.10.3.1 Profitability

The issue of profitability was associated with how to achieve enhanced profits in conjunction with increased turnover levels. It was observed that for growth to be

Table 6.4 Measures of growth in small business

Turnover	*Marketing*	*Management*
Turnover (dollars)	Increased sales	Increased wellbeing
Profits (bottom line)	Increased customer base	Staff numbers
Increased net profit	Increased market share	
Increased equity	Increased efficiency	
Increased dividends		
Return on investment		

Table 6.5 Means of achieving growth in the small business

Average importance rating	(N = 10/10)
Profitability (9/10)	Quality (7.1/10)
Management skill (9/10)	Technology (6.9/10)
Human resource management (8.1/10)	Production/logistics (6.7/10)
Strategic management (7.9/10)	Marketing (6.4/10)
Personal development (7.5/10)	Succession planning (5.4/10)
Finance (7.1/10)	Accessing professionals (4.9/10)

achieved profitability must increase along with sales to avoid *'running faster to stay still'*. Greater profits were needed to provide finance for investment in new technology or marketing efforts.

6.10.3.2 Management Skill

Management skill was related to a range of issues that included a need to increase an owner's knowledge of products, general managerial skills and ability to coordinate and lead subordinates. Two important sub-themes emerged from within this area:

1. *Balancing hands-on and proprietorship*. This considered finding ways to reconcile being a 'hands-on' practitioner at the same time as being a business manager, as the business grows. Lack of time to manage the business while operating within it. The need to balance personal life demands with those from a growing business, and getting more time to enjoy work rather than undertaking mundane tasks.
2. *Communication*. This issue related to the need to maintain a standard of care in internal communication and feedback with employees. It concerned the development of managers and supervisors to become more effective in their roles and independent of decision-making to assist the overall growth of the business.

6.10.3.3 Human Resource Management

Human resource management was concerned with recruiting, training and keeping good staff. A lack of good supervisors and skilled employees was identified as a key issue. Staff development to engender a sense of personal commitment, responsibility, customer service and 'best practice' behaviour was a major desire.

6.10.3.4 Strategic Management

Strategic management related to such matters as exit strategies, decision-making over what to do and over what time period to allocate resources. The general vision and mission of the business was considered here along with how to establish and implement effective marketing and investment strategies.

6.10.3.5 Personal Development

Personal development concerns focused on the management of stress – particularly that associated with financial worries – as well as issues arising from family and work colleagues. These revolved around the need to convince others that the owner-manager had the ability to lead the business in the right direction and the skill to resolve conflicts between staff and partners. Some owners even found themselves facing a sense of 'guilt' for being successful.

6.10.3.6 Finance

Finance related issues concerned financing growth and keeping up with the rapid changes in technology that required additional investment. Better information from improved reporting systems was required to enable the owner managers to control financial matters.

6.10.3.7 Quality

Quality considerations involved finding ways to achieve best practice and enhance customer service. Total quality management (TQM) and formal quality assurance systems were viewed as desirable in achieving this while staff training was seen as the means to do so.

6.10.3.8 Technology

Technology issues were divided into information technology and production technology. In the case of the former the main concerns were the need to keep up with the rapid changes taking place there and the cost of doing so. Also, of concern was how to make use of such technology for future competitiveness. On the production technology side, the future focus was particularly strong.

6.10.3.9 Production/Logistics, Marketing, Succession Planning and Advice

Production/logistics concerns related to finding ways to implement a better system of factory planning and logistics. Marketing focused on finding new market opportunities and the need to promote products and services. Succession planning was of concern to those from family businesses and Accessing professionals revolved around the need to find suitable consultants to assist the owner in their growth process.

6.10.3.10 Discussion of the Findings

Previous research into the successful growth of small business has highlighted many of these issues as being important for owner-managers to address as the business seeks to expand. For example, management experience and education were found to be related to success (Olson & Bokor, 1995). Also important was the owner's ability to adopt more sophisticated approaches to planning and strategy (Berman et al., 1997). Formal strategic planning has also been found associated with small business success (Jackson, 1994; Slevin & Covin, 1997). Other research suggests that small business growth may be positively associated with financial skills and family support (Kaufman, Weaver, & Poynter, 1996), and the ability of the small firm to offer customers reliability, value adding, quality, good service and long-term partnering (Simon, 1996).

6.11 Factors Associated with Small Firm Growth

Research undertaken with small fast-growing businesses in Australia suggests that owner-managers of such firms are likely to be associated with four distinct characteristics (Mazzarol, 1999b). Drawing a sample of 55 owner-managers and an examination of their business practices measured using a self-completed questionnaire of management behaviour and orientation. Respondents were classified into above or below average growth groups using a growth measure of sales turnover over a period of four consecutive years. Four factors were identified as being strongly associated with above average growth as outlined in Fig. 6.11. These findings provide a more comprehensive picture of the possible relationship between management activity and growth in a small firm. The four factors were identified in a statistical analysis[1] and the dimensions are explained further below.

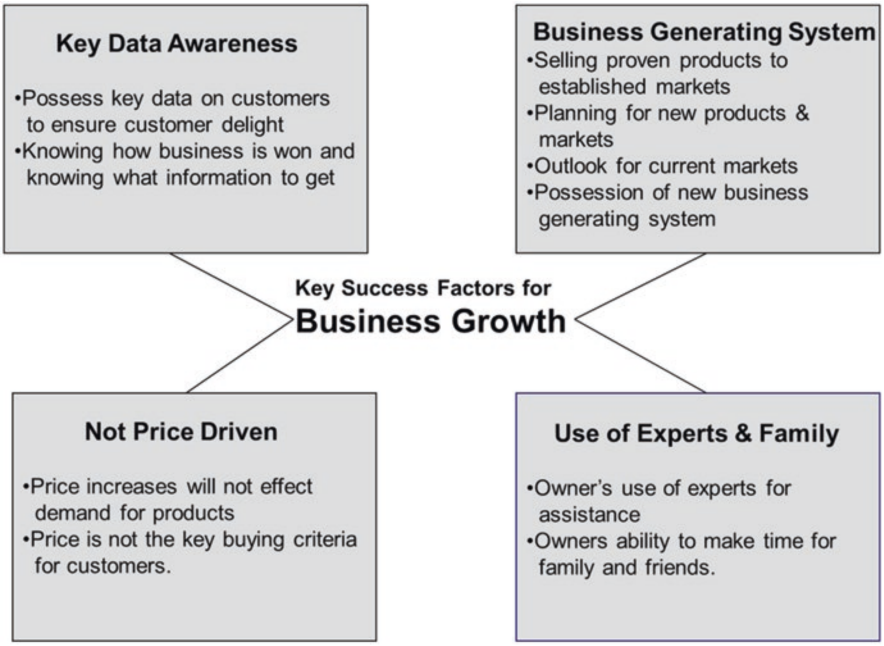

Fig. 6.11 The key factors for business growth
Source: Mazzarol (1999b)

[1]A discriminant analysis was used that correctly classified 74 percent of the high growth firms against these four factors. These factors were initially produced using a principal components analysis from the initial set of variables used in the survey.

6.11.1 Key Data Awareness

Key data awareness is comprised of two variables. The first relates to the owner-manager having clearly identified the critical information needed by them in order that they continually exceed their customer expectations. The second concerns whether or not the owner has examined how he or she gets business and identified what information they require. Owner-managers within the above average growth group were more likely to score highly on:

- Possession of key data to allow them to delight their customers.
- Knowing how their business was won and what information to get to monitor their customer's behaviour.

This response is consistent with the owner-manager's ability to maintain good marketing behaviour (see Chap. 5), and the ability to continuously delight their customers by understanding customer needs and wants, then responding with appropriate products or services.

6.11.2 Not Price Driven

Two variables comprise this factor. The first relates to whether or not an increase in the firm's prices will affect demand for its product. The second is whether price is considered to be a real factor in determining customer-buying decisions. Owner-managers within the high growth group were strongly associated with being able to state confidently that:

- price increases will not affect the demand for their products.
- price is not the key buying criteria for their customers.

This factor is consistent with the ability of the owner-manager to identify a clear point of difference in their market, and to value add so as to avoid being forced to compete solely on price. As noted previously, any small firm seeking growth must employ innovation to secure a unique selling point to allow it to command premium pricing within its chosen markets.

6.11.3 Business Generating System

The business generating system factor consists of four variables. The first is concerned with the owner's focus on growing their business by selling proven products or services to more customers. The second relates to the firm's capacity to plan for and allocate sufficient resources to the development of new markets. The third involves the owner's view that long-term prospects in their primary markets are excellent. Finally, it deals with whether or not the firm has an effective business-generating system in place to create new customers.

- Owner-mangers within the high growth group were able to state with confidence that:
- they sold proven products into established markets.
- they had confidence of continued growth in their established markets.
- they actively planned for new products and markets.
- they possessed a business generating system.

The specific nature of a business generating system was not clearly defined; however, it is likely to take the form of a systematic approach to sales management. An examination of the components of the business generating system likely to be employed in this situation found that it comprised some or all of the elements shown in the shaded box below.

A Business Generating System Comprises
- active networking to generate new business opportunities;
- development of market segments with good long-term growth potential;
- a problem seeking, problem solving approach to sales management;
- avoiding diversification strategies unless there are few alternatives;
- sales management systems to generate new leads;
- ensuring all employees are effective sales people; and
- planning for and allocating sufficient resources to new product or market development.

Source: Mazzarol (1999a).

6.11.4 Use of Experts and Family

This factor consists of two variables. The first is related to the owner's awareness of and ability to access grants and expertise available to assist their business. The second is a more personal one and concerns the owner's ability to make space to spend time with family and friends. The owner-managers within the high growth group were more likely to:

- make use of external advisors for assistance with their business.
- make time to be with family and friends to achieve life balance.

The value of using external consultants or advisors to assist in the business has been found to be positively associated with superior growth and performance (Kent, 1994). The need to find a balance between work and family life is also likely to be important for owner-managers, and effective business management leading to delegation to employees will potentially allow more time for such personal time.

6.11.5 Other Qualities

Owner-managers of small firms with high growth performance were also found to be significantly more likely to have the following characteristics:

1. a high level of environmental scanning;
2. a greater control over their key resources;
3. a stronger level of customer commitment;
4. an organisational structure to support their business plan;
5. a commitment to partnering with customers and suppliers;
6. a strong commitment to ISO9000 standards;
7. a clear knowledge of critical information;
8. good cash flow management; and
9. a commitment to taking action.

In summary, the elements of successful growth are likely to be numerous and will impact on different firms in different industries for many different reasons. However, there seems to be a pattern emerging from the available evidence that suggests small business owners who decide to follow a growth strategy, will be more likely to succeed if they can identify a good market opportunity within a market niche that has long-term growth potential, and allows them to build a competitive position whereby they are not competing on price. They must be able to fully understand the needs of the customers within this chosen market, and to develop a systematic approach to selling and customer relationship management that ensures continued new business generation while retaining existing market share. Time and resources must also be put aside for new product and market development. The owner-manager will need to seek outside help where needed to assist them to make strategic decisions as well as accessing resources beyond their immediate control. As one successful entrepreneur who attended a similar discussion forum run by the Kauffman Foundation in the United States described their motivation for growth in the business:

> I envision spending more time with my wife and daughter. At the same time, I want the company to grow where we can double our square footage. I expect to be privately held. I want to have a self-motivating group of people with proper controls and project tracking. I want to make sure that all of our sales leads are properly followed and closed. I'd like to be able to create more products within our niches and also create some wider, non-platform specific solutions. I see my role as more of a visionary, focused on new product ideas, designs, and leveraging us into new markets as opposed to dealing with the day-to-day issues (Kauffman Centre, 1999).

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Small Firms and Human Resources

7

7.1 Introduction

Frequently, small business owners have excellent knowledge of their particular field or core competency. However, research has indicated that many small business owner-managers lack important knowledge related to labour law compliance and human resources (HR) management (Massey & Campbell, 2013, p. 77).

The classification of firms into micro, small, medium and large is undertaken primarily on the size of their payroll. As the business expands in size the role of the owner-manager becomes more complex and leadership more important. The owner-manager's ability to develop his or her staff into a team who can operate systems efficiently and effectively is one of the most critical elements in the firm's long-term success. If the owner-manager is unable to develop an effective team, capable of taking over responsibility for operation of the business, it is problematic that they can ever successfully grow their firm. In this chapter we look at the duties and responsibilities of small business owners when recruiting employees, and the importance of team building to the successful development of a small business. We also examine the need for the owner-manager to view their role as that of a coach and the importance of coaching skills to successful team building.

7.2 Human Resource Management and Small Firms

In the previous chapter it was shown that as a small business grows its owners must begin to increase their staff and learn how to develop and implement human resource management (HRM) policies. The faster the growth experienced by the small firm the more likely it will experience HR problems. For many fast growing small firms

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the main problem is finding and retaining high quality employees (Fraza, 1998). Owners of such growth companies must learn to communicate their vision, mission and values to their employees along with a clear understanding of how the firm is to achieve these goals (Barrier, 1999).

As a firm grows and its employee numbers increase, the complexity of its human resource deepens. The owner-manager is usually burdened with a variety of HRM functions for which they are generally poorly equipped (Thatcher, 1996). Managing such issues as recruitment and selection, staff promotion and retention, wages and salary negotiations, compliance with government employment, tax and insurance regulations, training and development can severely burden the average small business owner (Macpherson, 2005). What is required is the development of a suitable HRM policy and procedure. Ideally this should be flexible and not a mere addition to the bureaucracy (Caudron, 1993a).

Developing the firm's HRM policies is critical to the long-term success of the small firm (ESDE, 2016; McGuirk, Lenihan, & Hart, 2015). Empirical research studies of small firms suggest a positive relationship may exist between effective HRM and successful business performance (De Kok, Uhlaner, & Thurik, 2006; McGuirk et al., 2015; Ogunyomi & Bruning, 2016). Rowden (1995) examined three successful manufacturers with fewer than 200 employees and found use of both formal and informal HRM practices had a direct influence on the overall success of the firms. Another study by Hornsby and Kuratko (1990) surveyed 247 firms with less than 150 employees. They found that size of the payroll had an impact on the level of HRM policy sophistication used in the firm. Firms that do not systematically develop suitable HR politicises as they grow can find themselves facing higher than average personnel related problems (Amba-Rao & Pendse, 1985).

As the number of staff employed within the firm increases the need for a formal HRM manager or process also becomes more pressing (Little, 1986; Mayson & Barrett, 2006). With less than 100 employees the firm can probably operate successfully without a full-time personnel or HR manager. However, once the employee base exceeds 150 a professional manager may be required and over 200 a dedicated HR department can be necessary (Caudron, 1993b; Oliver, 1997). A meta-analysis by Rauch and Hatak (2016) shows that skill enhancing, motivation enhancing, and empowerment-enhancing HR practices were related to performance in SMEs. They suggested a number of adaptations that could be specified for SMEs. For example, skill-enhancing HR practices seem more important in small firms, especially in young firms, operating in high-tech industries and in country contexts characterized by rigid labour regulations such as the Netherlands, Germany, or France (p. 500). This often requires from the start-up specific competences like organizational, temporal, contextual and relational ambidexterity in dealing with the tensions resulting from high growth (Grimand, 2013).

Although a substantial body of literature has emerged in recent years in relation to HRM within large firms, the same is not the case for small businesses which have largely been ignored by academic researchers (Battisti & Deakins, 2010; Heneman, Tansky, & Camp, 2000; Wilkinson, 1999). HRM practices in small firms are characterised by low levels of formality, and generally become more formal as the size of the firm's payroll increases (Kotey & Slade, 2005). Compared with large firms the average small business does not employ a professional HR manager and it is usually the responsibility of the owner-manager to deal with personnel matters. This is particularly the case for micro and small firms which are typically characterised by personalised management practices and informal approaches to HRM (Srimannarayana, 2006). In small family-owned businesses the management style is often "*negotiated paternalism*", as opposed to autocracy or harmony, often referred to in family businesses, and "family" is both a resource and constraint (Ram & Holliday, 1993).

A review of the academic literature relating to HRM practices in SMEs was undertaken by Bacon and Hoque (2005). They discovered a range of internal and external factors likely to influence the formal adoption of HRM practices within SMEs. Key internal factors were the level of skills found within the firm's work force. In firms with highly skilled employees and greater levels of innovation, the adoption of formal HRM systems was more common than in those with less skilled and more routine workplaces. Another important internal factor was the level of formal education and professional management education that the owner-manager had. Of these the skills and sophistication of the workforce was the more important.

Major external factors influencing the adoption of formal HRM practices by SMEs found by Bacon and Hoque (2005), were the nature of the firm's corporate governance and proprietary control. For example, firms that had boards and outside directors were more likely to adopt formal HRM practices. The presence of Trade Union involvement with the firm's workforce also served to trigger increased formality in HRM practices. This typically took the form of wages and conditions, recruitment and selection, grievance and disciplinary policies. In some cases, the firm's customers served to encourage formality in HRM, particularly in areas such as work health and safety, training and occupational certification.

7.3 Comparisons of HRM in Small and Large Firms

Several studies have attempted to examine the differences between small and large firms in their use of HRM. Deshpande and Golhar (1994) gathered findings from a sample of 100 firms comprising both larger (>500 employees) and smaller (<500 employees) companies. The study found no-significant differences between the two types of firm in terms of their overall HRM practices. However, small firms were found to rate the importance of worker characteristics – e.g. commitment, ability to work in a group, communication skills and self-discipline – significantly higher than did larger firms. Smaller firms were also more likely to use job tryouts prior to hiring staff. However, the definition of small firm (<500 employees) in this study may contribute to explain the lack of difference between small and large firms.

Marlow and Patton (1993) undertook a qualitative study involving in-depth interviews with 15 companies in the UK. They found a much lower level of professional HRM practice among the smaller firms as well as lower trade unionisation. Small firms were also less inclined to view HRM as a strategic tool for enhancing the firm's competitive advantage. This pattern of organisational behaviour is not restricted to any particular country. For example, Srimannarayana (2006), in a study of 42 small businesses in India, found low levels of formality in HR practice. While the firms had rudimentary recruitment, selection, training and performance appraisal systems, they were informal and flexible.

A survey of 991 small firms in Atlantic Canada found significant relationships between size of business and levels of unionisation or formalisation of HR practice. Most small firms had some form of employee induction and orientation program. However, the more *progressive* the firm's management culture the more likely it was to use formal HRM practices (Wagar, 1998).

In a further study by Deshpande and Golhar (1997) of large and small manufacturing firms in Canada no significant differences were found between the two types of business over the perceived importance of worker characteristics. Internal appointments for job vacancies were the preference in both large and small firms but the larger business was more formal in its recruitment and selection procedures. Large firms were more likely to make use of formal testing and selection panels when recruiting staff.

Savery and Mazzarol (2001) examined HRM and industrial relations practices among a sample of 569 small and 1202 large Australian firms. They found that the level of formalisation of the HRM function grew with the size of the firm, and that the level of industrial action (e.g. strikes, stop work meetings) fell dramatically the smaller the size of the workforce. Unionisation was also found to be associated with the size of the workforce, with small firms largely non-unionised in comparison with their larger counterparts. Use of external HRM specialist consultants and industrial relations experts also became more common the larger the firm became. This led to the development of some mimetics between the practices in small forms and the habits of bigger firms. For example some SME have started to explore the possibilities offered by the management of talents, as it is implemented in MNEs (Krishnan & Scullion, 2017).

The link between HRM and firm performance of organizations has been widely studied, however it has generally focused on large firms from developed countries. Investigating the relationship between HRM practices and the financial and non-financial performance of SMEs in Nigeria, Ogunyomi and Bruning (2016) conducted a survey of 236 small firms. Their results partially support a model of positive relationships between certain HRM practices and firm financial and non-financial performance.

Since the 1990s large firms have adopted strategic HRM (SHRM) systems designed to align the organisation's human resources systems and policies with its strategy and strategic business needs. For example in their conceptual paper, Mayson and Barrett (2006) advocate for a more strategic management of human resources in small firms. Schuler (1992) suggested professional HR managers integrate their role into the large business through a *Five P model* incorporating philosophy, policies, programs, practices and process. Each of these HR elements needs to be considered in the broader context of how they interact with the same elements for the entire

Table 7.1 Strategic HRM activities – the five P model

Activity	Outcome
Human resources philosophy: Expresses in statements defining business values and culture.	*Expresses:* How to treat and value people.
Human resources policies: Expressed as shared values (guidelines)	*Establishes:* Guidelines for action on people-related business issues and HR program.
Human resources programs: Articulated as human resources strategies.	*Coordinates:* Efforts to facilitate change to address major people-related business issues.
Human resources practices: For leadership, managerial and operational roles.	*Motivates:* Needed role behaviours.
Human resources processes: For the formulation and implementation of other activities.	*Defines:* How these activities are carried out.

Source: Schuler (1992)

organisation. The key elements of this *Five P model* of strategic HRM are outlined in Table 7.1.

Within a large organisation, this framework is a mechanism for coordinating the various activities that comprise the firm's HR system. It also defines the desired outcomes from each of these five activities. As might be expected from a strategic HRM system, the purpose of the model is to ensure that human resources are managed with the firm's strategic needs in mind. For example, the concept presented here proposes that the framework of strategic human resources management is made up of all activities affecting the behaviour of individuals in their efforts to formulate and implement the strategic needs of the business (Schuler, 1992).

This strategic approach to HRM requires the HR manager to view their role as one of managing cultural change within their organisation while adding value. To achieve this, they need to widen their thinking to incorporate strategies for the recruitment, selection and development of key managers and knowledge workers (Beatty & Ulrich, 1991; Eichinger & Ulrich, 1997; Kerr & Ulrich, 1995). The challenge for the HR manager of a large company is to make their function relevant to the future development of the organisation in a strategic sense. Failure by professional HR managers to achieve this may see their function out-sourced by the large companies of the future (McKee, 1997).

Small business owners are also faced with a need to adopt a strategic approach to HR policy and practice. For them the growth of their company is often linked to the removal of HR related bottlenecks that would otherwise inhibit successful expansion. HR management in the small firm is currently poorly understood and requires additional research. A closer examination needs to be undertaken into how small business owners implement HR policy and the link that appears to exist between the setting of strategy, expansion of operations and markets, and development of formal HR policy.

For small business owner-managers seeking to grow their firms, adopting SHRM practices, or what has been called *high performance management practices* is a potential key to success. However, a study of 1435 Australian SMEs found a “relatively bleak” picture in relation to such best practice SHRM activities. As firms grew in size, their likely use of SHRM and high-performance management practices increased. This adoption of SHRM was also more likely to be associated with the presence of professional HR managers and Trade Union representatives in the firm (Wiesner, McDonald, & Banham, 2007). A common practice for many SMEs is regular use of formal employee performance appraisal systems and the active engagement and communication between the employer and the employee (Wiesner & Innes, 2010).

In a study of more than 220 SMEs in Quebec, Lacoursière, Fabi, St-Pierre, and Arcand (2005) found that many HRM practices appear to be significantly linked with the performance of an SME. They identified that information sharing was linked with turnover and return on assets, that training was linked with productivity and that recruitment and performance appraisal were linked with sales growth. They suggest that HRM practices could have different impact depending on the size of the SMEs.

7.4 A Model of HRM in Small Firms

Research into how small business owner-managers deal with HRM issues during growth cycles suggests that the process involves a dynamic interaction between: the owner-manager’s characteristics; external market conditions; the company’s structure; and the nature of the work environment within the firm (Mazzarol, 2003). A crucial element of this process is the owner-manager’s commitment to partnering with their employees – that is finding ways to motivate and lead them via establishing mutually beneficial outcomes.

Figure 7.1 illustrates this process. The characteristics of the owner-manager have a direct influence on the company structure as well as the nature of HR policy and practice within the business. The decision-making of the owner-manager is influenced by the external market conditions facing the business, which also influence both the company structure and nature of the work environment within the firm. This is consistent with earlier research into small firm HRM practice (Kinnie et al., 1999; Matlay, 1999). However, of particular importance seems to be the owner-manager’s commitment to partnering with his or her employees.

The company structure influences the work environment within the business, but is in-turn, influenced by the work environment. Owner-manager characteristics, company structure and the work environment within the firm directly shape HRM policy and practice. These policies and practices seem to shift from informal to formal procedures as the company grows and the owner-manager becomes more experienced or capable of delegation, team building and transfer of authority to a professional management team. These HRM policies and practices result in either negative or positive outcomes in the area of employee turnover, productivity and commitment to the company (partnering). An iterative process is likely to occur

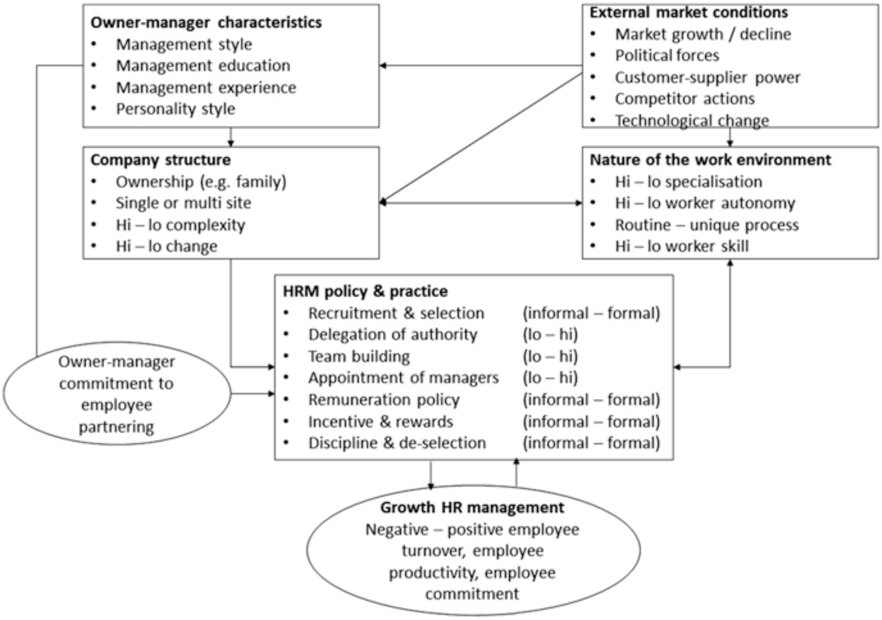


Fig. 7.1 A model for HR management of small business growth. (Source: Mazzarol, 2003)

between the formulation and implementation of HR policies and the actual outcomes of the HR growth management. A *trial and error* or *learning by* doing process takes place in which the owner-manager explores different strategies to achieve successful outcomes.

Effective management of small business growth demands a commitment from owner-managers to put in place structures, policies and practices that enable employees to take on greater responsibilities and participate in dynamic innovative teams. Formalisation of HRM policies and practices will become necessary as the scale and scope of the business grows. Learning to delegate authority and responsibility through the application of coaching and HR practice will be essential to success. This was highlighted by Aït Razouk (2011) in a study of 275 French SMEs. Firms that took a strategic approach to the creation of *high-performance work systems* (HPWS) were associated with profitability, innovation and enhanced social climate; firms with formal HPWS also managed to sustain such performance over time.

Although the use of strategic HRM within small businesses is likely to deliver positive benefits, the reality of HRM within most SMEs is quite different. Figure 7.2 illustrates a typology originally identified by Goss (1991) that classified small business HRM practices into four categories.

The first of these is *Sweating*, an unhappy environment in which the owner has little concern for the development of their employees and has an authoritarian management style. Dissent is not tolerated, and employee personal and professional growth is viewed as unnecessary. The second type of HR experience is *Paternalism*, which is a situation in which the owner-manager views their employees almost like

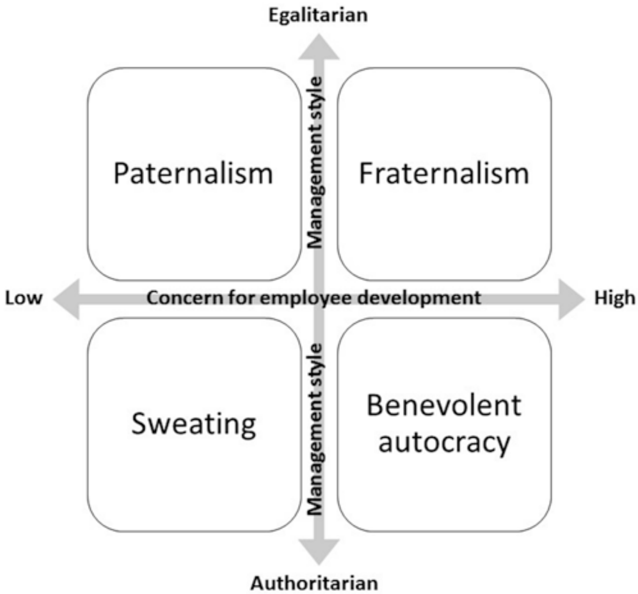


Fig. 7.2 A typology of HR management in small firms. (Source: Adapted from Kinnie et al. (1999) and Goss (1991))

a family. While their style of management is generally fairly egalitarian, they have a low level of interest or concern for the development of their employees. Of more concern is that the *status quo* of the family is retained. Employees who might seek to challenge the authority and leadership of the owner as *parent* is resisted.

The third type within the model is *Benevolent autocracy*, where the owner has a high concern for their employees' personal and professional development. However, they are also authoritarian in their management style and intolerant of contrary views. Such owners are unlikely to want to delegate authority, even though they may be keen to see their employees develop their skills and competencies. Finally, the fourth type is *Fraternalism*. This is viewed as the best situation, where the owner is concerned with their employees' personal and professional development. However, they are also egalitarian in their management style. As such, they are open to new ideas and willing to delegate authority to their employees as they develop their competence and skills.

7.5 Learning to Let Go – The Risks of Micro Management

For most small business owners, the initial years of company foundation require them to be *micro managers*, constantly engaged in the everyday minutia of the business. Companies founded by one or two owners are largely dependent on their owners for their survival in the first 1–3 years of operation. However, as the business grows it becomes necessary for the owner or owners to develop a team and learn to delegate.

Formichelli (1997) describes the problem as *Nano management* and points to the risks of the owner failing to break free from the constant micromanagement associated with the early stages of the firm's lifecycle. These risks include a lack of time for the owner to undertake important planning and business development tasks, failure to get the best out of their people, and owner *burn-out* under the work pressure. Smith (1992) has highlighted the need for fast growing companies to develop good teamwork and delegation skills among senior managers. Baker (1994) also emphasises the importance for CEOs to empower their team by learning how to step back and let empowerment take effect. As he explains, to completely abdicate responsibility is a recipe for disaster as control can be lost. Meddling around with teambuilding frequently fails because subordinates are not permitted to have real authority. What is needed is coaching. The successful coach carefully balances between intervention and interference.

Wright (2000) suggests a series of strategies for avoiding the micro-management trap. His prescription involves four elements:

1. Flexibility.
2. Establishment of SMARTER goals.
3. Being results oriented.
4. Being a player/coach.

In the first case the owner-manager needs to establish trust with and in their employees, and a willingness to listen to their opinions. It is not always true that the boss knows everything. Enforcing opinions on employees can lead to them feeling unappreciated in their views, and can impede the opportunity for the firm to become innovative and adaptable. The establishment of SMARTER goals is Wright's (2000) acronym for setting goals that are:

- **S**pecific
- **M**easurable
- **A**ttainable
- **R**ealistic
- **T**imely
- **E**asily **R**emembered.

Such goals should also be limited to a number, perhaps three to five, that can be easily placed on a focus card (that is, a small card that can be easily placed inside a diary or notebook). This card is used by the owner-manager and their employees to keep the firm's strategic objectives in mind, or to maintain the focus of employees during their daily work. Wright (2000) suggests developing these goals jointly with employees, rather than simply imposing them from above.

The focus should also be upon results or outcomes more than the process of how these are achieved. Everyone has their own way to do things and managers who insist on an employee doing something a certain way, regardless of whether this is the only way to do the task, can restrict productivity and innovation. If a task can be performed in different ways safely, ethically and without undue risk to the employee or the business, then it is best to allow it to proceed. Also, once the task is successfully completed and if it is done to a high standard, the owner-manager should give positive feedback to the employee.

Finally, the idea of being a player/coach involves provision of constructive criticism of work performance, and the opportunity for 360-degree feedback. For example, 360-degree feedback, is very important to an organisation's success. A key component to this process is for both the manager and the employee to provide both feedback (what we are doing wrong) as well as provide potential solutions (what we can try) (Wright & Boswell, 2002). This requires the owner-manager to build a position of trust with their employees and to have them also feel that they can speak freely and offer their opinions. The primary objective of this process is to ensure that both employees and management are in agreement as to what should be done, where, when and why it should be done and how it should be done. By following this system, it should be possible for the owner-manager to delegate more responsibility to their employees and avoid the micro-management trap.

7.6 Delegation and Team Building

Learning to step back and let go requires the owner to identify clearly where they wish the business to move over the longer term, and then develop a blueprint for their business accompanied by staff training and development (Bates, 1999). This blueprint should identify the job descriptions and duties required for each employee position. This may be challenging for many SME owner managers, as they often encounter proxemics biases, exposing them to microcosm effect and ego trophy, both resulting into a strong reluctance to delegate power in their firm (Torrès, 2003; Torrès & Julien, 2005).

Once such basic HR policy is in place the owner can set about adequately managing growth. Sharlit and McConnell (1989) point to a two-staged process of how a small firm grows. In the first stage of this process – creativity – communication is informal and jobs roles and functions equally flexible and unstructured. Owners frequently realise that they lack the skills to effectively manage their HR function and look to build a management team to assist them. During the second stage – direction – a newly-developed management team changes the company structure and sets more defined job descriptions. Employee training is implemented and supervisory jobs are created; communication becomes less spontaneous and more formal. A study of 364 small firms examined problems experienced over their life cycle (Dodge & Robbins, 1992). This found significant differences between the types of problems facing the firm during its lifecycle. During the growth stage accounting, inventory control and cash flow issues dominate.

For most small business owners, the key challenge is to learn how to delegate while simultaneously creating a team-learning environment within their company.

A longitudinal study undertaken with 576 start-up firms in the US over a 10-year period examined the owners' ability to delegate various functions (Ardichvili, Harmon, Cardozo, Reynolds, & Williams, 1998) This found that formal HR programs and policy did not emerge until turn over exceeded US$ ten million for manufacturers and US$ three million for service-based firms. Delegation of different business activities commenced first with the accounting functions and less so with production or information systems. Delegation of HR functions did not take place until much later. The owners largely retained the role of planning. Training was required fairly early among these firms and across a range of different functional areas.

The Six Stages of Delegation

1. Select the appropriate task – which can be delegated.
2. Choose the right people – who can undertake the task.
3. Briefing in detail – set clear objectives and standards.
4. Coaching and training – offer the right level of support.
5. Controlling the process – seek feedback and reporting times.
6. Evaluation of the process – were the goals achieved and benchmarks met?

Source: Snaith and Walker (2001).

If the owner cannot learn to delegate responsibilities, they risk becoming overextended, with detrimental impacts on their capacity to plan and to successfully develop market opportunities (Cronin, 1991). The ability to delegate is an important step in the owner's transition from a small entrepreneurial business to a larger mature one (Weiner, 1985). According to Baker (1994) the challenge for owner-managers is to create a suitable environment in which their employees can learn to assume responsibilities. Successful team building requires time and recognition of individual differences with some need for consideration of the most effective balance between one personality type and another (Darling, 1990).

7.6.1 Team Building in Small Firms

Effective teams are characterised by a clear set of objectives and a willingness to work together to achieve them. Individual team members appreciate each other's capabilities and are tolerant of their limitations. Power is shared. Management of effective teams requires the skill of coaching members through the formative stages to a level of high performance (Koehler, 1989). A study by Kerr and McDougall (1999) of 130 small business owners found the most important driving force for HR development initiatives was the owner's personal attitudes toward training and development. Further, the main benefit of such HR development activity was the ability to transfer core skills between staff.

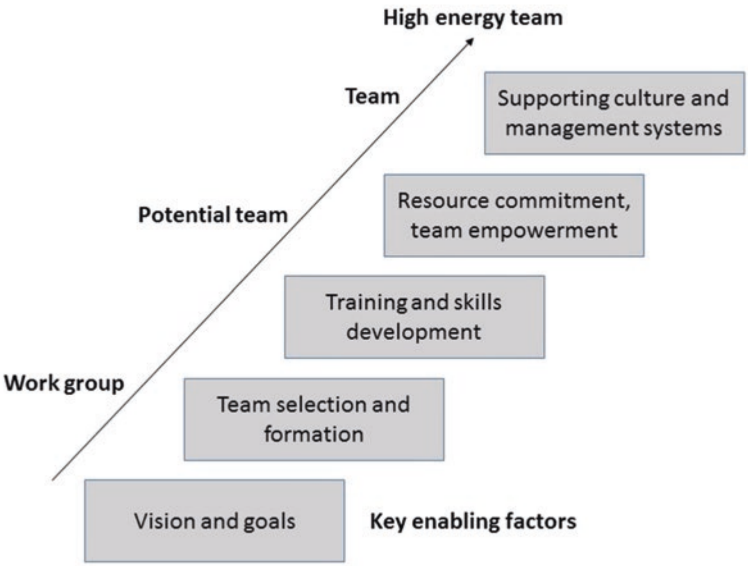


Fig. 7.3 Model of teamwork development. (Source: Drew and Coulson-Thomas, 1996)

Drew and Coulson-Thomas (1996) conducted a study of 100 firms and their approaches to team building and teamwork. They argue that the future of many industries will demand greater teamwork within organisations of all sizes. Further, the competitive success of firms may depend on their ability to develop new organisational structures that take advantage of teamwork and bring together networks or clusters of teams and firms spanning many traditional functions. The challenge for managers will be to implement adequate training and team development processes to take advantage of the opportunities.

Figure 7.3 shows a conceptualisation of the framework required to develop a high-energy team. As shown, it commences with a clear vision and goal setting, moves into the selection of the team and then their training and skills development. The organisation that seeks to make best use of the team must also ensure that it provides adequate resources and empowerment to team members. It will be important for the firm to have a culture that is highly supportive of teamwork and management systems that facilitate such work.

The development of effective teams is a time consuming and demanding task that will not be accomplished overnight. Small business owner-managers seeking to develop their own entrepreneurial team (e-team) will need to allocate sufficient time and resources to the team building process. According to Elmuti (1997), the failure of many team-based initiatives is due to a lack of clear goals and insufficient support from the company.

Further, the delegation of responsibility to self-directed teams when employees are not ready to assume such responsibilities can be detrimental to the organisation. Employees may also view the implementation of self-directed teams as little more than another passing fad. As such they may be reluctant to put in the time required to really make the team effective. However, the benefits of self-directed teams are generally significantly greater than more traditional work groups if the process is effectively managed.

Building the Awesome Organisation
Some key tips these entrepreneurs suggested to overcome the problems of delegation and avoiding the traps of micromanagement were as follows:

- Hire people who are smarter, better and more efficient than you.
- Ask questions first don't try to jump in with an answer.
- Constantly measure the downsides of all your decisions; will a bad decision break the business? If not proceed.
- Recognise the problems of being the 'expert' in the business; learn to delegate and transfer knowledge to the team.
- Get a mentor, someone who can teach or coach you.
- Change your management structure as you grow.

Source: Kauffman Centre (1997, 1998, 1999).

7.7 Building the e-Team for Future Growth

An important element of designing the new business venture or developing a business over time is the capacity of the owner-manager to select and train a competent team. Without the development of an effective entrepreneurial team (e-team), the founder-entrepreneur will be unable to delegate responsibility to others.

Successful growth in the small firm requires the owner-manager to learn how to step back and let go from the daily tasks associated with the management of the business. While this seems obvious it is not an easy task and is frequently the most challenging aspect of growth in the small firm. To achieve effective growth the owner-manager will need to learn how to develop an e-team or a self-directed team of employees who are motivated to make the business as successful as the owner would like it to be (see Fig. 7.4). Building this e-team will require the owner-manager to learn how to delegate responsibility, coach employees and recruit effective new team members. Leadership will be vital to the success of this and the owner must learn to provide clear vision and goals for the team and then resource and empower them.

As the firm moves through various stages of growth the size and complexity of the management task will also multiply. Owners must shift from *doing* to *leading*, working *on* not *in* the business. They must realise that team building and coaching will gradually take up more and more of their time as they create a self-sustaining, self-managing business entity. However, the rewards for the owner-manager will be substantial. A business that is able to confidently operate without the original

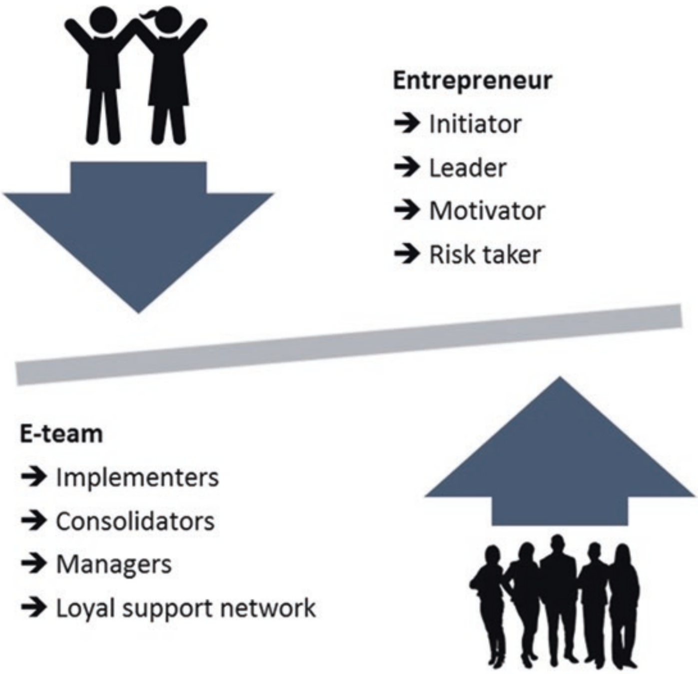


Fig. 7.4 The entrepreneur and the e-team

founder keeping their hand on the levers will be more likely to fetch a good price if sold, and will certainly permit the entrepreneur to either retire in comfort, or use it as a launching pad for new venture opportunities.

7.7.1 Lessons from Successful Small Firms

The Kauffman Centre for Entrepreneurial Leadership is one of the largest centres of its kind in the world. On a regular basis, the centre holds discussion forums for successful entrepreneurs to exchange ideas and build knowledge through sharing experiences. It regularly holds a gathering of entrepreneurs who discuss their management and enterprise growth strategies. In a series of such gatherings leadership, micro management and the challenges of developing a team were discussed (Kauffman Centre, 1997, 1998, 1999).

These gatherings highlighted the importance of motivation and inspiration for successful entrepreneurial leadership. Leaders of fast-growing small firms must provide motivations, positive reinforcements and empowerments to their employees. Of importance is the ability to be flexible in leadership style, adapting to the needs of the growing organisation.

During the early life of the business the entrepreneur or owner-manager is able to lead by being an expert. They know how to do the business better than most others. The need to be a 'jack of all trades' is also a requirement of this stage. Success in growing the firm is the ability to demonstrate leadership by having a clear vision and setting goals for people, having confidence in where things are going, and being the driving force for the company (Kauffman Centre, 1997). Some of the comments made by these entrepreneurs are reproduced below:

> **For example,** … The best thing I've done for creating an awesome organisation is hiring people that are smarter than me in a lot of areas but have been stifled in other companies. We've been able to give them an opportunity to grow and expand within their fields of expertise. It's like taking a plant that's root bound, cutting off the old roots and giving it room to grow. A lot of it involves having them set their goals and making sure their core goals coincide with company goals (Kauffman Centre (1999), p. 8).
>
> **For example,** … Get your existing employees to cultivate, explore and search out good candidates. We haven't had to provide any financial incentives because we're so desperate for staff, and they're excited to get additional capacity in the organisation. But you can add a bonus to make it more attractive (Kauffman Centre (1997), p.5).
>
> **For example,** … We give our key people a goal to work on and clearly define our values. We are very ethical and very customer-oriented. We go 110 percent to get the product out on time. All our key managers have that same focus. I discovered this when we defined our values and goals in our strategic planning session last year. It was like enlightenment, and our key people really responded to it. I see them going the extra distance because they see a common goal we are all working towards (Kauffman Centre (1998), p.3).

7.8 Performance Reviews

A key area for owner-managers to focus within their HR system is on employee performance monitoring and review. This is important to enhancing overall productivity. Performance reviews are an important part of SHRM and HPWS approaches needed within SMEs seeking to manage for peak performance (Kroon, Van De Voorde, & Timmers, 2013). Among the most important elements in the development of high performance management practices are to undertake performance reviews that address not only employee performance, but working hours, group working practices and performance-based pay and conditions (White, Hill, McGovern, Mills, & Smeaton, 2003).

Figure 7.5 illustrates a performance improvement process involving six stages. These are summarised in the *performance review process* box on the following page. It is important to note that the performance review requires significant input from both the employer, employee and the other members of the workforce and should not be rushed or avoided due to lack of time as it is an essential tool for enhancing workforce productivity. It is a key SHRM tool that the small business owner-manager can apply at relatively modest cost and use it to not only boost employee productivity, but also employee motivation and retention.

Being able to negotiate with employees over areas such as flexibility of working hours and location, career development, positive rewards, training and worker productivity are also very important. Constructive feedback that can fully engage and

Performance Review Process

The following process can be followed in order to create a system for ensuring delegation and team management within the firm:

Stage 1 – Identify key result areas

Using a timeframe of 3 months get the team leader, via mutual agreement, to set three or four goals that are to be achieved.

Stage 2 – Set performance standards for each key result area

These key result areas need clear performance benchmarks that should be realistic, measurable and achievable within the timeframe. The team should seek to set these performance standards by asking:

- What tells me that my performance is OK in this area?
- How will I know when I am achieving these goals?
- *Stage 3 – Identify who is affected by the key result area*

Identify which other people, outside the immediate team, are likely to impact on the team's ability to achieve its goals. Team leaders should ensure that they are aware of their impact on others in the business.

Stage 4 – Subordinate briefs colleagues

Team leaders should brief others within the company who may be affected or might affect the team's ability to achieve its goals. The key result areas and performance measures can be circulated within the company.

Stage 5 – Monthly review on performance standards

Set aside up to 1 h each month and have the team leaders present their progress toward the goals, and to offer an objective and critical analysis of their performance. They should make recommendations for corrective action if required.

Stage 6 – Quarterly appraisal of performance

Review performance over the period and set new quarterly goals for the teams.

Source: Snaith and Walker (2001).

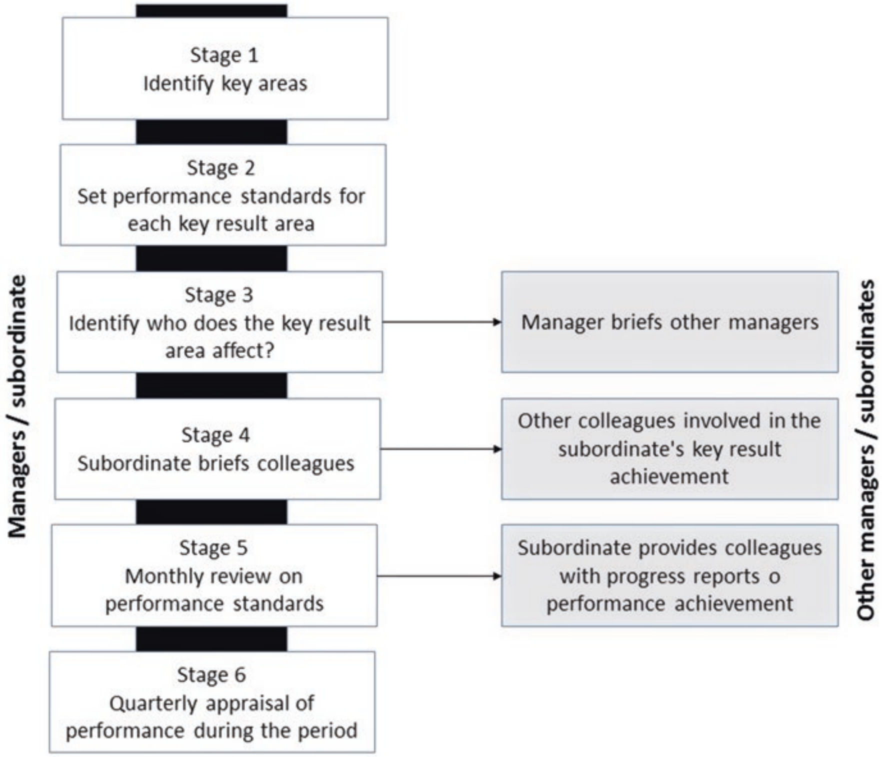


Fig. 7.5 A model of the HR performance improvement process. (Source: Snaith, 1997)

motivate the employee is also critical, and has been found to differentiate higher performing SMEs from their less successful counterparts.

> **For example, …** Our findings indicate that employment systems in high-performing small firms shared many attributes linked to organizational performance through employees who are aware of the practices that they believe will make the firm more successful, are highly committed to enacting those practices, and demonstrate quality consciousness. More importantly, our results reinforce the importance of participation mechanisms to enable and support enhanced firm performance. Firms with effective voice and participation, complemented by robust HR systems, showed enhanced organizational performance. (Verreynne, Parker, and Wilson (2013) p. 422)

In France recent changes have modified the requirements for the organisation of performance reviews in SMEs. It remains mandatory every 2 years, and since January 1, 2019, it has to include a new part relating (i) to the employee's personal training account, (ii) to the employer's possible contributions as well as (iii) to the employee's professional development. On the other hand, depending on more specific industry agreements, the periodicity of the interview may be modified (Lelièvre, 2018).

7.9 Management and Situational Leadership

An important framework for guiding the development of teams is found in situational leadership theory. The concept of situational leadership is a contingency model that recognises the leader exists within a given context or organisational situation. Hersey and Blanchard (1982) proposed a situational leadership model, as illustrated in Fig. 7.6. This suggests at least four distinct types of leadership style that are appropriate for a given situation.

The first of the situational leadership styles, as shown in Fig. 7.6 (S1), is a directing style of leadership in which the focus is on giving subordinates clear instructions for how they are to act and keeping a close eye on their performance. This has been called *Telling*. The second type (S2) is a coaching style of leadership in which the leader explains what needs to be done and why, with scope for more feedback and clarification of what is expected from the team members. This style has also been called *Selling*. The third style (S3) is a participation style of leadership in which the leader and their team share ideas and reach decisions via mutual agreement. Finally, the fourth style (S4) is a delegating style of leadership where the leader delegates authority to their team for all decisions and implementation.

An important issue within the situational leadership model is the degree to which the followers or team members are ready to take on their own responsibility for self-management. Where the team members are unable or unwilling to accept the responsibility for their own management, or feel insecure or are willing but unable to do so due to lack of experience or skills, the leader must take responsibility. In these instances, the most appropriate leadership style is coaching or directing. Where followers are able and willing to assume self-management, or where they are able but unwilling or lacking confidence, the delegating and participating leadership styles are more appropriate.

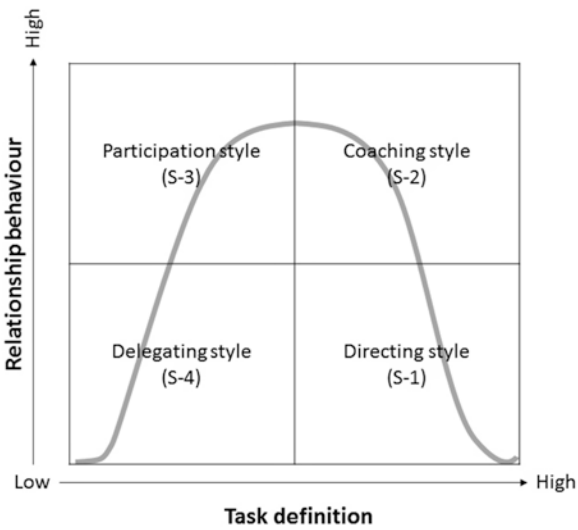


Fig. 7.6 Model of situational leadership. (Source: Hersey and Blanchard, 1982)

The leader-manager should, therefore, assess both the *willingness* and the *ability* of their team members before deciding which leadership style to employ. Where team members are both willing and able, it can be possible to delegate more responsibility. However, where they are unwilling but able, a more participatory style is required. In a situation where team members are willing but unable, the manager should employ coaching, and where the team is unwilling and unable, they will be forced to engage in a directing style.

Figure 7.7 illustrates this balance between the follower's readiness and the leader's need to direct. It can be seen that, where the following is in states R1 or R2, the leader must direct. This is typically the case when a new employee or team member joins an organisation. It can also occur where the employee is doing a new task that they find unfamiliar. For employees in state R1, the manager will need to employ an S1 directing style. Yet, if the employee is in state R2, they can employ an S2 coaching style and gradually bring them towards a level of competence. There is little point in attempting to delegate tasks much further when employees are not ready to take on specific work tasks.

Where the employee is in either state R3 or R4, a greater level of delegation can occur. In R3, the S3 participative style of leadership is likely to be appropriate. Here the manager can have the employee work along with them to gradually overcome any fears or insecurities they might experience. Finally, where the employee is in state R4, the manager can employ the S4 delegating style of leadership. Here they can transfer responsibilities fully to the employee. This may take time to achieve, and the small business owner should be patient. However, they will not grow their business unless they can delegate responsibilities to a competent team. It is therefore important that they use this situational approach to leadership as part of a coaching process designed to develop a high performing e-team.

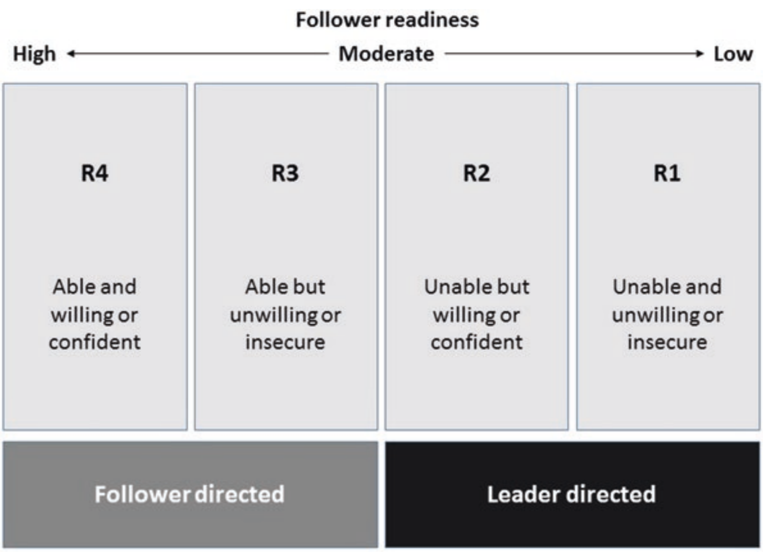


Fig. 7.7 Model of follower readiness. (Source: Hersey and Blanchard, 1982)

7.10 The Importance of Coaching

For the owner-manager operating a small firm experiencing growth, the need to delegate responsibility to a self-directed e-team is critical. As discussed above the challenge is to learn to delegate and avoid the micro-management trap. The answer to successful delegation and team building is coaching. Coaching is a process of unlocking a person's potential to increase performance and to help them to learn rather than attempting to teach them. The power of coaching is that if done well, the learner builds confidence and develops self-managed behaviours when acquiring new skills. However, effective coaching should be indirect and requires the coach to be a facilitator rather than a teacher. It does not generally work well in organisations that have highly directive and autocratic management cultures (Redshaw, 2000). It is important for those owner-managers who wish to undertake coaching tasks for them to realise that the qualities of an effective coach are listening skills, good questioning techniques, empathy, the ability to read non-verbal behaviour, and the capacity to establish motivation and commitment in others. Effective coaching requires the owner-manager to look for the potential in all employees (King & Eaton, 1999).

7.10.1 The Coaching Process

In a typical coaching situation, a subordinate or employee is coached by a manager to whom they report within the organisation. There are many other possible coaching situations, not described here for the sake of brevity, e.g. the coaching of management trainees, or coaching carried out by a specialist – for instance, in data processing – for the benefit of non-specialist managers, possibly senior to the coach. Even more important, perhaps, is the concept of coaching the *team* of subordinate managers rather than merely the individual. Whatever the situation or relationships involved, the principles outlined here can usually be applied.

An important consideration in coaching is that you cannot coach everyone all the time. The owner of a small business is very busy, but they also have a responsibility

The Stages of Coaching

Business coaching is a process that should involve at least four stages:

1. establish specific goals as well as long-term aims for the coaching process;
2. explore the current predicament in terms of personal reactions, problems and possibilities;
3. identify the options through which a realistic goal can be achieved; and
4. commit to a timed action plan through which the goal can be accomplished.

Source: King and Eaton (1999).

as the primary team leader and 'head coach' to make sure that they are systematically focusing on coaching all their employees throughout the year.

Coaching should not be restricted to just the new hires or those employees that are experiencing underperformance. All employees need to have coaching support, even those that have been with the business for a long time. Often, coaching is directed at the high performers or the under performers. Sadly, the bulk of employees who simply do a good job are left out.

Like any other management task, coaching does not take place in a vacuum. The quality and success of coaching depends on the culture and climate that the organisation has. It is influenced also by the quality of the personal relationships that the manager has with their staff and other members of the firm's management team.

Finding the time to coach employees is one of the most difficult challenges facing busy managers. However, if it becomes part of the firm's HRM system, it will be much easier to ensure that it does not get left over for another day and then never done. Of importance is the need for the business and the owner-manager to make a commitment to coaching.

7.10.2 The Climate for Coaching

To build an effective climate for coaching with the business, the owner-manager must see that it is their strategic goal to ensure that all employees are able to work at their best. This may encompass the development of employee skills, qualifications, career path planning, and even the personal relationships that exist within the workplace. Coaching is largely an on-the-job process rather than a formal training activity. It involves aligning the employee's successful achievement of set objectives to the strategic goals of the business. It is also important that the coaching process is not restricted by rigidly applied or over-detailed policies and procedures.

An understanding of the implications of coaching will, therefore, need to be present in the company as an entity, if it is to be required of the individual manager. A number of large organisations in recent years have viewed their management training less exclusively in terms of off-the-job formal courses, and have begun the process of training managers through attention to the demands and opportunities of the working situation – not only as individuals but in the context of the management team. Some organisations have gone even further, moving in the direction of schemes of organisational development and renewal in which not only traditional concepts of management training are address, but where the nature of working relationships, the definition of individual and overall goals, and the general internal climate of the organisation have all undergone substantial adjustment.

Coaching is more than a training or instruction process. It requires a two-way engagement between the manager (coach) and the employee. While coaching is not a replacement for formal training, it can be a valuable extra component in the employee's learning. An important outcome of coaching is to place the responsibility for learning with the employee. This is done by getting them to focus on:

- *goal setting* – identify what they want to learn.
- *a reality check* – identify what is happening now, get facts not opinions.
- *options* – identify possible options, benefits and costs.
- *what will be done* – encourage them to make a commitment to take action and setting the will to act.

Coaching aims at developing internal or self-motivation. It is aiming at the 'inner person' rather than the external motivations of telling, directing or instructing.

7.10.3 Coaching and Communication

Best Practice Examples of Small Firm HRM
Unisync Group Ltd

Unisync Group Ltd. of Ontario, Canada is a small corporate apparel and promotional products company employing 145 people. The firm puts great stock in involving its people in the management process. Managers sit down with staff to celebrate wins – and also to analyse losses, including what went wrong and how to fix it. The firm communicates with staff about where both they and the company stand through tools such as training, general meetings and follow-up interviews with new hires.

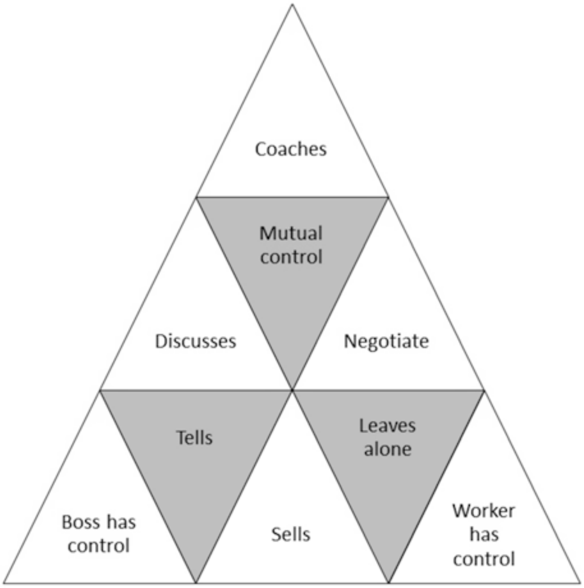
Halogen Software Inc.

Halogen is a small software development firm with 200 employees based in Ottawa, Canada. The company links each employee's goals to its overall corporate objectives, a practice is saying, give team members 'direct line of sight' on how their work contributes to better business results. To that end, all employees get access to training that supports both their personal goals and those of the company.
Source: Profit (2011).

Because coaching is aiming at helping the learner learn, a new approach to communication is necessary. Whereas a traditional trainer may tell or instruct, a coach will need to develop skills of helping the team member explore and identify. This is usually done through the use of questioning skills.

Figure 7.8 illustrates the range of communication styles that are available to a manager seeking to coach. As shown, the process can start from where the boss has total control and tells the worker what they should do. This is a one-way communication process. It can then move across to either a process of the manager selling their ideas to the employee by outlining why they want it done, or, alternatively, they can discuss with the employee what they want done. This may be appropriate where they want to receive input from the worker, and is a more democratic management style.

Fig. 7.8 Coaching dynamics



On the other side, the worker can have control and can be left alone to get on with their job. This option of leaving the employee alone may be an appropriate strategy where the individual is deemed competent, but it can also be inappropriate if the employee is not adequately trained or supported. In many respects, this option is an abdication by the boss. Where the relationship should be is in the coaching space at the top of the pyramid. Here the manager and employee have mutual control and can engage in discussions and negotiations where appropriate. However, the aim should be to return to a position of mutual control and coaching.

7.10.4 The GROW Model

One system that has been used effectively in business coaching programs is the GROW model (Kirwan-Taylor, 2000). This four-part framework is an easy method of assisting an individual to move through the desired stages of a coaching process.

The GROW Model

- **G** = *Goal,* what are you trying to achieve?
- **R** = *Reality,* what are the facts of the situation?
- **O** = *Options,* what are the possible solutions to the problem?
- **W** = *Where, when, how and why,* what is the action to be taken?

Source: Kirwan-Taylor (2000).

'**G**' stands for goal and asks the individual what they are seeking to achieve in their job or career. The ability to set realistic goals is important to how successful the individual is at the tasks they seek to achieve. '**R**' stands for reality and asks what the actual facts of the situation are. Too often people have many assumptions or prejudices, either about themselves or the organisation, and these serve to create unnecessary 'noise' when trying to get to the heart of the problem. '**O**' stands for options and asks what are the realistic options open to the individual in seeking to move from where they are to where they wish to be? Sometimes this stage of the process requires more information than is currently available. The coach may need to ask the individual to go away and gather more facts. Finally, '**W**' stands for where, when how and why. It seeks to commit the individual to concrete action.

7.11 Mapping Social Styles

In seeking to build an e-team, the owner-manager can make use of various psychometric scales that help to profile the personalities and traits of their employees. These measures can be useful when assembling teams, to match people with complimentary backgrounds. Research into social styles suggests that people may fall into four broad categories:

1. *Analytical* – logical, thorough, serious and systematic types.
2. *Amiable* **–** cooperative, loyal, supportive, diplomatic and easy-going types.
3. *Driver* – independent, candid, decisive, pragmatic and determined types.
4. *Expressive* **–** imaginative, friendly, enthusiastic, outgoing, spontaneous types (Darling, 1990).

Each type or combination of types (e.g. analytical-driver, amiable-expressive) can work differently in different circumstances. A balance of these types in an organisation is advantageous to the entrepreneur in selecting and developing a team. Figure 7.9 illustrates these social styles.

When faced with stress, these types have a primary and backup style. For example, analytical types may seek avoidance, not wishing to make decisions or confront issues. Driver types, by contrast, may become autocratic and dominating. Amiable types will tend to be acquiescent and compliant so as to avoid confrontation, even if they don't agree fully with a decision. Finally, the expressive type may attack the problem seeking to get an outcome. Faced with such types, the owner-manager should be flexible in their response.

When dealing with amiable types, it is usually important to remain relaxed and personal, to seek conversation of a social nature, and to communicate patiently. Any agreements reached should be mutual, and a personal contact is important in any follow up. By contrast, the drivers are best dealt with by being efficient with time and dealing only with specific facts. Such people are likely to be very task focused. It is important to be on time and display an energetic manner in relation to the task.

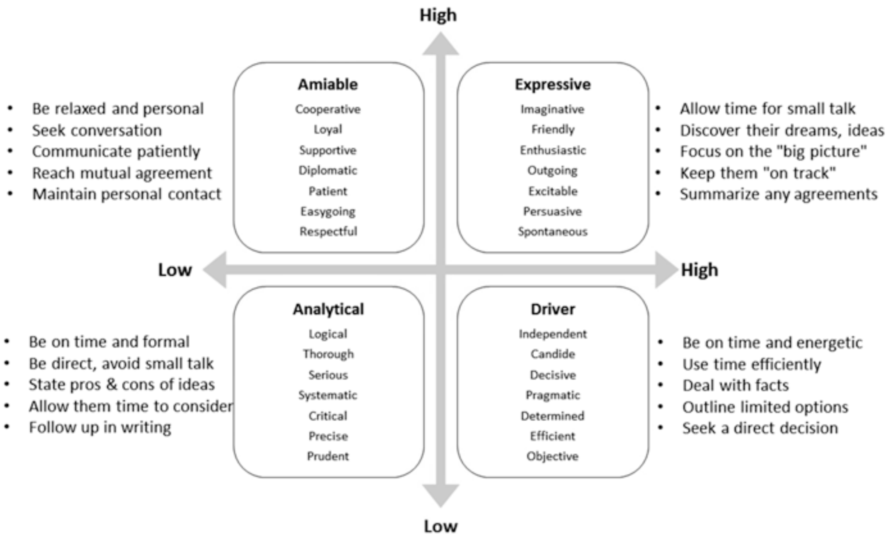


Fig. 7.9 The four basic social styles. (Source: Merrill and Reid, 1981)

Summarise or outline detail, and offer a limited range of options. Reaching a decision directly is usually possible with drivers.

Analytical types are interested in details, and usually like to consider all angles. Be punctual and formal with them and focus on the task. Small talk that does not address the issue may annoy. Outline the case, but make sure to provide both sides of the debate to allow them to weight the matter. They will also usually need time to consider the pros and cons of any case. It is usual for analytical people to prefer any follow up in writing.

Expressive types usually like to dream and enjoy looking at the big picture. They are creative and enjoy social chitchat, particularly if it allows them to discover their dreams and ideas. To capture their interest the discussion must look at the big picture but remember to keep them on track. Any agreements reached should be summarised to ensure that all parties are seeing things from the same perspective.

7.12 The Principles of Holistic, Ethical Management

Building a well-managed, high performing team-based business will require the owner-manager to outline a clear set of values to assist in guiding the activities of all employees. Large firms employ values as a mechanism to unite and focus the behaviour of their employees. Values should be based on a holistic and ethical foundation. Kuratko and Hodgetts (1998) outline four key principles for the 'holistic' management of a business on ethical lines. These principles are: hire the right people, set standards more than rules, don't let yourself become isolated, and set an example for others to follow.

1. *Hire the right people*. Careful selection of employees with adequate consideration of their ethical or moral standards can help overcome problems in the future. If employees know that the company management is looking to them to not only be competent in their work but ethical in their behaviour this will assist in creating a better climate and culture within the firm.
2. *Set standards more than rules*. Moral and ethical behaviour is a more effective control mechanism than laws. Company policy can be prescribed in regulations and rules but it can be largely ignored if the firm is unable to set clear standards of behaviour and practice for all to understand and follow.
3. *Don't let yourself become isolated*. The larger the enterprise becomes the more likely it is that the entrepreneur will have to delegate responsibility to others. While this is necessary to allow the owner-manager to move on to other tasks, they should not allow themselves to become isolated or they will find they may be unpleasantly surprised.
4. *Set an example for others to follow*. The owner-manager is usually the leader of the company and all look to them for the example and role model. If the owner-manager does not 'walk the talk' or 'practice what they preach' they will not only lose respect from their employees, they will have little chance to set the ethical principles into practice.

7.12.1 Setting a Values Framework

Hall (1992) has described the importance of having a clear set of well-established business values that the owner-manager can use to guide their own and their company's behaviour. The key questions that should be asked are:

- Does the owner-manager have a clear set of business values that guide their decision-making?
- Does the owner-manager behave in a manner that shows their actions are consistent with their business values?
- Do their employees have values that are consistently reflected by top management?
- Does everyone in the company understand the business values of the owner-manager?
- When the company management makes decisions, do they consider these business values when making plans?
- Is the company a 'good' business that behaves with ethical integrity in its dealings with customer, suppliers, employees and others?

It is important to have a strong 'yes' to all these questions or the owner-manager and their enterprise can become vulnerable to unethical practice.

7.13 Job Design and Recruitment in Small Firms

Once the small business begins to employ staff the owner-manager will need to consider the process of job design. While large firms usually have well-structured organisational designs and clearly defined job descriptions the opposite is often the case for small businesses. A feature of small firms is their lack of hierarchy and a need for employees to serve in a variety of roles. However, as the business grows in size it will become necessary to develop a 'blue print' for the firm's structure.

Developing a blueprint requires the owner-manager to map out the key positions required within the business and placing them into an organisation chart that identifies lines of reporting and responsibility, while outlining the overall structure of the firm. The most common organisational structure within a small business is that of a central hub comprising the owner-manager, around which revolve any employees (Hankinson, Bartlett, & Duchenaut, 1997). It is a flexible and informal method of management, but becomes inadequate as the number of employees grows and the span of managerial control widens. At this point a more structured approach to organisational design is required with the need for each identified role or position within the firm have a clear job description.

Figure 7.10 illustrates some of the key elements that need to be considered when seeking to design jobs. As outlined in more detail below, the main areas of focus for job design are the components associated with skill variety, task identity and significance, autonomy and feedback. These should be considered in any job description,

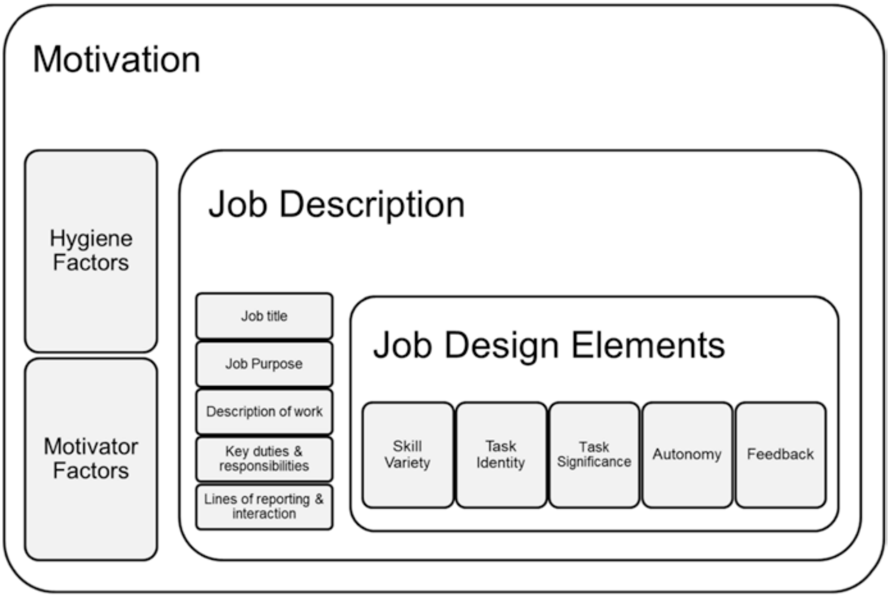


Fig. 7.10 The key elements of job design, description and motivation. (Sources: Adapted from Herzberg (1968, 2003) and Hackman and Oldham (1975))

which should identify and describe the job in sufficient detail to enable both the employer and the employee to understand what the job is designed to do. All these elements are critical to achieving motivation amongst the employees who will fill these positions. Well-designed jobs should be able to offer both ‘hygiene’ and ‘motivator’ factors (Herzberg 2003). The first of these relates to the pay and conditions offered within the job, while the second relates to the intrinsic interest the job engenders. The five job design elements are the foundation for achieving such motivation.

7.13.1 Job Design

Theories of job design have focused on the need for careful consideration of the tasks to be performed, skills or qualifications required and rewards that can be used to encourage employee performance (Umstot, Bell, & Mitchell, 1976). The core characteristics to be considered in the design of a job include:

1. *Skill variety* – the skills required by the incumbent in order to do the job.
2. *Task identity* – how much the job allows the employee to see tasks through from beginning to end.
3. *Task significance* – whether the job provides the employee with a sense of their work making a difference.
4. *Autonomy* – whether the job allows the employee an opportunity to have freedom or discretion to schedule their work tasks and how they will perform them.
5. *Feedback* – how much information the job provides to the employee about their performance and its quality or success (Hackman & Oldham, 1975).

Jobs that can provide an effective balance of these five elements are more likely to engender satisfaction among employees and enhance their performance. In determining the design of the job position that needs to be filled within a small firm, the owner-manager is required to consider the specific tasks that need to be performed, both physical and mental, including any equipment required. Clear performance standards should be defined and any qualifications that the employee needs for the position identified.

7.13.2 Job Description

Once these issues have been addressed the owner-manager can draft a detailed job description that should include most of the following (Schuler, Dowling, & Smart, 1988):

1. *Job title*. What is the position to be called?
2. *The purpose of the job*. This is a short but concise description of what the job is to do that should use action-oriented words (e.g. to design, organise, deliver, support etc.).

3. *A description of the work to be performed*. This section should provide an overview of the work to be undertaken by the person(s) in the job, and may include a summary of key duties with an outline of the amount of time (expressed as a percentage) that may be expected to be spent on each.
4. *Key duties and responsibilities to be performed*. This part of the job description should provide a detailed description of each of the job's main tasks (as initially detailed in the third section above). It should also include any performance standards, supervision involved, and equipment to be used.
5. *How the job relates to other positions within the organisation*. In this section there should be an explanation of where the position fits within the company and any lines of reporting or location specific issues. It may be necessary to identify the placement of the job within the firm using an organisation chart.

It may also be useful to outline within the job description the personal qualities that the owner-manager feels are desirable in the person to fill the position. This can include education and training qualifications, as well as attitude, appearance and communications skills. This can be built into a person profile that can be used to assist in the recruitment phase.

In preparing a job description and advertising, there should be no use of language or conditions that are likely to prejudice or discriminate against someone on the basis of race, age, gender, marital and family status, pregnancy, religious or political beliefs, sexual orientation or gender history.

7.13.3 Recruitment and Selection

Staffing is recognised as a critical determinant of whether small businesses succeed or fail, however this issue remains less researched than other strategic areas. More specifically, if there has been some research on specific recruiting and selection practices, the strategic aspects of staffing remain underestimated. In their recent paper, Greer, Carr, and Hipp (2016) investigated relationships between strategic approaches to staffing and small-firm performance. Their results suggest that recruiting approaches imitating the practices of larger businesses are positively related to firm performance. They also indicate that founders' and owners' perceptions of the strategic importance of human resources moderate this relationship.

Such a result is important to notice, as the process of recruitment and selection in SMEs is typically a more informal process than that undertaken in large firms (Bacon & Hoque, 2005; Carroll, Marchington, Earnshaw, & Taylor, 1999; De Kok et al., 2006). Torrès (2003) notes that this task is likely to be strongly influenced by proximity issues. Highly proxemics owner-managers would typically tend to hire people they already know and trust, or who have been recommended by someone they know and trust. However, this recruitment and selection process becomes more formal and sophisticated as the business grows in size (Kotey & Sheridan, 2004). Wiesner and Innes (2010) conducted a study of recruitment and selection practices among Australian small business owner-managers. They found that 88% used line managers and other employees to assist with the selection process. This typically involved unstructured interviews, with 62% of owner-managers reporting this practice. By contrast, 50% of medium sized firms employed outside consultants to manage the recruitment and selection process, with the use of psychometric testing of candidates occurring in 16% of cases.

Worst Interviewing Mistakes

- Making judgments based on emotion.
- Lack of preparation prior to the interview.
- Failing to check references and referees.
- Having preconceived notions based on the opinions of others who had previously interviewed the applicant.
- Wandering onto subjects that have nothing to do with the goal of the interview.
- Overlooking 'must haves' because other skills were strong.

Source: Kauffman Centre, 1997, p. 11.

In recruiting and selecting new employees the owner-manager needs to carefully match the applicant's skills, education and experience, against the requirements outlined in the job description (English, 1998). Interviews with potential applicants should be undertaken and should involve assessing not only the person's skills, qualifications and past work experience, but also their personality and capacity to 'fit in' within a small business. This can be difficult to assess, but can be explored through the interview via questions about hobbies, interests and personal achievements outside work. However, the interview should not ask questions about the individual's age, gender, ethnicity or religion. In conducting the interview, the owner-manager should prepare a list of questions designed to help them understand how the applicant fits the job description. Some possible questions might be:

- Has the applicant had similar work in the past?
- What does the applicant think about the position they are seeking and why are they seeking to take the job?
- Are they currently employed and if so, why are they changing jobs?
- Where does the applicant hope to go with their career over future years and how do they view this job as helping them achieve such goals?
- How well does the applicant work with others and what evidence can they provide to demonstrate this?
- What is the applicant's track record in terms of performance in past jobs and what supporting evidence can they provide? (Schuler et al., 1988).

It is important to check references and follow up with any referees prior to making any appointment. Where possible the owner-manager should involve a second opinion in any job interview. This might be their partner, another employee within the company, or even a third-party advisor such as their accountant if they have no one else to call upon. Selecting new employees can be a stressful and time-consuming task, but it is better to spend a little time getting the most suitable candidate for the position than making a hasty decision and having to dismiss the person later.

7.14 Workplace Laws and Regulations

Throughout the world, SMEs that employ are subject to labour or workplace laws and regulations. These laws and regulations vary across jurisdictions. However, they typically encompass wages and conditions, work health and safety, equal employment opportunity (EEO), anti-discrimination, the employment of children, collective bargaining and freedom of association (e.g. via trade unions), leave, discipline, dismissal and training (ILO, 2014, 2018a). More recently they added the issues linked with environmental concerns (ILO, 2018b).

7.14.1 The International Labour Organization

The International Labour Organization (ILO) provides the global framework for international labour standards. Founded in 1919, the ILO has 187 countries as members, and has been an agency of the United Nations since 1946. 2019 is an important year for the ILO, as they celebrate their 100th anniversary and take this opportunity to promote their action. It works through an International Labour Conference to set global labour standards and conventions that are ratified by its members (ILO, 2014). There are eight conventions, ratified by the ILO member states that deal with:

- Freedom of association and protection of the right to organise;
- The right to organise and collectively bargain;
- Forced labour;
- Minimum age of workers – i.e. child labour guidelines;
- Equal employment opportunity and anti-discrimination.

In relation to SMEs, the ILO has recognised the important role that small firms play in the creation and maintenance of jobs throughout most economies. However, they also note that relatively little is known about the employment conditions of workers within SMEs. They observe that at a global level many small businesses are *informal* in nature, and are not registered for taxation or as businesses in a legal sense. This results in an absence of protections for both the employers and their employees (ILO, 2015).

Research undertaken by the ILO, UN Economic Commission for Europe and Eurostat into labour force management within SMEs, identified seven key areas that are important to the provision of quality of employment. These are illustrated in

Fig. 7.11 The dimensions of quality of employment. (Source: ILO, 2015)

Fig. 7.11 where it can be seen that work safety and health, plus the ethical treatment of employees is an important first issue. This is followed by ensuring that wages and benefits are also adequate. A third issue is working hours and the ability of employees to secure sufficient balance between their work and non-work life.

Other important issues are the security of work and the protection of employees in relation to sick leave, maternity leave and redundancy. Also important is the social responsibility of the employer to their workforce, as well as their ability to provide adequate skills training and development, and the maintenance of a harmonious, productive workplace.

7.14.2 Industrial Relations and SMEs

The ILO (2015) report states that while collective bargaining and freedom of association are fundamental rights for all workers, the majority of SMEs are non-unionised with less than 2% of SMEs in France and Japan having unionised workplaces, and between 13% and 15% in Ireland and the Netherlands. This pattern of low unionisation is also found in Australia (ABS, 2016; Savery & Mazzarol, 2001), as well as across the European Union (Moore, Jefferys, & Cours-Salies, 2007). The same is found in the United States, where trade union membership has declined steadily across the entire country and in both large and small firms. From a peak of 36% in 1953–1954, union membership within the private sector in the US fell to less than 8% by 2006 and has continue to fall (Griswold, 2010).

Gunnigle and Brady (1984) described the importance of owner-manager influences upon industrial relations practice within small firms. Owner-managers were frequently opposed to trade union activity within their business. This was either because they saw no role for unions, or out of a paternalistic view that unionisation reflected employee disloyalty. However, research shows that employees can be committed to both the organisation and their union (Savery & Soutar, 1997). Chapman (1999) noted that research into industrial relations practices within small business shifted away from simplistic stereotyped models to a realisation that the process is highly complex – a view echoed by others such as Curran and Stanworth (1981).

Employer's Obligations
As an employer, the small business owner is obliged to:

- pay correct wages;
- reimburse employees for any work-related expenses.
- ensure a safe working environment;
- not act in a way that would seriously damage an employee's reputation or cause mental distress or humiliation;
- not act in a way that damages trust and confidence necessary for an effective working relationship;
- not provide false or misleading references;
- forward PAYE tax instalments to the Taxation Office; and
- make appropriate superannuation guarantee payments.

Source: www.business.gov.au.

Industrial relations within small firms are therefore highly contingent upon such variables as size, industry and owner-manager characteristics. For example in France the employer's obligations vary from a participation to the employee's continuous education (under 20 employees) to the creation of a more formal employees representation (above 200 employees) with at least 9 other intermediate thresholds with an increasing formalisation of the relationships between employer and employees (JURITRAVAIL, 2018).

Much has to do with the impact these relations have upon the dilution or reinforcement of power that can be exercised by either the owner-manager or their workforce. For example, Kizilos and Reshef (1997) examined 230 small firms in

Canada and noted a curvilinear relationship between unionisation and worker responses to HRM innovation. According to their analysis, union resistance to HRM innovation was contingent upon whether the union viewed the change as threatening their power.

7.15 Employment Contracts

Once a small business hires an employee, the owner-manager is required to enter into an employment contract with that individual. Labour laws vary from country to country, but most generally outline the rights and obligations of the employer and employee within the workplace. Most labour laws will specify the working conditions including hours of work and minimum wages.

7.15.1 In Australia

The Australian Federal Government introduced National Employment Standards (NES) in January 2010. The NES sets down ten minimum workplace standards that apply to employment contracts covered by the Federal system. Table 7.2 lists these standards, which cover hours of work, leave arrangements, public holidays, termination and redundancy.

Table 7.2 National employment standards – Australia

Entitlement area	Entitlements
Maximum weekly hours of work	38 h plus reasonable overtime.
Request for flexible working arrangements	Allows for parents or carers of children to seek flexible hours for caring.
Parental leave and related entitlements	Up to 12 months' unpaid leave for every employee, plus 12 months' unpaid leave and other related leave.
Annual leave	Four weeks' paid leave per year, plus additional week for some shift workers.
Personal/carer's leave and compassionate leave	Ten days paid personal/carer's leave, 2 days' unpaid carer's leave as required, 2 days' compassionate leave (unpaid for casuals) as required.
Community service leave	Unpaid leave for voluntary emergency activities and jury service, plus up to 10 days paid leave for jury service.
Long service leave	Uniform national long service leave standards.
Public holidays	A paid day off on a public holiday, except where reasonably requested to work.
Notice termination and redundancy pay	Up to 5 weeks' notice of termination and up to 16 weeks' redundancy pay.
Provision of a fair work information statement	Employers must provide this NES statement to all new employees.

Source: Fair Work Ombudsman (2016)

Australian employers and employees can also enter into workplace agreements that specify certain wages and conditions of employment. These can take the form of industrial awards, enterprise agreements, and contracts. Each of these options is discussed below, however, it should be noted that most SMEs use awards and individual agreements rather than enterprise agreements. For example, research into Australian SMEs suggests that 90% pay "market competitive wages" and 85% based this on the award rates of pay (Wiesner & Innes, 2010). However, a high proportion (87.7%) also paid additional or "above award" rates of pay to employees to recognise specialist skills, and good performance. Despite this, many SMEs are "award reliant" and as a result they tend to pay their employees lower average rates of pay to large firms that make greater use of enterprise agreements (Farmakis-Gamboni, Rozenbes, & Yuen, 2012).

An industrial award is a legal document outlining the minimum wages and conditions that must be provided to an employee. They bind the employer and are legally enforceable subject to variation via a legal tribunal. Awards exist for most industries and generally override any other agreement where wages are concerned. The award system has been in existence within Australia in various forms since the nineteenth century (Lambropoulos, 2013).

Industrial awards have been favoured by trade unions due to their ability to secure a set of conditions within one industrial case and then have these applied across all workplaces within a given industry. Small businesses have also tended to favour the award system as it offers relatively uniform standards for pay and conditions in a given industry.

It should be noted that each state in Australia has its own awards system, and so information should be obtained from the respective state government agencies when making decisions in relation to award agreements. However, the introduction of the NES in 2010 has sought to create a set of uniform national minimum standards. Most industries have now transitioned to the national award system (Australian Government, 2010).

The system of *Modern Awards*, introduced in 2010, provides details for pay rates, hours of work, overtime and penalty rates, allowances, leave, superannuation, dispute settlement, sub-contractors and redundancy schemes. These awards apply in addition to the underlying provisions of the NES (Fair Work Ombudsman, 2016).

The Western Australian Government chose not to join this national workplace relations system. This meant sole traders, partnerships and other unincorporated or non-trading corporations in that state remained in the WA awards system (Fair Work Ombudsman, 2010).

Modern awards may not apply to all employees, e.g. some managers or those on high incomes (e.g. over $113,800 per annum year ending 30 June 2011). They may also not apply to employers that are already bound by enterprise awards, that is, awards covering a specific enterprise.

Employer Obligations and Rights

Employers must keep records for each employee containing:

- the firm's registered business name and Australian Business Number (ABN).
- the name of the employee.
- whether the employment is full or part-time, permanent, temporary or casual.
- the date employment commenced.

Employers must provide employees with pay slips which must comply with the *Fair Work Regulations 2009*.

Source: www.fairwork.gov.au 2010

The Australian system of enterprise agreements specifies the employment conditions for a group of employees at one or more workplaces. They are governed by Federal workplace relations laws and generally override an award. Such agreements are made under the Australian *Fair Work Act* 2009.

In addition to enterprise agreements, employers and employees can enter into common law employment contracts. These set out the wages and conditions for a particular job not otherwise covered by an award or agreement. Contracts can be more easily changed than enterprise agreements and awards. As a result, they offer a greater level of flexibility for the employer and employees.

7.15.2 In the European Union

In the European Union (EU), work laws differ from one country to the other. However, the EU has decided a certain number of minimal rules. These common rules are summarised below:

- *Working hours in the EU:* If you employ staff, you need to know the basic rules about working hours and guarantee the minimum standards set by the EU directives. You should respect the rules covering minimum daily and weekly rest, breaks, night work as well as annual leave and maximum weekly working time.
- *Working time and rest:* As an employer, you must ensure that your staff do not work more than 48 h per week on average (including overtime), over a reference period of up to 4 months. Your employees must be given at least 11 consecutive hours of daily rest and at least 24 h of uninterrupted weekly rest every 7 days, over a reference period of 2 weeks.
- *Breaks:* If your employees work more than 6 h a day, you must ensure that they are given a break, the duration of which is specified in the collective agreements or by national law.

- *Annual leave:* Beyond the daily and weekly rest periods your staff have the right to at least 4 weeks of paid holidays per year. You cannot replace these holidays with a payment, unless the employment contract has ended before the staff member has used up all their annual leave. (Source: https://europa.eu/youreurope/business/human-resources/working-hours-holiday-leave/working-hours/index_en.htm)

In France the current legal duration is 35 h a week and regulations are generally more favourable to workers, although they may change regularly. The last important evolution has been made in 2016 in an attempt to modernise work laws and is detailed in the LOI n° 2016–1088.[1]

How Many Days of Leave Is an Employee Entitled to in France?

- The full-time employee is entitled to a leave of 2.5 working days per month of actual work with the same employer. One month of actual work is equivalent to 4 weeks or 24 working days.
- The total duration of the leave payable by the employee may not exceed 30 working days, i.e. 5 weeks for a full year of work (from June first to May 31st of the following year, unless otherwise fixed by company agreement or establishment or, failing that, agreement or branch agreement).
- The main holiday (the longest holiday of the year for an employee) cannot be less than 12 working days. It must be taken (unless otherwise stated in the collective agreement) between May first and October 31st.
- Unless otherwise stated, a leave taken at one time may not exceed 24 working days
- Any employee is entitled to 2 days of additional leave per dependent child

Source: https://www.economie.gouv.fr/entreprises/conges-payes

7.16 Conditions of Employment

Conditions of employment vary considerably from country to country. Although we cannot examine the employment laws for every nation, we provide some information relevant to Australia and the European Union.

7.16.1 In Australia

Employees can be full time, part time, casual, probationary and fixed term in nature. In Australia, full time employees are generally those that work at least 38 h a week.

[1] https://www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000032983213&categorieLien=id

They have a continuing contract with the employer and can expect full conditions of wages, leave and other entitlements as specified in the award, agreement or contract. Part-time employees work regular hours like full-time employees, but they work fewer hours. Their entitlements are the same as full-time workers, but paid on a *pro rata* basis.

Casual employees are typically engaged for short periods or irregular perhaps seasonal work. They have no guarantee of future work or continuing employment. Due to their relative job insecurity, casual workers are usually paid special loadings. Casual employees are not protected under dismissal laws but can be protected under federal awards if they have been employed for longer than 12 months.

Only certain NES entitlements apply to casual employees. Australia's *Fair Work* laws entitle them to 2 days' unpaid carer's leave and 2 days' unpaid compassionate leave per occasion. They are also eligible for community service leave and to take a day off on public holidays unless the employer can make a reasonable request for them not to do so. If they have been employed for over 12 months, these workers are also entitled to make requests for flexible working hours and parental leave (Fair Work Ombudsman, 2010).

A probationary employee is one whose contract is conditional upon a trial period (typically 3 months) and can have their employment terminated without recourse to the federal termination of employment conditions. Fixed term employees are usually employed to fill vacancy positions for employees on leave. They may accrue leave entitlements and may have remedy under law if their contract of employment is terminated prior to the completion of their agreed term. Conditions of employment vary in Australia from state to state, and small business owners need to check the recruitment arrangements for their specific location.

Once the employee has been recruited the owner-manager will need to provide a range of benefits, both financial and non-financial. While the nature of these benefits differs depending on the employment contract, most employees in Australia are entitled to benefits in addition to their wages. It is the responsibility of the employer to pay these on-costs and failure to do so can result in legal penalties. Among the more common benefits that employees will receive are: superannuation, worker's compensation, and leave entitlements. The following sections discuss these in detail as they apply in Australia.

Under the Superannuation Guarantee Levy (SGL) scheme introduced by the Federal Government in 1992, an employer must pay a sum equivalent to 9.5% of an employee's wages into a complying superannuation fund in that employee's name to provide for their later retirement income. This does not apply if the employee earns less than $450 gross income in a calendar month, is over 65 years of age or under 18 years and working less than 30 h a week.

7.16.2 In the European Union

Due to its diversity of culture, the European Union is characterised by a great variety of conditions of employment. European comparisons in terms of hours of work are thus complex, primarily because of a great deal of legislative and institutional diversity in working time between countries.

> **For example, …** in some countries' legislation is a strong determinant of hours of work; in others, it is almost non-existent; in others, working time is a matter for collective bargaining. Beyond these differences, the characteristics of the employed population (share of women, young people, older workers, managers, workers, tertiary in the sectors of activity ...) may differ between countries and vary the working time and the share of part-time employees (DARES, 2018).

In a study comparing weekly working hours in 2016 of eight EU Member States: Germany, Denmark, Spain, France, Italy, the Netherlands, Sweden and the United Kingdom United, they note a certain number of differences.

For example, in 2016, the usual weekly duration of all employees is higher in France, Sweden and the United Kingdom than in the other countries studied. This duration of full-time French employees, equal to that of the Netherlands, is however among the lowest with 39.1 h on average. In France, the proportion of part-time employees (18.3%) is close to that of the EU as a whole (19.5%). It is also close to that observed in Italy; while those of Germany, Denmark and the United Kingdom are above 25%. In the Netherlands, half of the employees are part-time. The weekly duration of part-time employees in France is also among the highest in Europe (23.7 h on average). In all European countries, the part-time rate of women is much higher than that of men. Part-time work is generally more frequent for young people, especially in the Nordic and Anglo-Saxon countries (Denmark, the Netherlands, Sweden, the United Kingdom) where the number of working students is relatively high. Finally, part-time is more frequent in low-skilled occupations and employees work in Europe in general.

7.16.3 Superannuation

In Australia, superannuation payments should be made by the employer at least four times a year. The due dates are quarterly: 28 October, 28 January, 28 April and 28 July. Employees are generally entitled to have these payments made into a fund of their own choice. However, businesses with fewer than 20 employees can register with the Small Business Superannuation Clearing House (SBSCH). This allows small businesses to pay into a single entry point rather than multiple superannuation funds. The SBSCH will then make payments to multiple funds on behalf of the employer for the employee without charge (<www.business.gov.au>).

European countries began in the early 1990s to question the sustainability of their retirement systems. Since then, all have undertaken reforms sometimes even several times. The diversity of their histories and their economic and demographic situations has led to different choices, even if convergences are apparent. In France the payment is made by the Social Security every month. However, due to an aging population, Social security contributions are not enough to finance superannuation.

Taxes have therefore been added, and the government tries to monitor an increasing deficit on that area.

7.16.4 Worker's Compensation Insurance

Occupational health and safety laws in Australia require that workers who are injured have access to first aid, fair workers' compensation, and return to work rehabilitation. Employers are responsible for:

- the maintenance of a safe workplace;
- the maintenance of workers' compensation insurance; and
- programs to protect employees from financial hardship in the event of a workplace injury.

All Australian employers must pay their employees compensation for any injuries that occur during their work and it is a legal requirement for businesses to have a worker's compensation insurance policy from a licensed WorkCover Insurer. The premiums paid for such insurance are based on the size of the payroll and it is the responsibility of the employer to keep records of wages so that WorkCover can audit them if this becomes necessary.

It should be noted that in Australia there are 11 different workers' compensation systems, which have emerged under state and territory legislation. There are also three federal schemes which apply to Australian Government employees and defence personnel. There is insufficient space in this book to address all these schemes. Small business employers should check with their local authorities to determine the nature of their specific scheme and how it applies to them (Safe Work Australia, 2017).

In France sick leave due to an accident at work give right to daily allowances paid by the primary health insurance fund. The amount of compensation and the conditions of payment differ from those provided for a sick leave. The employee can also receive, under conditions, additional benefits paid by the employer.

7.16.5 Termination and Dismissals

The decision to end an employee's contract can occur either because the worker choses to resign, or is dismissed or made redundant. Under Australian law, an employee has the right to resign but should give the employer notice to do so in writing. Redundancy occurs where the job is no longer required. This may be due to a restructure or the introduction of technology. Employees who are made redundant are often entitled to benefits, depending on the nature of their award or the agreement or contract under which they were employed.

In the case of a dismissal, the employer must have a valid reason. This might be based on the employee's poor performance, misconduct or some changes to the operational requirements of the work they do. A dismissal can take more than one form and is considered unfair if it is harsh, unreasonable or unjust. In Australia, there are federal and state laws that govern unfair dismissal.

Under the *Fair Work Act* 2009, the dismissal laws for small businesses applies for firms with fewer than 15 full time employees or casuals who are employed on a regular and systematic basis. These provisions also make it impossible for employees to make an unfair dismissal claim against a small business if they were employed for less than 12 months.

The small business fair dismissal code was introduced in 2009. There are several types of dismissal identified under the code. However, it should be noted that it is not unfair for a small business owner to terminate an employee's contract if the firm is no longer able to employ them due to poor trading conditions, although the redundancy must be genuine. A small business employer can initiate a summary dismissal of an employee if the worker has committed an act of serious misconduct. This may include theft, fraud, violence or serious breaches of the occupational health and safety procedures. The employer does not have to report this misconduct to the police, but if they do so this is reasonable grounds for summary dismissal.

In other cases of dismissal, the employer must give the employee a reason why they are at risk of being dismissed. This should involve grounds that show the employee's conduct or capacity to do their job is impaired. The employer must give the employee a verbal or preferably written warning stating that they will risk dismissal if their conduct does not improve.

The small business employer must provide the employee with an opportunity to respond to the warning and every chance to rectify or redeem the problem. This may involve undertaking additional training and making sure that the employee knows what is expected of them in the performance of their work.

In France conditions of dismissal have been recently adapted to small firms. The recent reforms of work laws have included a series of thresholds to take into account the specificities of SMEs. This includes specific criteria, which should be adapted to the "fragility of small firms": e.g. for companies under 11 employees, a significant drop in orders or turnover for at least one quarter, compared to the previous year can be a reason for economic dismissal; for firms with 11–49 employees, two consecutive quarters will be required and for firms with 50–299 employees, the requirement is increased to three consecutive quarters (Rey, 2016).

7.16.6 Non-discrimination

As an employer, small business owners are obliged under federal legislation to ensure that they maintain a workplace that is free from discrimination, both direct and indirect. Direct discrimination is to treat a person less favourably due to their race, skin colour, gender, marital status, pregnancy, age, disability, medical conditions, and family situation, criminal record, and trade union affiliation, political or religious beliefs. Indirect discrimination is where a person is disadvantaged because of policies and practices that might be pursued by the business. For example, a business that does not have wheel chair access might be indirectly found to discriminate against disabled employees.

Dealing with Discrimination and Harassment

The employer has an obligation to ensure that all employees can work in an environment that is free from discrimination and harassment. Where such activities are found to have taken occurred, the employer should take all reasonable steps to deal with the situation. This action may include:

- Preparing and promoting a written policy on workplace discrimination and harassment.
- Training staff to identify and prevent workplace discrimination and harassment.
- Establishing an effective internal complaints procedure.
- Appointing trained harassment contact officers.
- Treating all complaints seriously and investigating them promptly.
- Ensuring that appropriate action is taken to address and resolve complaints.
- Monitoring the workplace environment and culture, such as holding staff surveys or reviewing recruitment practices.

Source: Australian Human Rights Commission 2010.

Australia has a range of legislative Acts that govern anti-discrimination policies. These include:

- Racial Discrimination Act 1975;
- Sex Discrimination Act 1984;
- Disability Discrimination Act 1992; and the
- Human Rights and Equal Opportunity Commission Act 1986.

The obligation for employers to abide by these acts and ensure that their workplaces are not subject to discrimination is outlined in the *Federal Workplace Relations Act* 1996. Most state and territory governments have enacted complimentary legislation.

In France, 18 criteria listed in the law prevent discrimination at the workplace. They include: age, sex, origin, marital status, sexual orientation, morals, genetic characteristics, true or supposed affiliation, ethnicity, nation, race, physical appearance, disability, state of health, state of pregnancy, surname, political opinions, religious beliefs and trade union activities.

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8 Operations Management

8.1 Introduction

> Firms which place more importance on activities that are critical to operational performance (e.g. HRM activities) are also seen to be earlier adopters of "best practices" (e.g. developing a shared vision with employees), and thus should perform better (Raymond, 2005, p. 939).

Operations management is crucial to the success of any small business. It impacts both the firm's financial and non-financial aspects. Of importance is the control that can be obtained over the firm's cash flow, stock and other productive assets to achieve the maximum levels of operational efficiency and effectiveness. Each business is likely to be different in how it operates, and the key performance indicators (KPI) that it needs to monitor how it is performing. This chapter examines operations management and how it applies to small businesses. It includes a review of business process analysis, the development and use of meaningful KPIs, operations management systems and techniques.

8.2 The Nature of Operations Management

Operations Management (OM) involves the management of human, technological, financial and cultural systems that relate to the production of products and services produced by a business and sold into its markets. The aim of OM is to ensure that all these systems and activities are appropriately configured and aligned, so that they simultaneously achieve desired performance benchmarks of quality, flexibility, costs and deadlines. OM is broadly responsible within most companies for procurement (inbound logistics), production activities that transform inputs to outputs, quality assurance and distribution (outbound logistics). How well as business conducts its OM activities is often a key factor that determines its ability to hold a

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competitive position within its market. In most manufacturing companies, OM contributes around 80% of added value, 80% of assets, and 60% of the workforce (Gonzalez, Martin, Buiza, Hidalgo, & Beltran, 2015).

At least five things are important to the efficient execution of OM within SMEs:

1. *Process:* How well the employees within the company do things in a systematic manner and in doing so how well they pay attention to working smarter not harder and seek to continuously improve the systems and processes. When effective processes are identified they need to be monitored, recorded and disseminated across the business to all employees, as well as taught to new employees. They then become the best-practice benchmarks.
2. *People*: Employees need to be well trained, motivated and fully aware of the best-practice benchmarks that they need to follow and achieve in order to deliver the necessary levels of quality of product or service outcomes required by the business. Here, training, culture and effective HRM is critical.
3. *Plant & Equipment*: The business needs to have the most up-to-date and appropriate equipment to allow it to achieve its operational task and meet its best practice performance benchmarks. All equipment costs money to purchase, hold and maintain. It is therefore important that any item of plant and equipment is regularly monitored to ensure that it is fit for purpose, operating at is peak efficiency, as well as making a direct contribution to the firm's bottom line. Underutilisation of plant and equipment is a major drain on the firm's financial performance
4. *Premises*: The building or buildings in which the business is located should be reviewed to ensure that they are appropriate for the purpose. Retailing and many service businesses need good locations to ensure that they secure access to customers. However, it is also common for a business to find its premises a limiting factor on its operations. This can come from these premises being too small for the firm's planned operations or too large and costly for its operations.
5. *Control*: Finally, the business must have appropriate control systems in place that balance efficiency and effectiveness. These can be manual or supported by enabling technologies. However, they need to be appropriately configured, able to generate timely information, reliable and accurate, and fully supported by employees who understand their importance and take corrective action to ensure that performance benchmarks are attained.

Figure 8.1 illustrates these five key elements and the things that are important within each. As shown, these elements should operate within a system that sees all five interconnected so as to create a mutually reinforcing operational management structure that will scale-up along with the business should the owner-manager wish to grow. In the following sub-sections, the operational management system is discussed in more detail along with specific implications for management.

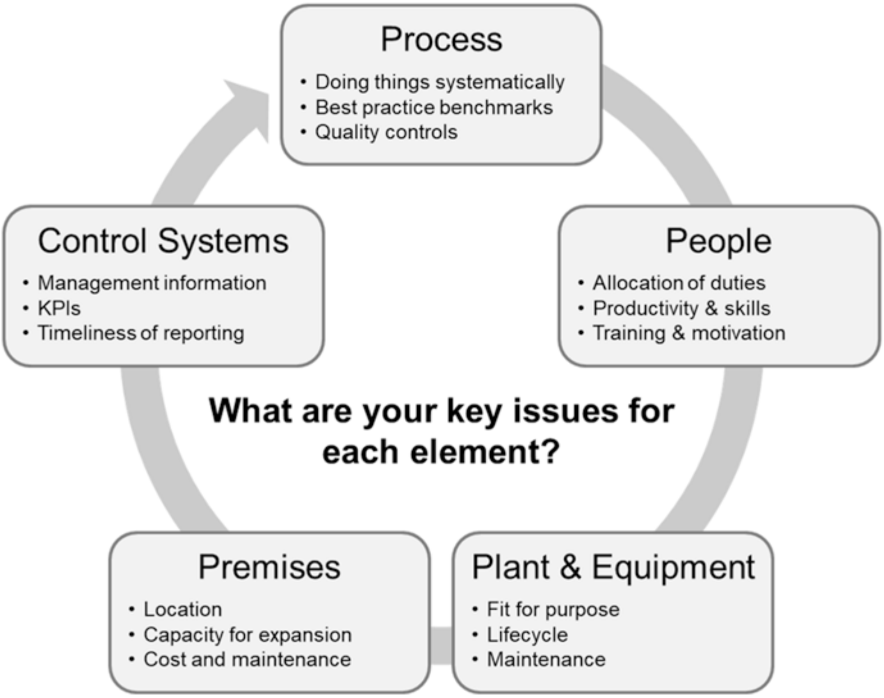

Fig. 8.1 Key elements in operations management

8.3 Fundamentals of a Management System

An effective management system needs to be an integrated system that draws together a range of strategic and operational activities, and ensures that they work together in a manner than generates both synergies and desired levels of performance and quality. A good management system should have at least seven key attributes:

1. *Transparency*: information should be available to all relevant employees and communicated in a timely and effective manner.
2. *Work must be related to time*: all activities should be scheduled so as to be performed on time and within the most time-efficient manner. Time is a critical and finite resource and must be managed well.
3. *Performance expectations impact productivity*: all employees should have well-defined and clearly understood KPIs that allow them to understand what is expected of them, how it is expected to be performed, when it is expected to be completed and the quality to which it is to be performed.

4. *Manage the whole by managing the parts*: a management system is a sum of its parts. If the individual elements and activities are not all performing to the optimal level, the entire system can become adversely affected.
5. *Continuous improvements*: not only should a management system be designed to achieve best practice benchmarks, but it should also be configured so that all employees are focused on making continuous improvements in products and processes.
6. *Interdependent*: the various elements of the organisation (e.g. procurement, production, sales and marketing, administration) should be viewed as parts in a management system with each connected to and providing information and guidance for the others.
7. *Measurable*: all activities within the organisation should be managed by KPIs that are measurable in a timely, efficient, reliable and relevant manner.

Figure 8.2 illustrates the basic elements of a generic management system as might apply within most business organisations. As can be seen, there are five key elements. The first is the need to *forecast* future activities (e.g. sales, in-bound logistics, production, out-bound logistics, staffing, financing and expenses). So that the business has sufficient resources available to meet demand. This process of forecasting is part of the firm's strategic planning, and the assumptions that are made here should then be transferred into the second stage of developing a *business plan* to guide future operational activity. It is important that the business plan specifically addresses the way in which resources (e.g. people, equipment, finances) will be allocated, with attention given to how, when, and how much of any resources will be needed to implement the plan.

Fig. 8.2 Elements of a management system
Source: Mazzarol and Olivares (2007)

This *scheduling* stage of the cycle is a critical element and requires the firm's management team to make decisions about future costs such as hiring staff, purchasing raw materials, and making sure that these resources are available at the right time, within the right quantity and quality, and that there is sufficient funding available to cover expenses against the firm's forecasted cash flow. Once these preliminary stages have been completed, the firm can *implement* its plan and make sure that all necessary activities and associated resources are managed in a coordinated, efficient and effective manner.

Of course, even the best laid plans can be challenged by the harsh reality of real-world competitive markets. It is therefore important that the management system is able to provide timely, accurate and reliable *reporting* so that corrective action can be taken. Here, the management system requires well-developed and understood KPIs that link to best practice performance benchmarks. This will allow the management team to monitor how reliable its initial forecasting was. Any variance from the forecast sales or expenses will require revisions of the business plan, and this will, in-turn, flow on throughout the entire system.

8.3.1 The Management System Applied

To understand how these elements of a management system might be applied, the conceptual model illustrated in Fig. 8.3 offers a simplified overview. As shown, the

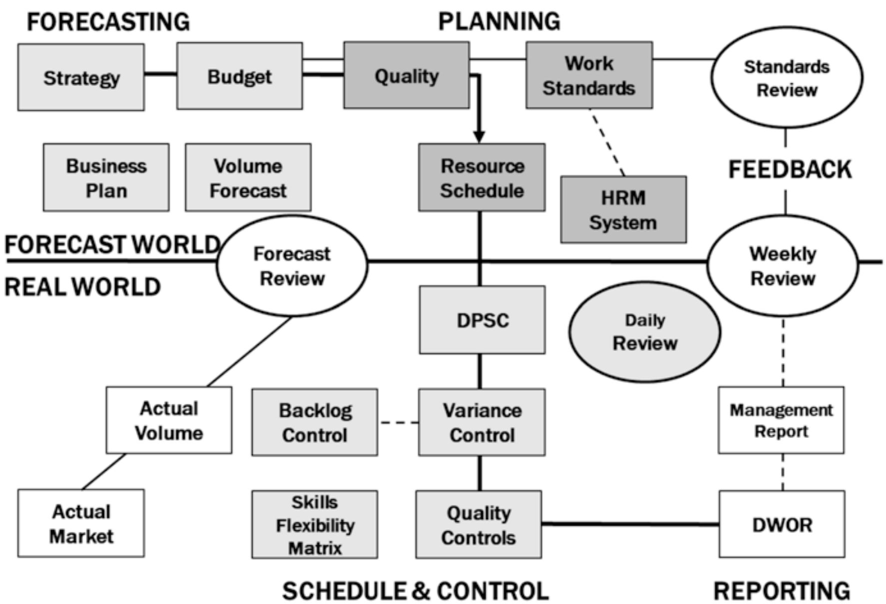

Fig. 8.3 Management system applied
Source: Mazzarol and Olivares (2007)

management system can be broadly separated into the *forecast world* and the *real world*. The primary areas of forecasting, planning, scheduling, implementing and reporting as shown in Fig. 8.2, are expanded within the model. Each element is discussed below.

8.3.1.1 Forecasting

Within the forecasting area the key elements are the preparation of the firm's *strategy* (see Chap. 4), and the preparation of a *business plan* or strategic plan that provides overall guidance to future activity. The two additional elements that should be found within the forecasting process are the firm's *budget* and *volume forecast*. The budget, which is usually referenced in the business plan, provides a detailed outline as what income and expenditure is anticipated for the relevant time period over which the planning and operations cycle is to take place. This might include forecasted revenues, fixed and variable costs, capital expenditures and any need for the acquisition of new funding requirements from either debt or equity sources (see Chap. 10). It should also provide forecasts of cash flow, and this will be guided by the *volume forecast*, which makes predictions about future sales volumes drawing on market research, previous experience, and any forward orders already secured. The ability to make accurate cash flow forecasts and develop a cash budget, is important, particularly for small firms that rely heavily on cash flow to fund growth and allow the business to remain solvent (see Chap. 11).

8.3.1.2 Planning

Within the planning area the management system translates the forecasted information into operational actions. Here there should be a close association with the firm's quality assurance management system (QAMS). This will determine the *work standards* required, and that will be informed and supported by the firm's *human resources management (HRM) system*. From the *quality* system the *resource schedule* process will then allocate the money, employees, equipment, facilities, raw materials and other relevant resources, to the *real world* of implementation.

8.3.1.3 Schedule and Control

Once the management system moves from the *forecast world* into the *real world* an important first step is the *daily planning schedule control* (DPSC) system. This involves the allocation of the resources to the firm's operations on a day-to-day basis and, depending on the size and complexity of the business, might be as simple as an office whiteboard that allocates employees to different tasks for the day. In larger, more complex organisations, this DPSC system could be a computer-controlled system that manages workflows and schedules employee activities and the deployment of plant and equipment.

It is important to monitor any variation in the forecast activity and the actual activity. This might involve such things as activities taking much longer than anticipated, sales demand rising or falling, quality targets not being met, or unforeseen events. A process of *variance control* is therefore needed that can ensure any such problems are quickly addressed so that quality is maintained. There should be a process of *backlog control* that takes over the tasks of ensuring the firm's production activities are not jeopardised by variances that were not foreseen.

One means by which scheduling and control can be enhanced, and quality maintained, is to keep a *skills flexibility matrix*. This is a database, usually held in an EXCEL spreadsheet, that records all the firm's employees and their relevant skills, qualifications and certifications. This can allow management to quickly identify staff that might be able to be redeployed with the company to fill in gaps or contribute to overcoming backlogs. It can also be useful as a planning tool to allow the HRM system to identify and allocate employee training and development resources.

The management system should also generate sufficient information to allow for a *daily review* that summarises the issues discussed above, and feeds into the *reporting* process discussed below. It should be noted that the *actual market* activity and *actual volume* of sales as experienced within the *real world* is information that needs to be captured and reported within a regular *forecast review* that feeds into the firm's *forecasting* processes.

8.3.1.4 Reporting

The information captured within the *daily review* process should then be fed into a regular *daily-weekly operating report* (DWOR), that is encapsulated into a weekly *management report* and examined as part of a *weekly review*. In a small business, this DWOR might be a summary of financial and non-financial data that outlines the hours spent, raw materials consumed, products sold, cash flow, sales and expenses, wastage, time lost through sickness, accident or injury, and any other relevant information. It is here where the firm's *quality* system and a well-designed and targeted set of KPIs and performance benchmarks are valuable.

8.3.1.5 Feedback

The data from the weekly reviews can then be examined on a monthly or quarterly basis as part of a *standards review*, in which the firm's overall operational performance is assessed. Any shortfalls in meeting quality or budget forecasts should be investigated to ascertain what might have caused these problems, and how the firm might take corrective action. This process of regularly reviewing performance standards is essential to encouraging a culture of continuous improvement and innovation with the business.

8.4 Concepts of Control

Within any organisation, be it manufacturing, commercial or a service company, the basic functions of selling, buying, designing, planning, doing, distributing and score keeping are carried out. These all occur on a day to day basis and form the operational infra-structure of the business (Snaith, 1997). To control the business the small business owner must manage these individual functions and integrate their control activities at the correct level. Senior management within the company, in most cases the owner-manager, is responsible for directing the business strategically, but in order to do this effectively they must have operational control. Successful implementation of strategy requires the communication of *goals*, *objectives*, *standards* and *directive* throughout the organisation.

To exercise control over each of these elements requires an appraisal of the objectives of the total company. Critical questions to be answered are:

- What systems are in existence?
- What are they actually doing?

Systems develop in organisations over time, and no matter how formal the process designed to monitor and administer them, it is rare that any single person has the full picture of what is happening. This is typically the case as a business grows in size and complexity. As such, when the small business owner is seeking to grow their firm, they need to realise that this growth can quickly outstrip the capacity of any existing control systems to adequately manage operations.

A holistic view is very important if the company's systems are to add value to its business. Total value should equal more than the sum of the parts. Small business owners and managers in all industries should continue to ask the two questions outlined above if they wish to develop a culture of continuous improvement. Industrial change, driven by the impact of digital technology (see Chap. 9), is going to place significant pressures on all firms in relation to maintaining a competitive position in what will be digitally disrupted industries. Fortunately, this digital revolution will also open up significant opportunities for SMEs willing to embrace technology and develop their operational systems to make best use of what will become increasingly accessible software and hardware (Karagozoglu & Lindell, 2004; Schlichter, Klyver, & Haug, 2018).

8.4.1 Operational Control

In developing effective business operations, attention should be given to four key elements:

1. *Utilisation:* How well are you using your labour and equipment or premises?
2. *Efficiency*: How efficiently are these assets being used?
3. *Quality*: Do you have clear standards for quality and performance?
4. *Wastage*: Do you monitor wastage rates to ensure that they are minimised?

It is common for small business owners to lack adequate measures to monitor these four areas. Manufacturers should monitor labour and equipment utilisation, productivity and quality levels and wastage to ensure that they are within set tolerance levels. Any evidence of benchmarks not being met should lead to management taking corrective steps as soon as possible. Retailers might set standards for floor space utilisation, sales per salesperson or square metre of floor space, and number of customer complaints, stock losses or theft. Service firms might monitor hours spent per job, with attention given to the quoted rate and the actual rate, as well as use of parts.

8.4.2 Operational Efficiency and Effectiveness Measures

Each business is different and small business owners may need to develop a set of specific KPI that can be used to monitor their firm's operational efficiency and effectiveness in a manner that best suits their particular situation. However, Fig. 8.4 outlines a list of possible measures that can be applied within various types of businesses to monitor its operations. These focus on the four operational control measures and require managers to set their own standards of performance or to benchmark against industry best practice.

It may be difficult in some industries to secure access to benchmark data. Setting your own performance standards is good so long as you seek to continuously improve and work to get enhanced performance and lower rates of wastage through a systematic measuring and control system (Alpander, Carter, & Forsgren, 1990).

An application of how to investigate operational management issues is illustrated in Fig. 8.5, which shows a problem-solving framework for a generic small manufacturing business. This framework was developed by the Durham University Business School (DUBS) (1995) as part of their small business development programs. It provides a useful tool for assessing areas where problems might exist that could be caused by sub-standard utilisation, efficiency or quality, and excessive wastage rates. Working around the outside of the framework, the management team can

- **Utilization**
  - Of labour & equipment
- **Efficiency**
  - Of operations
- **Quality**
  - Of standards & performance
- **Wastage**
  - Monitored & controlled

TYPE OF MEASURE	KPI
Utilisation of Labour or Machinery:	Actual people and/or machine hours / Available labour and/or machine hours
Utilisation of Space:	Space utilised for operations / Space available for operations
Efficiency of Labour or Machinery:	Output per person and/or machine hour against standard Actual production hours / Standard hours available
Efficiency of Space:	Sales per person and/or per square metre against standard
Quality of Output:	Units rejected / Total Sales
Quality of Sales:	Number of returns / Total Sales Number of customer complaints
Wastage of Materials, Components & Inputs:	Material, content or final product / Materials input Components sold out / Components bought
Wastage of Materials in Retailing	Goods Sold / Good Bought

What systems exist?

What are they actually doing?

Do you have all these issues under control?

Fig. 8.4 Operational efficiency and effectiveness measures
Source: DUBS (1995)

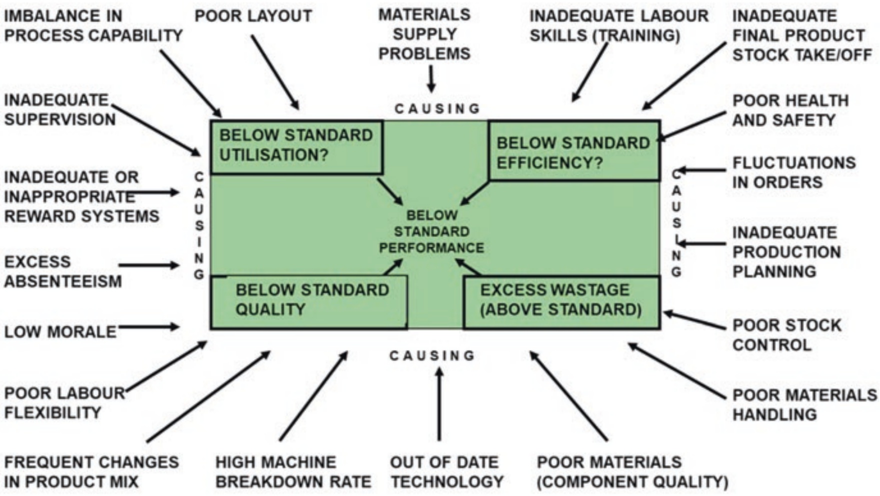

Fig. 8.5 Production problem solving framework
Source: DUBS (1995)

investigate each of the potential causes likely to impact one of these four areas. This allows for a systematic elimination of all possible causes and the pinpointing of any specific problem areas.

As shown in Fig. 8.5, the centre of the framework is a performance that is below standards. This is in turn mapped back to one of four primary causes:

1. *Below Standard Utilisation:* Caused by a range of potential factors such as poor or inadequate supervision of staff, poor layout of the work environment or materials supply problems.
2. *Below Standard Efficiency*: Caused by such possible factors as poor skills or training among staff, poor health and safety, fluctuations in orders.
3. *Below Standard Quality*: Caused potentially by low staff morale, too frequent changes in product mix, high machinery breakdowns or out of date equipment.
4. *Above Standard or Excess Wastage:* Caused by such potential factors as poor-quality raw materials, poor materials handling, poor stock control or inadequate production planning.

The causes of below standard performance are many and varied, but can be broadly grouped into those that impact utilisation; such as poor layout, inadequate supervision or rewards systems or efficiency; such as a lack of training or the fluctuations of raw material supply. Quality and wastage levels are influenced by both human and systems factors and only through careful monitoring can you be sure of what is causing them.

It is important to set clear performance benchmarks – supported where possible by industry best practice – and to monitor any variance over a period of time (e.g.

3–6 months). Trends should be mapped and where the performance is below standard an investigation should be undertaken that can identify the possible causes. The use of business process analysis and mapping (discussed below), is useful to this systems review. Once the possible causes of the problem are identified, corrective action can be taken. This is likely to involve changes to work patterns, job re-design, re-training, equipment upgrades or adjustments to supplier contracts. Where the problem is identified as being associated with employee skills or attitudes it should be incorporated into the Performance Development Review (PDR) process (see Chap. 7) and monitored.

8.5 Operational Control Mechanisms

Based on best practice principles, a business must have a mechanism for controlling how work is done and what work is done. Also, for an organisation to work efficiently it must have equipment for people to work on and that equipment must work in the proper manner when it is required. At least three controls can be readily applied within a small business to assist with operational control: (i) *short interval control*, (ii) *product mix report*, and (iii) *service level agreements*. Each of these are discussed in more detail below.

8.5.1 Short Interval Control

The purpose of the *Short Interval Control* is to provide a tool to allocate work and monitor key volume and performance indicators by each person within the business on a daily basis. This tool visually formalises the decision-making process for any future action that is needed to achieve production or service requirements. The *Short Interval Control* should be linked to and able to automatically update the *Daily Weekly Operating Report* (DWOR) (see Fig. 8.3) on a daily basis. The *Short Interval Control*:

- Records actual time and the status of assigned work activities by person and area.
- Records lost time and variance to plan.
- Is a management tool to enable transparency of work activity by person and area.
- The *Short Interval Control* enables the supervisor or manager to:
- Plan, assign and prioritise work to achieve service levels on a daily basis.
- Assign work across the available resources.
- Follow-up on work and to take prompt corrective action if necessary.
- Control lost time either obvious or hidden.

The *Short Interval Control* records should be available to any member of the management staff who needs the details. The data that feeds into the DWOR should be presented at a daily meeting to show the achievement of the specific part of the organisation. The responsibility for maintaining the *Short Interval Control* should reside with the manager or frontline supervisors who are responsible for the allocation of daily work tasks to team members. They need to ensure that such work is allocated according to appropriate skill and experience, and taking into account any HRM issues (e.g. overtime, leave or agreed flexibility in working hours). In a relatively simple system, daily work is assigned on a sheet or work notice board, and updated by the close of the last shift for the day. The *Short Interval Control* is usually finalised by the manager or supervisor at the start of the next day and amended if required. With the use of ICT systems, work allocation and scheduling can be managed by the company ERP system, or a relevant software application that could be distributed via smartphones, tablets or portable laptop computers.

It is the responsibility of management to diligently apply the system in its entirety and to ensure full compliance to the system through consistent follow-up. In the development and installation of a *Short Interval Control* mechanism within the management system, the major emphasis should be placed on designing a network of controls and procedures, which permit all levels of management to apply the following principles to their areas of responsibility:

1. All work must be related to time for purposes of planning and scheduling.
2. All work and related elements must be pre-planned and controlled on a short-interval basis.
3. All tooling problems must be investigated immediately for prompt solution and to prevent recurrences.

Since the management system is (or should be) integrated into a complete reporting network, each level of management should be aware of the management system's effect when properly completed. As each level within the organisation views the system from a different perspective, each level will likely see different benefits derived from the system. The following is a brief outline of some of these benefits.

The Benefits for Management Are:
- It provides a means of monitoring and evaluating performance levels.
- It provides a basis of information as a planning tool for establishing reasonable goals for budgets and forecasts.
- It provides a sound basis for evaluating status and reasonable decision making.
- It provides for the use of a common language where goals and objectives are transmitted and understood at all levels of the organisation.
- It provides the means of maintaining a basic cost improvement system by continually balancing manpower to work and requiring that action be taken to maintain the balance.

The Benefits for Supervisors Are:
- It provides management with a well-thought-out guideline for weekly and day-to-day events and it helps spot problem areas before they develop into a crisis.

- It provides the means of relating forecasted workloads to manpower in order to forewarn management of changing conditions.
- It provides a means to evaluate performance against a plan and to periodically monitor progress.
- It provides a means of communications with all levels of management in common, objective language.
- It defines responsibilities and assigns accountabilities.

The Benefits for Employees Are:
- It provides a means to objectively assigned work and a reasonably balanced workload for everyone.
- It helps to provide a more even flow of work.
- It opens the lines of communication at all levels.
- It helps develop a sense of pride and ownership for a 'job well done'.
- It provides a means to display personal ability and accomplishment.
- It provides a means of evaluating personal performance against defined goals using a common language.

8.5.2 Product Mix Report

The product or service mix within an organisation can make a large difference in the profitability of the business. Each item in the product-service mix gives a different amount of profit and cost. With a careful consideration of what products and services are produced, and in what proportions, a number of important factors can be controlled:

1. Profitability;
2. Return on Investment;
3. Cash Flow;
4. Efficiency of use of raw materials;
5. Efficiency of use of machinery and/or staff.

Determining the product mix will require a good forecast which:

- Is an objective look into future based on key volume trends;
- Combines information from current and future projects and existing and anticipated work volumes;
- Is reviewed and revised periodically, on a 6-monthly basis;
- Forms the basis from which to plan resource requirements; and
- Includes a long-range view of the external world and reflects its industry.

The *product mix report* should be reviewed by management and production plans developed in accordance with this. The management team should develop the *product mix report*, and present it to the firm's executive leadership meeting, or board, for discussion and approval. The *product mix report* should be prepared at least annually, as part of the firm's forecasting process of strategic planning. However, it should be updated regularly and adjusted in response to any changes to market demand, customer requests or supplier-side influences.

8.5.3 Service Level Agreements

All plant and equipment need to be maintained effectively regardless of the organisation's size. The *Service Level Agreement* (SLA) is a document that describes the commitment a maintenance department or contractor has made to the firm's production (or other departments) to deliver its services with measurable KPIs including quality of service and timeframes for response etc. The SLA should be designed around the following key principles:

- *Visibility:* In order to be effective, management needs visibility. Key indicators are kept transparent and accessible, thus communicating what is important to management to act upon.
- *Objectivity:* The cornerstone to having a collaborative management focus is to ensure discussions are based on facts (objective measurements) rather than perceptions (subjective basis).
- *Measurement*: What is measured is acted upon and determines the focus of management's time.
- *Continuous improvements focus:* Improve performance by planning the resources at the desired level of performance – start with the end in mind.
- *Equity*: All personnel and departments are accountable for their performance based upon mutually agreed and measured bases.

It is important to remember that an SLA will not solve problems, but merely act as a guide to help the signatories to understand their obligations and benefits. The system is designed to provide control of the various activities within each area. The effectiveness of the program is directly dependent upon the degree of involvement and support by all levels of management.

The SLA once agreed should be available to all staff as it is the agreement under which all production and maintenance or contractor staff work. The manager or supervisor must develop and agree on the SLA. The maintenance may be outsourced which makes the SLA far more important. Once developed the SLA should be reviewed at least annually to ensure it is still supplying the performance criteria that are needed by the organisation.

8.6 Quality Assurance Management Systems

Quality assurance management systems (QAMS) include the process of TQM and the family of QAMS performance standards that are recognised by the International Standards Organisation (ISO). Historically, the evolution of modern QAMS can be traced to the experiences that many countries had during the Second World War. During that conflict, quality controls on military equipment were a major problem, leading to high rates of failure. Pre-war production systems had involved a substantial level of customised work involving skilled workers. However, the pressures of the war saw factories staffed with semi-skilled workers, and many firms being asked manufacture weapons and equipment that had previously not been their core business. During the 1950s, with the development of integrated military systems, logistics and hardware, organisations such as the North Atlantic Treaty Organisation (NATO) established common standards for all alliance members. This in turn, led to the adoption of common quality assurance standards in the United States, Britain and other nations, and these were applied to industry. In 1987 the first international standards, ISO 9000 system was introduced (Stickley & Winterbottom, 1994).

8.6.1 ISO9001

Since that time, the ISO system has become widely adopted and is mirrored around the world by participating nations who adopt identical common QAMS standards as benchmarks for their own industries. The most recent standard at time of writing was the ISO 9001:2015. This provides a global family of QAMS standards that are part of a QAMS framework, which focuses on *continual improvement* and requires firms to set their own standards and strive to achieve them. The ISO 9001 framework is designed around seven *Quality Management Principles* (QMP) (ISO, 2015).

QMP 1 – Customer focus: The focus of quality assurance is the ability to meet and exceed customer expectations. This is achieved by understanding customers' current and future needs and expectations. It involves linking the firm's objectives to customer needs and expectations, and communicating these throughout the firm. The planning, design, development and delivery of new products and services should meet customers' needs and expectation. In addition, the firm should measure and monitor customer satisfaction and take action to correct any problems. It also needs to monitor any third-party actors likely to affect customer satisfaction and manage these relationships, while simultaneously actively managing customer relationships.

QMP 2 – Leadership: The firm's management should communicate to all employees the organisation's vision, mission and strategy. They should also create and sustain shared values, fairness and ethical behaviour, and establish a culture of trust and integrity. In addition, they should encourage an organisation-wide commitment to quality and ensure that leaders, at all levels, set positive examples and role models. Resources, training and support should be provided to facilitate accountability.

QMP 3 – Engagement of people: The firm's management should communicate to its employees the importance of their contribution, and promote collaboration throughout the organisation. They should facilitate open discussion and sharing of knowledge and expertise, while empowering people to take initiatives without fear. They should also recognise and acknowledge individual's contributions and efforts, while enabling self-evaluation of performance against objectives. Finally, they should conduct surveys to assess people's satisfaction and report the results and actions taken.

QMP 4 – Process approach: The management of the firm should define objectives and the actions needed to achieve them, and establish authority, responsibility and accountability for all activities. It should understand the team's capabilities and resource constraints prior to action, and determine process interdependencies and their overall effects. Finally, it should manage processes and interrelationships as a system, ensuring all necessary information is available to monitor the system, and manage risks that might affect the overall QAMS outcomes.

QMP 5 – Improvement: The management should promote improvement objectives throughout the organisation, and educate and train people how to apply basic tools for improvement. It should ensure people are competent to successfully work on improvement, and develop and deploy processes for improvement. Finally, it should track, audit and review all improvement projects, integrate improvement suggestions into new products or services, and recognise and acknowledge improvement outcomes,

QMP 6 – Evidence-based decision making: The firm's management should determine, measure and monitor the key indicators that demonstrate benchmark performance, and make all relevant data available to the employees. They should ensure that data and information is accurate, reliable and secure. Data should be analysed and employees should be competent to analyse and evaluate data. All decisions should be taken based on evidence supported by experience and intuition.

QMP 7 – Relationship management: The firm should identify and engage with all key stakeholders (e.g. customers, suppliers, investors, employees, regulators), and determine how to manage their priorities and interests. All such relationships should balance short-term gains against long-term considerations. Collaboration with key stakeholders should be undertaken where sharing of expertise, resources and information is mutually beneficial. This can focus on innovation and improvement projects. Company performance should be reported to key stakeholders where appropriate. Encourage and recognise improvements and achievements of suppliers and other strategic partners.

8.6.2 Total Quality Management

Process re-engineering, *continuous improvement*, *total quality management* (TQM) are labels commonly given to describe such business culture. However, these are often misunderstood, over used and abused, but taking a look at the meaning of TQM can provide just a little insight into what it means to *work smarter not harder*. TQM is a QAMS system that has had a lot of publicity and has been actively promoted towards SMEs since at least the 1980s (Rahman, 2001).

In general terms TQM is a philosophy designed to bring about the process and management of change. As an approach it involves every aspect of the business and is the responsibility of everybody, including suppliers and customers. TQM means taking a strategic view of business operations from a quality-focused perspective and provides an 'umbrella' or various quality improvement initiatives. A business that adopts the TQM approach will have an organisational culture that revolves around continuous process improvement involving employees, customers and suppliers to define and meet true product and service quality requirements.

To explain TQM a little further:

- *T is Total:* Sharing common goals and objectives across the organisation. Working together to improve the processes in order to achieve the desired level of satisfaction for all customers both internal and external.
- *Q is Quality:* Endeavouring to meet and, where appropriate, exceed the customer's expectations. Every customer (internal and external) contact is important no matter in what form it takes, e.g. maximising value – minimising waste and recognising that customers set the standards.
- *M is Management:* Optimising value by managing the organisation's processes, understanding the customers' needs, setting the appropriate objectives and focusing on continuous improvement and development.

TQM is a strategic approach to operations management, and the beginnings of effective process management can be achieved by a thorough analysis of key business operations, perceived and measured quality. Quality is all about two things: (i) doing the right things, and (ii) doing things right. Achieving both of these simultaneously will bring about efficiency and effectiveness.

According to Van der Wiele and Brown (1998), the benefits of TQM to an SME will come only if the firm's owner-manager or senior managers are convinced of the need for a TQM approach. However, due to the relatively simple organisational structure of most SMEs, the process of implementing TQM should be more visible to all employees. It should also be easier in the small firm to engage and manage employees in the TQM process. Their survey of 160 SMEs in Australia, who had engaged in TQM, found that the adoption of this quality management approach was challenging for many as its impacts were strategic in nature and the mindset of the owner-manager to the adoption of TQM was critical to its successful implementation.

> **For example,** … So, in many SMEs the main problem in moving up the quality ladder is not financial, or related to the needed knowledge base around TQM. However, the major problem is to convince the owner or manager of the SME to get them onboard. This might be referred to as developing 'emotional quality' at the highest level of the SME. If emotional quality at the right level is in place, then the knowledge base can be developed, experts can be arranged, participation in networks will take place etc., and solutions for overcoming the blocks related to these issues will be found (Van der Wiele & Brown, 1998, p. 66).

TQM in Action

In an organisation that practises total quality management, quality becomes the standard operating procedure and part of the culture. It is not simply a programme or project, but a way of life. It is proved by the quality of materials purchased from suppliers, the approach to detection on the production line, the appearance of the building, the way problems are solved for customers, the way employees are organised and the organisation's internal communication system.

Source: Hannagan and Bennett (1995).

8.6.3 The 7 principles of TQM

For many businesses, TQM is difficult to fully harness and manage. It requires constant top-level management, time and attention. Besides funding the initiatives, themselves, TQM requires significant investment in time for training. The following seven principles underpin total quality:

1. *Philosophy*: Prevention not detection,
2. *Approach:* Management led.
3. *Scale*: Everyone is responsible.
4. *Measure*: Costs of quality (non-conformance).
5. *Standard*: Right first time.
6. *Scope*: Companywide.
7. *Theme*: Continuous improvement.

Most quality and continuous improvement initiatives have emerged as a result of documenting the success of Japanese manufacturing techniques. Tools, techniques and strategies are now adopted in every industry sector and company size. The focus is upon improving efficiency and effectiveness in order to achieve competitive edge. Table 8.1 lists a number of different activity systems that have been used within the TQM process. While these techniques originate mainly from manufacturing environments, the process management view allows their tailoring and application within service sector industries, e.g. flexible working, quality circles, and statistical process control can all be applied within service industries by focusing upon employee ownership and the allocation of resources to *key business processes*.

Table 8.1 Activity systems within the TQM process

Activity system	Concept and outcome
Total quality control	Responsibility for quality is at the point of production.
Quality circles	Small groups who meet to find ways of improving quality.
Statistical process control	Statistical monitoring of quality by sampling.
Just-in-time	Production and delivery just-in-time for selling/
Kanban	System for pulling materials through production to control stock levels during assembly processes.
Flexible working	Team working and multi-skilling to alleviate bottlenecks.

Source: Mazzarol and Olivares (2007)

Just-in-Time – An Overview

Just in time means exactly what it states, that goods, materials and services are delivered to the point of need, at their time of need. Central to the philosophy of total quality, the just in time philosophy aims to minimize costs of poor quality; costs of stock; costs of long delivery times. To minimise these costs, it is important that the philosophy cascades throughout the company and associated supply chains.

Suppliers should make their deliveries just in time (minimisation of stock costs). For some businesses this may mean sourcing supplies more locally. The quality of supplied materials should be assured upon delivery to the point of need (ideally by establishing a supply agreement contract with the suppliers). It is also important that preventative maintenance on any machinery or equipment should be carried out. In the service sector this may mean regular servicing of office equipment or ICT.

There should be a continuous drive towards zero defects through continuous improvement (e.g. non-acceptance of 'acceptable' quality). To illustrate this further, the following features can characterise a JIT organisational environment:

- *Environment:* Accurate and timely paperwork. Effective communication of targets with excellent feedback focussing upon motivation.
- *Quality at source:* Minimise inspection and correction. Make use of best people and best products and services.
- *Make to demand:* Minimise stocks by linking production and service supply to demand.
- *Changeover flexibility:* Reduce equipment set-up times wherever possible, especially where product and service variants are high.
- *Preventative maintenance:* Maintain equipment and systems before breakdowns or failures by standardising wherever possible.

(continued)

- *Layouts:* Evaluate efficiency of layout; functional or 'cell' based. Design or modify layouts to achieve the most effective and efficient process flow.
- *Pull scheduling:* Allow customer (internal and external) to 'pull' or trigger the manufacturing or service process, thus ensuring minimal costs associated with stock or waste (e.g. Kanban card system).
- *Co-operative purchasing:* Reduce the number of suppliers and develop the supplier relationship. Treat suppliers as a part of the business (pass down quality assurance costs by agreeing to standards).

Source: Mazzarol and Olivares (2007).

Figure 8.6 illustrates the four primary areas of focus for the implementation of TQM and the minimisation of costs. In common with every business is cost effective management of quality and continuous improvement. There are trade-offs that need to be considered. Investing in preventative activity to minimise poor or substandard quality will rise dramatically if the aim is to achieve zero defects in product/service delivery. Similarly, the costs of failure through little or no preventative activity can be high if it means redesign or redelivery, and especially high if failure is only discovered once the customer has complained! Obviously, the extent to which preventative measures need to be taken will be dictated largely by the industry and products/services delivered (in manufacturing industries, there are often minimum quality specifications detailed prior to agreeing business which will direct

Internal Failure Scrap, Re-work, Re-inspection, Waste	**External Failure** Repair/servicing, warranty claims, complaints, returns, loss of goodwill
Appraisal Audits, Inspection equipment, vendor rating	**Prevention** Product/service requirements, training, quality assurance, quality planning

Fig. 8.6 Minimising quality costs
Source: Mazzarol and Olivares (2007)

levels of preventative activity). Total costs of quality can be minimised by pre-evaluation of failure, appraisal and prevention costs.

8.6.4 Six Critical Challenges

Arriving at true evaluations of how such costs are likely to affect the customer (internal and external) should provide a fair indication of *actual* business costs of sub-standard quality. This, in turn, should guide the extent of necessary funding for quality initiatives and drives. However, perhaps more important than costs of quality are the costs associated with changing the way of doing things and employee mindsets. Kick-starting a 'quality and continuous improvement' approach to process management inevitably means changing everybody's way of viewing tasks and activities. The six critical challenges to manage are:

1. Moving away from purely functional approaches to the way in which employees work.
2. Reduction of control of people by systems and/or 'fear' of non-compliance.
3. Elimination of notions that there are 'acceptable' levels of quality.
4. Losing any 'macho' image associated with firefighting.
5. Eliminating the 'it's not my problem' mindset.
6. Eliminating the 'reasons why not' approach.

Achieving the above will mean investing in time and money. Training and development of employees in process improvement techniques should be facilitated. Gradual introduction of mechanisms for dealing with process improvement should utilise the consultation and involvement of employees.

8.6.5 The TQM Cycle

The TQM cycle is a four-process of continuous improvement: *Plan*, *Do*, *Check, Act.* These are discussed below:

- *Plan:* The work allocation is typically planned around the skills of the employees or operators. It incorporates the flow of goods, materials and information critical to the successful execution of a business process. It should also include the scheduling of work tasks and the setting of job priorities.
- *Do:* As the work is carried out, performance is measured and resource planning is done at intervals during the day to ensure that the plan/target is met. This will involve allocating employees to specific tasks and ensuring that they have the right supporting systems, skills and time to do it properly.
- *Check:* The data, which is generated, is analysed and performance is plotted. Attention should be given to where the data suggests there are significant variances between what is planned and what actually happens. This is where performance benchmarks can be set.

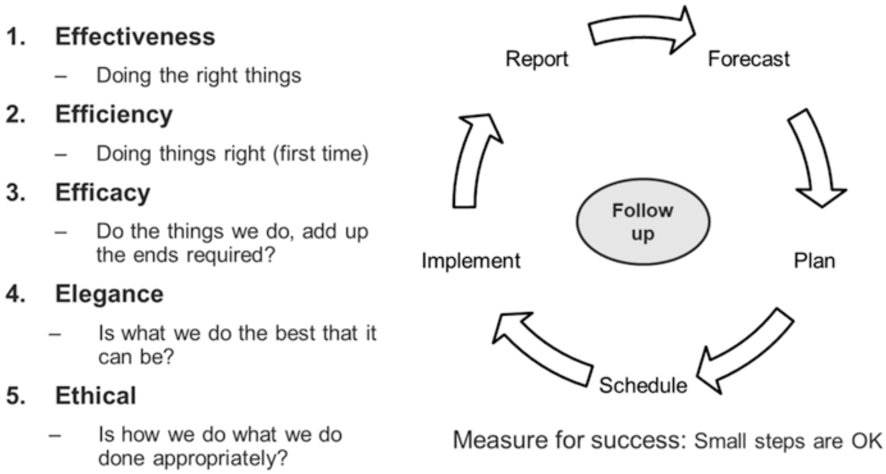

Fig. 8.7 Quality management – the 5 "Es"
Source: Mazzarol and Olivares (2007)

- *Act:* Corrective action is taken and fed back into the plan and allocation of work. This data can link to the employee performance development review (PDR) process as well as the budget and costing structure within the business.

This particular management control system ensures that any short-term targets are met. It requires that all parties are communicating developments and sharing information through daily reviews. Discussion at these reviews leads to actions being taken in work allocation to utilise labour more effectively and responding to sudden changes in the workload. The feedback of productivity performance gives a measure of the decisions being made. All this leads to better working practices, tighter control, better understanding and thus continuous improvement.

The overall TQM approach to quality management is summarised in Fig. 8.7. The five elements that form the cycle of management activity originally described in Fig. 8.2 are related to the five "Es" of quality management that address: (i) *effectiveness;* (ii) *efficiency*; (iii) *efficacy;* (iv) *elegance,* and (v) *ethical* behaviour within the management system. Quality management is as much about mindset, philosophy and culture as it is about the measurement and monitoring of performance benchmarks. For small business owner-managers who are starting to build their own QAMS systems, incremental steps, learning by doing, and following the formal and well-established principles, is a recommended approach.

8.6.6 The Benefits of QAMS and TQM to SMEs

Academic research into the benefits that SMEs get from formal QAMS and TQM systems reveals a somewhat mixed result. Not surprisingly the use of formal QAMS systems has been less common in SMEs than larger firms, and its adoption is more likely to be found within manufacturing firms, or those supplying to larger customers who demanded ISO 9000/ISO 9001 accreditation. Many SMEs found the cost of accreditation a barrier, and viewed it as a 'necessary evil' that had been imposed upon them by customers, suppliers or government authorities (Van Der Wiele & Brown, 1997, 1998; Brown, Van Der Wiele, & Laughton, 1998).

A problem that influenced the early adoption of ISO 9000/ISO 9001 by SMEs was that these QAMS systems were designed by and for large firms, which served national or international customers, competed within global markets, and possessed the necessary resources to implement these frameworks. In addition, such firms were large and complex, with a greater need for internal systems to help manage their operations towards best practice. By contrast, small businesses, with local customers, small teams of employees and largely informal systems of internal operations management, did not see the need to adopt QAMS, or invest in the cost of accreditation (Chittenden, Putziouris, & Mukhtar, 1998).

Case study research of SMEs in the United Kingdom and Australia found that possessing formal QAMS such as ISO 9001 accreditation, was not sufficient to guarantee the firms' competitiveness. However, it did offer benefits if the firms' management viewed the QAMS process as an opportunity to improve internal operations management systems, enhance customer and employee engagement, product quality and control (Brown et al., 1998; Chittenden et al., 1998). These findings were echoed by other research.

> **For example,** … Becoming quality-driven is a lot more than achieving ISO 9000 certification. Quality must be rooted firmly in the culture of the organisation. ISO 9000 assurance scheme can never be a substitute for a value-driven quality management approach. The main concern about the registration is metaphorically similar to passing a school exam – the result obtained may not be able to differentiate between those who truly learned something and those who merely passed the exam by cramming (Nwankwo, 2000, p. 9).

Other studies have supported this view. For example, Sharma (2005) examined the relationship between the possession of ISO 9000 certification and the financial performance of firms using a sample of 70 Singaporean companies over a 6-year period. This quantitative analysis compared the financial performance of 35 firms with ISO 9000 certification and 35 firms that did not possess formal certification. It found significant relationships between the possession of formal ISO 9000 certification and higher financial performance. There were benefits to the firms' profit margins, sales growth and earnings per share, with profitability the more significant area of improvement. This was suggested as a reflection of the impact that formal QAMS has on enhancing the internal efficiencies within the firms' operations and business processes.

An empirical study of the differences between small and large firms in Norway and their use of ISO 9001 certification and TQM processes found that most SMEs were motivated to adopt these QAMS systems due to customer demand, and that their application was to help them secure or maintain contracts with their larger firm customers. The small firms were also likely to adopt the ISO 9001 certification at a similar rate to that of their larger counterparts, but less likely to embrace TQM (Hongyi & Tsz-Kit, 2002).

In a further study undertaken in Northern Ireland, by McAdam and McKeown (1999) the benefits of formal ISO 9000/ISO 9001 accreditation to SMEs was also highlighted. However, they also found a confusion and tension between ISO 9000 and TQM. Rather than an 'either-or', they suggested that ISO 9000/ISO 9001 should be viewed as a 'route to TQM'. They recommended that ISO 9000/ISO 9001 accreditation should be the first stage of a two-stage process that leads to TQM. This is because TQM requires underlying QAMS systems that the ISO 9000 accreditation process helps to create.

8.7 Business Process Analysis

Business process analysis (BPA) is an important part of the operations management system and has its origins in the development of enhanced operational efficiencies within the production systems of large manufacturing firms. However, despite its origins, BPA can be equally applied to small firms, and also to service businesses. In fact, any business process that takes place within an organisation can be assess using BPA techniques in order to design, or redesign it, to achieve optimal performance. During the 1970s BPA was enhanced through the application of office information systems. This work diminished in the 1980s, but was revitalised during the 1990s under the title *work-flow management*, which has now been labelled business process management (BPM) (Fisteus & Kloos, 2006). Today, most BPA activity is undertaken using ICT systems that form part of the firm's *enterprise resource planning* (ERP) system (see Chap. 9).

8.7.1 The Idea of a Process

Before any improvements or changes can be made within an organisation it must identify its current process. A process is anything that has an input, steps to follow, and an output. Everything we do is, or is part of, a process. A process is some combination of; methods, materials, equipment, people and the environment, used together to perform a service, produce a product or to complete a task. The products and services that are sold to customers are a product of all the thousands of processes in all areas of the business, each with its own immediate customer and each with an inherent variability in its output.

Management action to improve each process and to satisfy the internal customer will ultimately improve the quality of the final product with a similar impact on the satisfaction of the external customer. Some typical processes are: (i) processing purchase orders; (ii) estimating costs; (iii) handling complaints; (iv) recruiting staff; (v) invoicing customers, and (vi) issuing documentation. Like all processes these

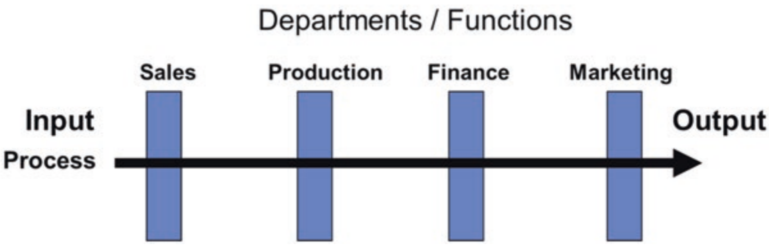

Fig. 8.8 Process managment workflow basic concepts
Source: Mazzarol and Olivares (2007)

examples have an inherent variability in their output. The objectives of managing processes must be:

- To produce outputs which are consistent over time.
- To produce products and/or services that meet the needs and expectations of the customer.
- To do these two at an economical cost.

It is not sufficient to see the objective as simply meeting requirements. This will not lead to the continuous improvement we seek, nor will it necessarily satisfy the customer.

Figure 8.8 illustrates a basic process management workflow chart. BPA requires the mapping of how work is undertaken within the firm, and follows the workflow from the initial customer engagement, through to the after sales service and support. It is important for each stage of the workflow to be mapped and examined to ensure that all elements of the *value chain* are undertaken efficiently and are able to add value to the overall business operation.

Business Process Management Principles

- Define the 6 to 10 cross-functional business processes that describe your organisation.
- Assign business process owners who will have oversight responsibility for their process.
- Identify approaches to understanding existing processes, focusing on problems, issues, and opportunities for improvements, particularly looking at those places were errors occur, or where handoffs between departments are problematic, or inefficiencies exist (a process of selecting analysis and design tools).
- Design process flows between transactions or events that address these issues.

Source: (Worster, Weirich, & Andera, 2012)

8.7.2 Business Processes

Business processes describe how the work that gets done in a company actually gets carried out. Business process analysis then takes this a step further and looks critically at the work done inside the process, identifies gaps, duplications and dead ends and finally re-engineers the process to make it more efficient and more responsive to customers' needs.

The simple definition of a process is a series of linked activities which take an input from a supplier and produce an output for a customer where an activity is a task or set of tasks that can be described. The customer of the process is responsible for defining the output and its quality characteristics. Most non-trivial processes have more than one customer and frequently the output of a process is information. The *Process Management Philosophy* adopts this view by tracking products and services across functional business areas. Managing the process will touch upon every department and involve many employees.

All processes will have key stakeholders both internal and external to the business. Likewise, there will be resource requirements, standards and measures that all impact productivity, costs and margins. This might include:

- a *customer,* who receives the output.
- an *output*, the customer defined result of the process.
- a *supplier,* that supplies the input.
- an *input,* from which the output is produced.
- *Resources*, that are used to produce the output.
- a *standard*, that describes the requirement of the output;
- *Measures,* that determine the efficiency and effectiveness of the process, and
- *Feedback*¸ to provide information to improve the process.

8.7.3 Business Process Design

As noted above, the evolution of BPA since the 1970s has been strongly influenced by the concurrent development of computer-based technologies that have enabled the business process management functions to be incorporated into the firm's ERP systems. In Chap. 9, we focus specifically on the use of technology and ERP systems. However, within the context of business process design, it is worth noting that BPA and ERP systems, while closely related, have traditionally been disconnected from each other within many organisations (Worster et al., 2012). This disconnection between the ERP and BPA system is typically caused by a lack of knowledge about the operation of these systems, which results in misalignment of the ERP and BPA systems architecture.

> **For example,** … The goal of any organization in selecting IT applications must be to provide the most comprehensive set of business applications that will support fundamental business logic and enable designs to produce optimal business results (Worster et al., 2012, p. 79).

It is important that the business design its ERP system to provide the necessary data capture and reporting on the core operations functions within the "back-office" software that encompasses logistics, financial, HRM and production activities taking place throughout the firm's operations. This allows management to monitor the overall performance of the business, and make sure that it is operating at the desired levels of efficiency and effectiveness.

In order to effectively undertake BPA, it is important that all members of the team engaged in the process possess sound *business knowledge* of how the firm's operations work, and the reality of their operation rather than how they should be performing in theory. This can be assisted by a physical examination of the process via a review such as a *business process mapping* exercise, which is discussed below. In addition, BPA team members need to have a good understanding of the operation of ICT and related technologies that form the backbone of any ERP system. They don't necessarily need to be computer IT specialists, but they do need to understand the basics of how data is captured, stored, retrieved and shared across the system. Poor database and IT systems design can create significant problems for future business process management. Too often data is found in silos that cannot be shared, or are stored in a format that cannot be easily integrated into the firm's wider ERP and reporting systems.

For a small business that has yet to develop its operations management systems, it is potentially value for it to seek expert advice about the design of the company IT systems (see Chap. 9), and the use of the ERP system as the engine room of the firm's BPM system. It is often very expensive to have to reengineer the company's systems at a later date to bring them up to a level where they are able to provide the necessary integrated management and reporting architecture that is becoming essential to the contemporary business. Finally, the business should consider undertaking training in business process thinking and design. Getting the company to collectively map its business processes from end-to-end is relatively achievable for most small firms with simple structures and only a few products and customers. However, it can be very revealing to both the management and employees, and can form the basis of a wider discussion over the adoption of QAMS systems and future innovation ideas.

8.7.4 Business Process Mapping

The key to gaining control over the entire business is to recognise that the system is a sum of its constituent parts and that the ability to control each part ultimately results in the control of the whole organisation. This is where business process mapping helps managers and their teams to examine each individual, separate process within the system, and identify how it is being managed, and where it might require attention for improvement. All parts of the firm's value chain need to be examined and therefore a starting point for understanding business process mapping is to examine the concept of the *value chain*.

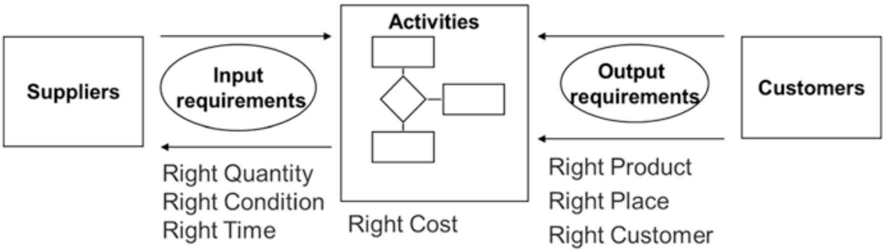

Fig. 8.9 Business process mapping and the 7-Rs

> **For example,** … The value chain is a tool to disaggregate a business into strategically relevant activities. This enables identification of the source of competitive advantage by performing these activities more cheaply, or better than its competitors. Its value chain is part of a larger stream of activities carried out by other members of the channel-suppliers, distributors and customers (Brown, 1997; Walters & Lancaster, 2000, p. 160).

Business process mapping is a technique that has been used widely in industry since at least the 1970s. It has also been referred to as *Business Process Model and Notation* (BPMN), which describes a standardised approach to the visualisation of how the operational activities of a business organisation are conducted across the value chain through a flow chart diagram (Silver, 2017).

The main point of focus for most business process mapping is how to improve the overall value chain of the business and thereby enhance value to the customer. As illustrated in Fig. 8.9, the business process is mapped from the suppliers' inputs through the firm's activities, to the customers' receipt and satisfaction with the final products or services. As the various stages and associated activities are investigated and mapped, attention should be given to determining that the overall operations of the business order the right quantity of inputs, that have the right condition of quality, and that arrive in the right time. They then need to be processed through the firm's internal systems so that they are transformed at the right cost, and then the right products can be delivered to the right place and the right customer every time.

8.7.4.1 Brown Paper Methodology

Business process maps are sometimes referred to as a *Brown Paper*, which reflects their origins in business process consulting in the 1970s, where the business process was physically mapped out on a long roll of brown paper stuck to the wall and the entire system was drawn up in a flow diagram to help management teams fully understand the end-to-end process of their firm's operations. Today, business process mapping is undertaken with visualisation software (Silver, 2017). However, the basic process is the same regardless as to whether it is done with paper and pens, or via sophisticated software tools (Jacka & Keller, 2009).

To provide a simple overview of how the business process mapping can be undertaken we will follow the traditional *Brown Paper* approach by way of illustration. So, imagine taking a large roll of brown paper and placing it up on the wall to provide the foundation for mapping out the overall process or system flow of the firm's operations. It is worth noting that even in the simplest of organisations the map can become very complex so it is important to develop the process in a controlled manner. It is advisable to develop a number of *Brown Papers* across the organisation and then cross reference processes or systems to one another rather than fit the whole organisation on to one system flow. For example, in a business with some complexity, or multiple production lines, each team within a given division, could produce their own particular *Brown Papers* and then compare them with those from across the organisation.

The *Brown Paper* becomes a working document that can be referred back to on a constant basis. It never becomes a finished article because that is not the nature of a business process. All relevant staff should have some involvement in its development. After gaining agreement that the system flow is correct, observations and comments etc. should be captured on the document. After completing a comprehensive *Brown Paper* exercise many employees and managers have gained increased insight and understanding into the process that surround them in the work place.

The output from this process will be a number of issues that have been recorded on the paper. Management must then decide how to address these issues. If the system requires a complete re-design then the *Brown Paper* can be developed into a new process which is then detailed on a *White Paper*. This might take the form of a computer rendered flow chart as used in some proprietary BPMN software (Silver, 2017).

8.7.4.2 There Is No One "Right" Way to Do a Brown Paper Analysis

The key to Brown Paper process mapping is to follow a process right through from start to finish, noting all participants within the company who deal with the issue and how they deal with the issue. In the development of the process map it is important to involve as many people, (those who are part of the process) as possible. Using a simple roll of brown paper (available from stationery suppliers), you should attempt to map out the process flow in a logical manner. Take care to include all steps and details and the order in which they occur.

For example, you might map a customer order from the time that it is placed, through the generation of the product or service that creates it, through its delivery to the customer and any billing or follow up after sales service and installation. Every time the order is handled, by whom and how should be noted. It is important to observe areas of system or people failure so that the work flow can be analysed and improved.

Collect actual documents from the people who you speak to about their work, and where it is relevant take photos and place them onto the *Brown Paper* at the appropriate place in the process flow. This should help to define the tangible elements of a process. It will also be easier for employees to relate to these sources of evidence, and this will help everyone analyse what actually happens and who is involved. For example, you might include actual copies of the sales order, production schedules and invoices etc.

The process map should be drawn with a standard flowchart approach. Figure 8.10 shows some of the more common symbols that are used in such flowcharts. These

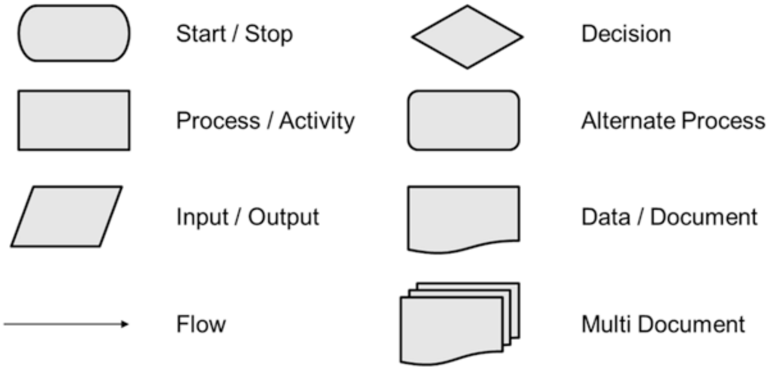

Fig. 8.10 Business process mapping standard flowchart symbols

are common within most software programs (e.g. Microsoft Office), and can be replicated from the original *Brown Paper* diagram into the final *White Paper* model using these standard symbols.

8.7.4.3 Black, Blue and Red Mapping

It is generally useful to put the *Brown Paper* map up on a wall using blue tack or equivalent, allowing it to be as long as is necessary to chart the flow of activity. The overall *system* that is being examined should be mapped out in a **BLACK** line. This is best done using a large felt pen and marking the line of activity as you move physically through the process. Take care to collect copies of any documents that are used within the business to manage or record the process. These can be glued to the *Brown Paper* at the points where they are used within the system. Ensure that every document on the paper is labelled. What it is, as defined by the users. In some cases, documents are officially recognised and labelled, but others may be informal and known only to those who use them. Decide the relevance of each document that you collect. Usually this is best done by the users of the documents. Their comments need to be captured on the paper as they are raised. Ask lots of questions and encourage the asking of questions, even if you think they are obvious. Take care to be aware of the organisation's culture. If this is a sudden change in the way things are usually done you may meet some resistance.

Most problems within business systems are caused either by process (*hard*) issues, or people (*soft*) issues. The first of these relates to what the people in system actually do. As the information gathered from these participants is examined the facts about the process should be mapped out with a **BLUE** pen. This can take the form of any informal activities or processes that deviate from the official system, and/or comments that capture the essence of what was being experienced by the people operating the system. The data can be recorded as comments such as: "the foreman completes this …" or "we have two shifts …" or "we have five suppliers …". This provides a real-world context to the official system, and offers the perspective of the way the system is managed from the perspective of the employees who are engaged with it.

Recording the *soft* issues in the *Brown Paper* is done using a **RED** pen to visually flag areas that require attention. The investigation with the people along the process should be conducted with a view to identifying any abnormal *soft* issues. This might be observations you have made, or comments from those employees who have supplied the documents and information, as to what problems exist in the way the system is working or not working. In most organisations problems are due to either systems or people failures. Note which is which and offer confidentiality to the information suppliers as you deem appropriate.

This will require the data collection process to be undertaken carefully and where it is necessary, for some information to be provided in confidence. For example, it is not uncommon for process problems to be caused by human behaviour that is the result of poor culture, inadequate training, leadership, guidance or support, and perhaps the failure of processes due to poor systems design, insufficient resources or outmoded equipment.

Ensure *everybody,* including you**,** understands the process and why it is being done. Work from the *Brown Paper*, with the users, letting them decide on the relevance of each document. These comments need to be captured on the paper as they are raised. Encourage open discussion and critique of the system with the users from all levels within the organisation. Refer back to the paper regularly.

The *Brown Paper* can be developed over time and used to help engage all management and staff to review the process, and build up their understanding as to how, why and where areas for improvement have emerged. It can then be used to undertake a process or system redesign.

8.7.4.4 Abbey Estates Example

Figure 8.11 illustrates an example of a *Brown Paper* process map undertaken for a real estate agency known as *Abbey Estates*. It shows the flow of activities from the initial vendor inquiry to a personal viewing by the vendor of a property. Each stage of the process is mapped and examples logged of the key documents or forms that are generated along the way and how they are used. This type of systems mapping can assist in identifying systems slippage and blockage in order to enhance the system and offer a more co-ordinated approach to management control. Small firms that are experiencing rapid growth can quickly find that they are facing systems problems that require such a holistic approach to business re-engineering.

The *Abbey Estates* business process map is a simple example, but serves to illustrate the overall approach. In developing the maps, it is important to look not only at what happens, how and why, but also at the overall way in which people and information flows through the process and across the process, within the business and with any key outsiders (e.g. suppliers or customers). The interconnection between the marketing and sales, procurement, production, financial and HRM systems must be examined. It is here that any areas for improvement in the general flow of information can be identified. Howe data is captured, stored, reported and integrated within the firm's wider systems architecture is critical to achieving best practice (Fassoula & Rogerson, 2003). In the following section we examine approaches to benchmarking within the SME.

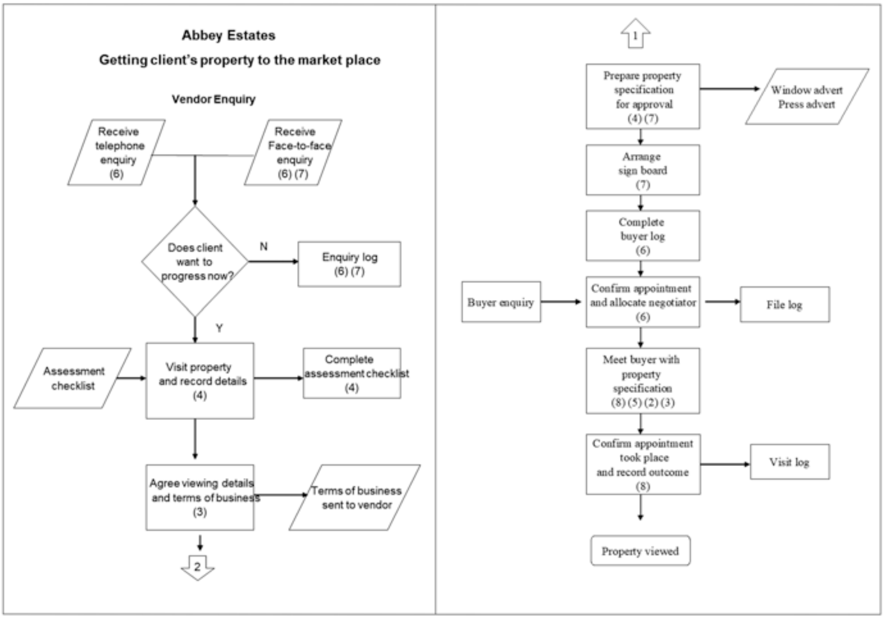

Fig. 8.11 Abbey Estates business process map example
Source: Snaith (1997)

8.8 Benchmarking Methods and Tools for SMEs

The term *benchmark* is a concept that has its origins in a process employed by land surveyors, who used a fixed point from which all other measurements were made when mapping. This involved chiselling horizontal marks in stone structures, into which were placed angled-iron to form a "bench" onto which a levelling rod could be placed. This ensured that the level was accurately repositioned in the same place each time. It therefore relates to a process of establishing a firm standard against which to make meaningful comparisons.

During the 1970s the term became widely used to refer to a process of identifying best practices against which industry standards could be benchmarked. This created the concept of *benchmarking*, which relates to the process of systematically measuring or comparing a business and its activities against best practices (Bogan & English, 1994). Major firms such as Xerox, AT&T and Motorola adopted benchmarking as a part of their TQM processes (Blakeman, 2002). As a business tool, benchmarking is a *reference process* that involves making comparisons with best practice and then replacing an existing system or process with one that has been identified as superior (Maire, Bronet, & Pillet, 2008).

> **For example,** … more precisely, it can be defined as a process based on an improvement obtained by the adaptation and, in some cases, by the substitution of one process by another recognized as better, that we will call a *reference process* (Maire et al., 2008, p. 765).

It is also about looking at what exists globally to ensure that firms and industries are able to maintain international best practice.

> **For example,** … the process of … identifying, understanding and adapting outstanding practices from organisation anywhere in the world to help an organisation improve its performance (Ashford, 2007, p. 50).

Benchmarking can be applied to a wide range of areas, although it broadly focuses on three distinct types, which are described as follows (Bogan & English, 1994):

1. *Process benchmarking:* this type of benchmarking aims to identify best practice in specific operational activities and then apply them to another business. It is largely operational in nature and focused on lowering costs and enhancing productivity.
2. *Performance benchmarking:* this type of benchmarking focuses on such areas as pricing, product and technology quality, reliability, timeliness and customer satisfaction. It is useful for helping firms get a sense of how competitive they are against other firms competing in the same market.
3. *Strategic benchmarking:* this benchmarking is not focused on a specific industry or market, but on identifying general trends that have assisted firms, from any sector, to secure and retain market dominance and competitive advantage.

8.8.1 The Benchmarking Process

The benchmarking process typically follows a multi-stage design and this has ranged from four to twelve steps, although a "generic process" with five stages has been used in some case examples, which is based on the approach taken within Motorola (Bogan & English, 1994). This sees the following five stages:

1. *Launch;* Decide what to benchmark.
2. *Organise:* Find companies to benchmark.
3. *Reach out:* Gather the data.
4. *Assimilate:* Analyse the data and integrate.
5. *Act:* Recalibrate and recycle the process.

This model is relevant for large firms and in the first *launch* stage, it is important that management decides what areas within the company it wishes to focus upon for future improvement. This should be a strategic decision rather than simply reacting to areas of low quality or productivity. As the process moves into the *organise* stage, the senior management should identify existing areas of known weaknesses, and thoughts about future areas for improvement. It will also need to secure agreement from internal and external stakeholders that have direct roles to play in the processes being examined. The benchmarking team assigned to this project will then prepare a plan of action. This team should be around three to eight people and their plan should outline the purpose, justification, problem being addressed, any relevant data, potential KPIs and benchmark measures, methodology and resources required.

In the *reach out* stage the team commences talking to people in the areas being examined, collecting data and relevant evidence. This should involve a review of internal company documents and data as a form of "literature review" prior to any primary data collection via interviews, surveys or direct observations. During the *assimilate* stage the data is collated, analysed and a final report developed that outlines the recommendations and lays out the strategy for an implementation of these findings. The amount of data that may be found within the final report is likely to be significant for a large organisation. As a result, it is recommended that the project team use graphs, charts and visualization of data to make it easily digested by senior managers. It is also important that there are clear examples of how the firm that is being benchmarked is compared against other firms so as to illustrate how the data identifies areas for action. Finally, in the *act* stage the benchmarking team should work with management and the individual areas that will be impacted, and develop a plan for implementing any recommendations that may have emerged from the review and that have been accepted by the senior management. This process needs to be a positive one designed to help the impacted areas achieve best practice (Bogan & English, 1994).

8.8.2 Benchmarking Processes for SMEs

For SMEs a six-stage approach comprising: (i) preparation and planning; (ii) research and data collection; (iii) observation; (iv) analysis, (v) adaptation, and (vi) improvement activity via implementation and review has been proposed by some researchers (McAdam & Kelly, 2002; Ashford, 2007; Marie et al., 2008). Table 8.2 outlines these steps.

It is important to note that benchmarking requires the ability to make comparisons across multiple workplaces and firms. Often, the tools and approaches used are too complex for SMEs, and it can be difficult for them to gain access to comparison

Table 8.2 The steps of a benchmarking process

Step	Aim of the step
Plan	To determine critical processes to compare, to define types of data to be collected on these processes and to plan the various steps of the project.
Research	To determine the measurements to be used, to identify the future partners of the benchmarking and to collect the data already available at these partners.
Observe	To collect the complementary data at the partners and to observe the similarities and differences in the processes.
Analyse	To analyse the current practices and to decide on the operational or strategic practices to carry out on the process.
Adapt	To understand new practices and to adapt them to the specific context in which they will be applied.
Improve	To implement and to follow up the implementation of these practices.

Source: Maire et al. (2008)

data. In addition, benchmarking can be focused on a wide-range of areas relating to the company's activity, and should include both financial and non-financial data, as well as the assessment of areas that can be measured relatively easily (e.g. cost, time, quantity produced/consumed), as well as those that are less easily measured (e.g. customer and employee satisfaction, perceived value).

8.8.2.1 The ISC Matrix

Maire et al. (2008) have suggested that SMEs seeking to undertake benchmarking make use of an ISC Matrix, which refers to the model outlined in Table 8.3, where the matrix has the six steps of: *what, who, when, where, how* and *why*; with the three focal points of: *Is*, *should not be* and *could be* comprising the ISC framework. This matrix is used as a structure for data collection and each of the questions within the matrix boxes should be addressed and the results recorded in these boxes as part of the benchmarking process.

The first area relating to the *is* focuses on the actual process that is observed during the benchmarking audit. The questions that are asked here can be supplemented with a wider range of items that help to generate sufficient data to make reliable assessments. The *should not be* element was added to provide a focus on things that the company may either have already identified, or that it anticipates will be relevant to future activities. The final *could be* element addresses the potential for improvement of the existing process.

Table 8.3 ISC Matrix for SME benchmarking

Step	Is	Should not be	Could be
What	What types of problem are tackled in this process?	What types of problems should not be tackled in this process?	What types of problem could be also tackled in this process?
Who	Who is an actor and who is responsible for the process, including outsiders?	Who should not be an actor or responsible in the process, including outsiders?	Who could be an actor or responsible for the process, including outsiders?
When	How often is the process set up and controlled, including outsider involvement?	How often should the process not be set up and controlled, including outsider involvement?	How often could the process be set up and controlled, including outsider involvement?
Where	In which departments/areas of trade has the process been implemented?	In which departments/areas of trade should the process not be implemented?	In which departments/areas of trade could the process be implemented?
How	How is the process considered and managed by senior management including allocation of staff?	How should the process not be considered and managed by senior management including allocation of staff?	How could the process be considered and managed by senior management including allocation of staff?
Why	What are the results expected of the process?	What are the results not expected of the process?	What are the results that could be expected of the process?

Source: Maire et al. (2008)

8.8.2.2 The OMP matrix

Maire et al. (2008) also offer a second matrix known as the *operational management part* (OMP), which is illustrated in Table 8.4. The OMP matrix is designed to describe the practices used in the processes that are being benchmarked. Some elements of the matrix focus on the operational part of the process, dealing with how the process is being carried out. The remainder focus on the management of the process, which relates to how it is being controlled. According to Maire et al. (2008) this matrix is useful as a generic framework for most organisations to use.

> **For example,** … This matrix, called OMP matrix, is based on a census of generic activities that any process uses or must implement. These activities are divided into two parts: An *Operational* part and a *Management* part … (Maire et al., 2008, p. 769).

Table 8.4 OMP Matrix for SME benchmarking

Input data	Activity	Output data
Are all input data formalised?	Is the process formalised?	Are all output data formalised?
Operational Level:		
Axe	*Action*	*Assistance*
To carry out (realise):	To carry out (realise):	To carry out (realise):
Balance and select critical themes.	**Assess initial state of all subjects.**	**Analyse cause of non-performance of subjects.**
Define problem, needs and tasks.	**Measure performance on all tasks.**	**Build schedule of interventions on subjects observed.**
To control:	To control:	To control:
Build schedule of all tasks.	Optimise means of operation of subjects observed.	Establish solutions planned for each subject.
Follow all tasks to monitor performance.	Follow up all subjects and react in case of deviation.	Follow, react and validate all improvements made.
Management Level:		
Organisational	*Human*	*Technical*
Structure:	Individual skills:	Material:
To define – are people allocated to this task?	To train – is formal training needed for this task?	To adapt – is specific material allocated to this task?
To budget – is there a schedule for this task?	To give responsibility – who does this task?	To standardise – are the materials used in this task the same for all?
Performance indicators system:	Collective skills:	Information:
Design – are there KPIs to measure this task?	To capitalise – is there regular feedback on this task?	To post – are the results of this task publicly disclosed?
To follow – is this task reviewed?	To formalise – are there formal rules for this task?	To communicate – how do you engage people in the task?

Source: Adapted from Maire et al. (2008)

The *Operational* part of the matrix examines three main functions: *Axe*, *Action* and *Assistance*, with each function sub-divided into the tasks that should either be carried out (realise) and controlled. These are discussed as follows:

- *Axe function:* this focuses on all the activities that define the target objectives to be achieved by the benchmarking process. It has the sub-tasks of carrying out an identification and balancing of all the critical themes that need attention, as well as the definition of the problem to be addressed and the needs and requirements for each subject being reviewed. In terms of control, it requires the building of a schedule of all tasks for each subject, and the following of each subject through the process to assess and validate how they have achieved the desired objectives.
- *Action function:* this addresses the tasks that will enable the process to achieve its desired end state, and that provide information on the current status of the process. In this function the *realise* activities include assessing the initial state of each subject to be observed, and measuring the performances of these subjects and recording any performance results. In relation to control issues, the requirements are to look for ways to optimise the tasks being undertaken by the subjects being reviewed, and to follow how these subjects perform and take action in the case of any deviation of performance from the desired standards
- *Assistance function:* this focuses on the tasks that relate specifically to the analysis and control over any deviations of the process, plus tasks designed to achieve new solutions and increase performance. Here, the realise tasks are to analyse the cause of any non-performance by subjects, and to build a schedule of any interventions that might be made with the subjects being observed. Finally, in relation to the control actions, there is the need to establish solutions for the observed subjects, and then follow their behaviour and validate any improvements that might be made.

The *Management* part of the matrix examines three main factors: *Organisational*, *Human* and *Technical*, again with each function sub-divided into tasks that should either be carried out. These are discussed as follows:

- *Organisational factor:* this includes two sub-factors, *structure* and *performance indicators system*. The first relates to what the manager does to coordinate the system. This has two sub-tasks that relate to the need to define what allocation of personnel is required, and whether these allocations have been allocated resources within the budget. The second sub-factor encompasses the KPIs that the manager will use to ensure that the activity is undertaken to the appropriate level. This involves the design and monitoring of these KPIs.
- *Human factor:* this focuses on *individual* and *collective skills*, which relate to the individual's know-how, and the collective know-how of a group or team engaged in the same tasks. For the *individual skills* area attention needs to be given to training and delegation of responsibility. For the *collective skills* area the focus is on how to generate formal rules for the task and regular feedback to and from the team about the task.

- *Technical factor:* this examines *material*, such as plant and equipment, raw materials, facilities, and *information*, such as data reporting and communication. In the first case attention needs to be given to how materials are allocated within specific tasks, and whether or not there is a common or standard allocation of materials for the task. In the second case, the attention is placed on whether the results from a task are communicated to others, and how such communication is used to help engage people within the organisation.

Data collected from the OMP matrix can be analysed using either a quantitative or qualitative approach. Maire et al. (2008) suggest using a binary 1 = Yes, 0 = No coding for the various questions within the OMP matrix, although more detail is likely to be gathered and should be recorded.

8.8.2.3 Comparing the ISC and OMP Matrix Results

Once the data is collected in the ISC matrix and the OMP matrix for the firm and any comparison firms that have been examined within the benchmarking process, the results can be compared. Table 8.5 shows a structure for examining the differences between the ISC elements as identified between the firm being benchmarked and the comparison or reference firms. It is important to compare the findings from the target and benchmark firms across the *is*, *should not be*, and *could be* elements in terms of how they differ from each other.

In comparing the OMP Matrix, assessments should be made between the processes observed within the firm being benchmarked and the comparison firms that are providing the benchmarks. A series of comparisons should be made correlating the six elements of the OMP matrix. Maire et al. (2008) suggest that this be undertaken using quantitative analysis. However, a simpler approach can be undertaken using a layout as shown in Table 8.6, which lists in each cell the activities that were found to be common between the firms, those that were identified as being additional to the original reference process, and those that were identified as needing improvement.

According to Maire et al. (2008) many SMEs face difficulties in undertaking benchmarking and their proposed framework is an opportunity to provide a systematic approach to the process. Judgement should be used when undertaking such benchmarking and each small business should approach the task with the realisation that any comparisons will need to be placed into the context of an overall strategic aim of achieving best practice by learning from others and adapting existing systems via continuous improvement and innovation.

Table 8.5 ISC Matrix comparison

	Process to be improved	Reference process
Is	No difference … Major difference	No difference … Major difference
Should not be	No difference … Major difference	No difference … Major difference
Could be	No difference … Major difference	No difference … Major difference

Source: Adapted from Maire et al. (2008)

Table 8.6 OMP matrix comparison

	Axe	Action	Assistance
Organisational	1. 2. 3.	1. 2. 3.	1. 2. 3.
Human	1. 2. 3.	1. 2. 3.	1. 2. 3.
Technical	1. 2. 3.	1. 2. 3.	1. 2. 3.

1 = Activities in common
2 = Additional activities in the reference process
3 = Additional activities in the process to be improved
Source: Adapted from Maire et al. (2008)

8.9 Research into SMEs and Operations Management

The value of operations management, including QAMS, TQM, business process mapping and benchmarking, to SMEs is acknowledged within the research literature. However, there is no consensus over how best practice and success should be measured within SMEs. This is due to the unique nature of these firms, with high degrees of individualistic and idiosyncratic perspectives found across the SMEs themselves (Simpson, Padmore, & Newman, 2012). The adoption of formal systems of operations management have tended to be found most commonly amongst manufacturing firms, although they can be applied to firms from any sector (Prasanna & Vinodh, 2013). There is also a relationship between operations management and knowledge management within SMEs (Vazquez-Avila, Sanchez-Gutierrez, & Nuñez-Moreno, 2013), which is discussed further in Chap. 9.

Research also identifies a relationship between operations management (OM), entrepreneurial orientation (EO) and the performance of SMEs, with EO playing a mediating role. For example, a survey of small manufacturing firms in Kenya undertaken by Mkala, Wanjau, and Kyalo (2018) found that while no significant relationship was found between OM practices and firm performance in a direct sense, the relationship between OM, EO and performance was significant. This highlights the strategic nature of operations management within the SME and reflects the use that it can be put to by owner-managers who have an entrepreneurial focus and use it to secure competitive advantage.

Most SMEs lack formal systems of management and control across all areas. Formality in a small firm during its early stages of life is usually low due to the lack of systems, the dependence on a single owner-manager, or a small team of owners and/or managers who are essentially learning by doing. However, as a firm grows in size and complexity, it becomes increasingly important for it to adopt formal systems to protect its quality, provide guidance to its employees and relieve the pressure on its senior management having to personally direct all activities (McAdam & Kelly, 2002).

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Using Technology

9

9.1 Introduction

> ERP systems are standardized, off-the-shelf packages that, if implemented in SMEs, can deliver benefits such as efficient business processes, real-time access, visibility and accuracy of information, and effective information management (Seethamraju, 2015, p. 475).

Technology offers small business owners an opportunity to enhance the productivity of their firm, widen its marketing reach and significantly improve the level of control they have over information and communications within the company. The use of technology, particularly information communications technologies (ICT) by small businesses has grown significantly in recent decades. This is due to the proliferation of high performance, but relatively low-cost ICT and their enabling software. One of the main areas in which this technology use has manifested itself is in the area of online and 'in-the-cloud' business software for marketing, accounting, HRM and operations. This chapter examines the use of technology in SMEs such as *enterprise resource planning* (ERP), *customer relationships management* (CRM), and *knowledge management* systems (KMS). It also examines the use of *e-commerce*, *e-business* and *e-marketing* within the small business.

9.2 The Adoption and Use of Technology by SMEs

Technology, in particular digital technologies, provide SMEs with significant benefits. This can include enhanced access to market intelligence, global supply chains, online marketing and sales, operations management, customer relationship management, procurement, HRM, financial control and knowledge management. However, despite the benefits offered by technology, SMEs are generally lagging behind

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larger firms in the adoption and use of digital technologies such as ICT. For example, a study of SMEs across twenty-seven nations within the OECD group of economically developed countries, found that fewer than 28% had ERP systems (OECD, 2017, 2018a). Even fewer were making use of cloud computing or associated software systems such CRM (OECD, 2017, 2018b). Most SMEs were also facing challenges in managing digital security and privacy risks, due to a lack of expertise and knowledge (OECD, 2018a).

A study of SMEs in Australia found that most were late adopters of digital communications technology preferring to wait until the technology had been tried and tested (ACMA, 2014). This same study identified that most owner-managers recognised the benefits of technology, in particular for enhanced access to and engagement with customers, improved flexibility, time saving, cost reduction, data management and communications. They also felt that using technology would help their firms secure better competitive advantages. However, while a few SMEs were leading in their adoption and use of technology, many were laggards, largely due to a lack of awareness of how to adopt and why.

> **For example,** … I think SMEs lack the depth of understanding about the products on the market. They understand the high-level concepts but struggle to see how these would make sense in their own situation (Suzanne Roche, AIIA cited in ACMA, 2014, p. 4).

According to the ACMA (2014) study, there are four main factors likely to influence the adoption of technology within SMEs. First, there is the life-stage of the business. Younger firms, particularly those under the age of 2 years, were more likely to be open to technology adoption. Second, the age of the firm's owners or directors is likely to have an influence. Older aged senior managers were less likely to have an openness to the adoption and use of technology. Third, the type of industry is potentially influential. In this case, service firms were less likely than those in sectors such as manufacturing, to see the benefit of technology to their business. Finally, firm size was also found to play a role. Firms with fewer than 6 employees were less likely to adopt digital technology than their larger counterparts. Much of the resistance to technology adoption was attributed to the owner-managers lack of trust in information as to what technology they should use, and a lack of confidence in their ability to make a decision. Many felt they were faced with 'information overload' in relation to what new technologies they could or should adopt.

A review of academic research into the use of technology within SMEs across a range of countries and industry sectors found similar results (Mazzarol, 2015). For example, most SMEs possess 'basic' ICT systems such as computers for online banking, websites, emails, accounting and administration (e.g. word processing, basic spreadsheets). However, more advanced use of such technology includes CRM, ERP, virtual private networks (VPN) and supply chain management (SCM) software tools. Using more advanced systems could be beneficial to SMEs, but the most significant impact required the firm to combine technology adoption with enhanced staff training and support in its use (Colombo, Croce, & Grilli, 2013; Alonso-Almeida, & Llach, 2013). In fact, evidence from OECD (2016) research highlighted the importance of providing SME owner-managers with management education and training in the use of digital technologies, and combining this with benchmarking and technology implementation consulting.

A survey of SMEs in Australia found that 96% of firms owned a computer for the 'basic' activities described above. However, possession and use of more 'advanced' technologies was significantly less common (Yellow, 2018). In terms of *e-commerce* and *e-marketing*, this same study found that 72% of small and 95% of medium sized enterprises had websites. While just over half (57%) indicated that possession of a website had improved the effectiveness of their business, but the specific nature of this benefit was difficult for them to assess. Further, only 47% felt that their website was optimised for smartphones or other mobile devices. More specifically, 65% of medium sized firms indicated that their websites were not optimised in this way, which is interesting given that 82% of Australian consumers access the internet via mobile smartphone (Yellow, 2018). In terms of e-commerce, the study also found that just over half (54%) of SMEs took customer orders through their websites, while only 39% used their website for procurement. This pattern varied by sector. Of the firms that were not currently engaged in e-commerce, 39% were not interested in taking any future action to trade via the internet.

9.2.1 Technology Adoption Within SMEs

As noted above, the adoption and use of technology by SMEs generally lags behind that of large firms. This is due to a variety of factors including cost, perceived usefulness, and the overall capacity of the small business owner-manager to understand the complexity of the technology and how to implement it. The need for SMEs to embrace technology is recognised by governments, which also understand that a failure to adopt digital and online technologies may place many firms in jeopardy (OECD, 2017). The Department of Trade and Industry (DTI) in the United Kingdom developed an 'adoption ladder' for SMEs in relation to technology, specifically online digital technologies such as e-commerce and e-business applications. This model is illustrated in Fig. 9.1.

As shown in Fig. 9.1, the majority of SMEs commence their use of ICT applications with the 'basic' types such as e-mail and then a website. This is where most SMEs continue to operate. However, as they progress the focus shifts to e-marketing and e-commerce with transactions occurring via the firm's website. Depending on the firm and its industry sector, the business may move to the fourth stage and develop an e-business strategy. This is typically characterised by an integration of the firm's operations within a supply chain using online procurement and delivery systems. Finally, the business will reach a final stage of digital transformation via which it is closely integrated with its suppliers and customers, sharing data and developing a business model that is both highly networked and digitally managed (Taylor & Murphy, 2004).

This is a pattern of technology adoption found in other studies, in which the small business initially moves online through the publishing of a website, then

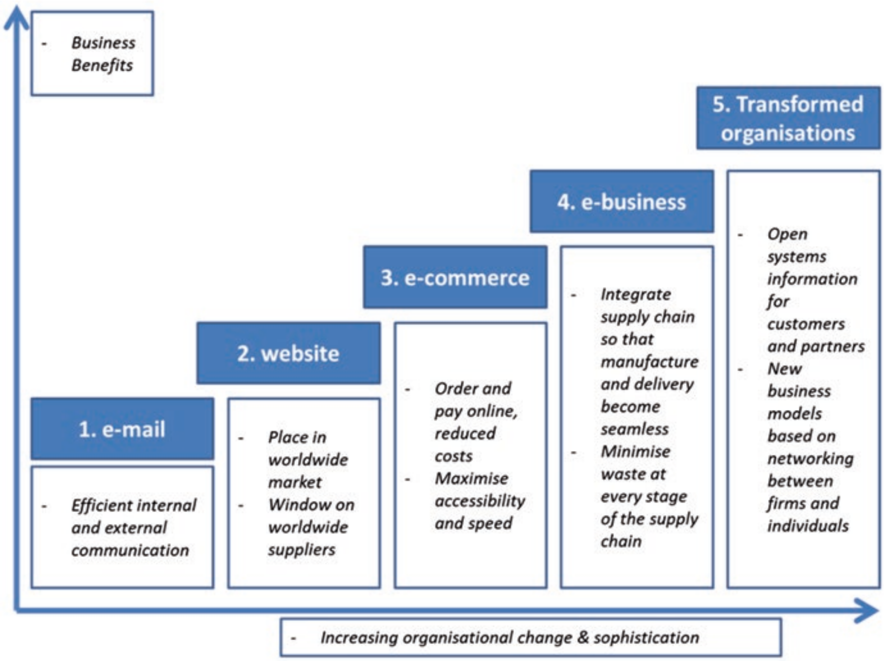


Fig. 9.1 DTI technology adoption ladder for SMEs. (Sources: Martin & Matlay, 2001; Taylor & Murphy, 2004)

online exchanges in the form or ordering and/or purchasing with suppliers and customers, and then more complex 'advanced' systems that enable the firm to manage the supply chain and business operations via use of e-business, ERP, CRM, SCM systems (Foley & Ram, 2002). For SMEs that are prepared to invest in the development of digital, online technologies, the general rewards are significant enhancements in sales and profitability. However, there can also be substantial costs for such firms in both the initial expenditure for new technology, and the training and support needed for employees (Karagozoglu & Lindell, 2004).

Research by Karjalutoto and Huhtarnaki (2010) into the evolution of micro retail businesses in Finland, from a 'bricks and mortar' business model to an online one, found that the process moved through four stages and was influenced by at least four major factors. Figure 9.2 illustrates this process. During the first stage the business is engaged at a basic *informational level*, with the internet used for web-based research and the firm's website for a one-way transaction that serves little more purpose than that of an online brochure. In the second stage *communicational level*, the business uses its website and email system for a more interactive dialogue with its customers and potential customers. From there the firm moves to the *transactional level*, with an online store built within the firm's website that has the capacity

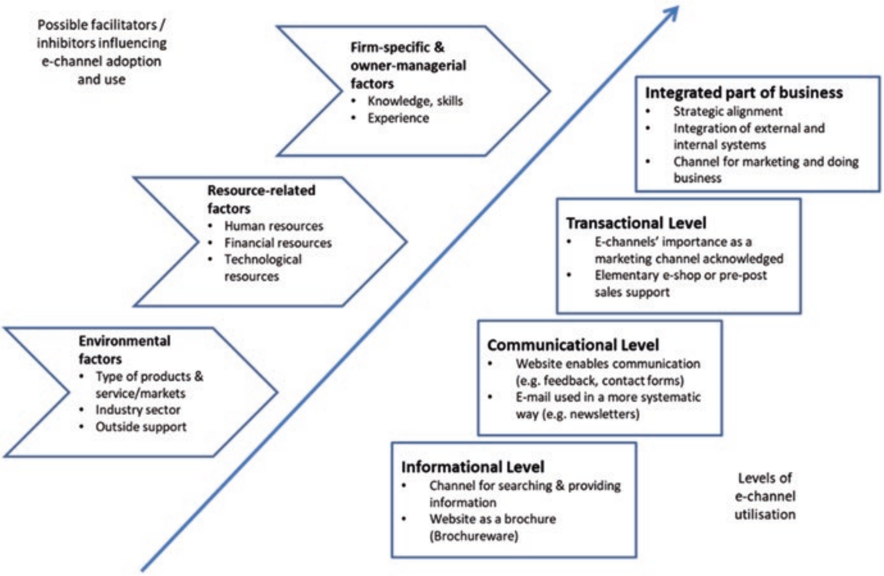


Fig. 9.2 E-channel use in micro-firms. (Source: Karjalutoto & Huhtamaki, 2010)

to allow customers to place orders and make payments. Finally, by the fourth stage the firm has made e-commerce and e-marketing an *integrated part of business*, with a close strategic alignment between the firm's marketing and sales activities and the website and related CRM systems.

It is worth noting in Fig. 9.2 the three potential facilitators and inhibitors for the firm's engagement with online e-commerce and e-marketing activities. These include *environmental factors* such as the firm's industry sector, types of products or services and availability of outside support. Also, important are *resource-related factors,* such as the firm's human, financial and technological resources. Finally, the *firm specific owner-manager factors*, such as the owner-manager's experience, skills and knowledge about technology. These factors have been identified as common to most SMEs.

The slow adoption and use of digital technologies by SMEs have been identified by the OECD (2017) as a cause for serious concern. This reflects a recognition that such technologies are now becoming essential for business survival.

> **For example,** … The adoption and effective use of ICT hardware and software is a form of business innovation, but also a prerequisite and further driver of other forms of business innovation. Certain management software (e.g. customer relationships management or enterprise resource planning) can support the professionalisation of small business management, but may require upstream improvements in managerial skills through training and consulting (OECD, 2018b, p. 5).

9.2.2 Digital Transformation and SME Readiness for Industry 4.0

SME adoption and use of technology needs to be placed into the wider context of the digital transformation that is currently spreading throughout the world. This is now becoming increasingly important as the pace of digital technology sweeps through the majority of industries creating disruption in what is referred to as the *Fourth Industrial Revolution* or *Industry 4.0* (Lasi et al., 2014; Schwab, 2016, 2018). The *Industry 4.0* concept relates to the diffusion of a range of digital technologies that promise to significantly enhance productivity, lower cost, improve quality, flexibility and speed to market (Moeuf Pellerin, Lamouri, Tamayo-Giraldo, & Barbaray, 2018).

Industry 4.0 Technologies Relevant to SMEs

- *Internet of Things (IoT):* describes the network of digital devices interconnected via wireless ICT systems that can share data, including vehicles, plant and equipment, appliances.
- *Cyber-physical-systems (CPS):* equipment or other mechanism that is controlled or monitored by computer-based algorithms and is integrated with the internet and can respond to external environmental conditions.
- *Cloud computing:* describes the use of remote servers to host, store, manage and process data rather than having it stored on a local server or computer.
- *Big data & analytics:* refers to storage, retrieval and analysis of large volumes of digital data of both a structured and unstructured nature.
- *Virtual reality:* the use of computer-generated simulation of three-dimensional images or environment to enable enhanced training, monitoring or control over technology.
- *Cyber security:* the protection of internet connected digital technology such as data, hardware and software, from unauthorized access, disruption, damage or theft.
- *Co-bots:* collaborative robots able to interact physically with humans in a share workspace.
- *Artificial intelligence:* the development of computer systems with the ability to perform tasks normally requiring human intelligence, including visual perception, speech recognition, logic and decision making.
- *Machine learning:* a development of artificial intelligence that provides digital technologies the ability to learn autonomously by relying on patterns and inference.

Sources: Kagermann, Wahlster, & Helbig, (2013); Moeuf et al., (2018).

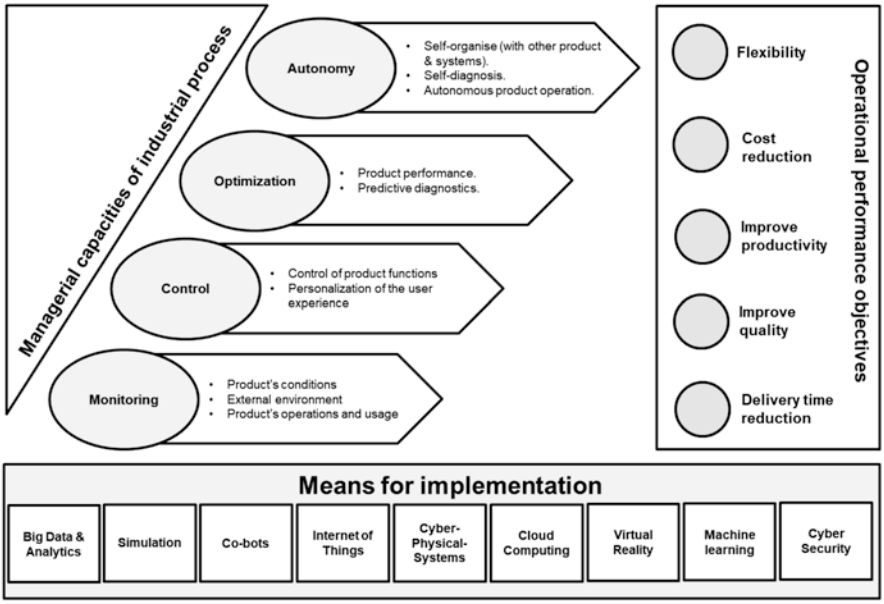


Fig. 9.3 Analytical framework for SME adoption of *Indusry 4.0* technologies. (Source: based on Moeuf et al., 2018)

According to the OECD (2018b), SMEs may get significant value from the use of *cloud computing*, and the potential for this to facilitate access to *big data* applications and analysis. However, this is just a small part of the overall range of technologies that will drive business competitiveness in the future. Moeuf et al. (2018) reviewed academic research into the impact of *Industry 4.0* on SMEs and found that the most common areas studied were *cloud computing* the *Internet-of-Things* (IoT).

Figure 9.3 illustrates the analytical framework used by them in their examination of the academic literature. As shown, the five major operational performance objectives being sought by SMEs in their adoption of these new technologies are enhanced flexibility, reduced costs, and improved productivity, quality and speed to market. The application of this digital technology within the firm is focused on at least four operational activities, which relate to autonomy, optimisation, control and monitoring. As shown on the bottom of Fig. 9.3, the main digital technologies that are likely to impact on SMEs in relation to this are: *big data*, *simulation, co-bots, IoT, CPS, cloud computing, virtual reality, machine learning* and *cyber security.* The impacts of these technologies are summarised in Table 9.1.

Table 9.1 Application of *Industry 4.0* technologies to SMEs

Technology	*Application and use*
Big data & analytics	Use by SMEs for data structuring and analytical services via use of cloud computing.
Simulation	Used for operation scheduling and scenario-based simulation.
Co-bots	Support to employees and improvement of work health and safety, but few current examples of use.
Internet of Things (IoT)	Used in conjunction with RFID technology for production feedback in real time. Also used in distributed production networks to enhance collaboration between firms via data sharing and communications.
Cyber-physical-systems (CPS)	Useful for production planning and control to help control and optimisation of plant and equipment within manufacturing operations.
Cloud computing	Primary uses focus on document sharing, collaboration, distributed production and resource optimisation. Specifically, planning and use of shared resources. However, requires firms to have systems able to connect with online servers.
Virtual reality (VR)	Use of smart glasses enables data to be distributed to user's field of vision in real time.
Machine learning	Allows for decentralisation of decision-making but few current examples of use.
Cyber security	Protection of company data against unlawful access or attack.

Source: Moeuf et al. (2018)

9.2.3 Technology Use by SMEs

Despite the opportunities that technology offers, SMEs tend to use ICT as a tool rather than a communications medium, preferring face-to-face contact with customers and staff (Nyame et al., 2013). Unlike larger firms, the average small business can adopt ICT systems quickly and adapt more quickly, although they also lack the resources to implement major technology platforms. For small business owners who seek to use technology as a source of competitive advantage, the application of ICT must move beyond facilitating daily work routines, and be used in strategic planning and the development of market opportunities. In this regard it is important to ensure that the firm's technology systems are aligned with its general strategic direction (Pollard & Hayne, 1998; Chong, Ooi, Bao, & Lin, 2014; Jones, Simmons, Packham, Beynon-Davies, & Pickernell, 2014). In its simplest form this might involve the use of data transfer and file sharing via intranets or data processing of customer orders and invoicing, through to such sophisticated applications as ERP and KMS. The use of customer databases can assist in CRM, *cloud computing* and *business intelligence* (BI) systems, and many large firms and public sector agencies require online supply chain management via the internet (OECD, 2004).

Let us now look at several key technology systems common to most businesses and relevant to SMEs. These are the *enterprise resource planning* (ERP) system,

Technologies Relevant to SMEs

- *Enterprise Resource Planning (ERP):* Use of ICT to integrate internal business systems for enterprise-wide optimisation of data capture, storage and reporting within a management information system.
- *Customer Relations Management (CRM):* Use of ICT to integrate external and internal business systems to monitor and support customer engagement throughout the full buying cycle and customer lifecycle.
- *Knowledge Management (KM):* Use of ICT to capture, store and report intangible assets within the firm, including knowledge, skills and competencies upon which to build a competitive edge.
- *E-Commerce:* Use of ICT to undertake transactions such as business to business (B2B) and business to consumer (B2C). Essentially selling goods and services via the internet.
- *E-Business:* The use of ICT to enhance production processes, customer engagement processes, and internal management processes. Includes ERP, CRM and Supply Chain Management (SCM) systems.
- *E-Marketing:* The use of ICT to undertake marketing and promotion that complement e-commerce and e-business strategies.
- *Social media use:* Social media use to support e-marketing and CRM activities.

Source: Mazzarol (2015).

customer relationship management (CRM) systems, *knowledge management system* (KMS), and their use in *e-commerce, e-marketing, e-business* and *social media* applications. In the following sections we will examine each of these technologies, and relate them to the management system applied framework that was introduced in Chap. 8 (see Fig. 8.3).

9.3 Enterprise Resource Planning (ERP) Systems

An *Enterprise Resource Planning* (ERP) system describes a process in which an organisation seeks to integrate all data processing and related systems. This will generally include data from marketing and sales, operations, CRM, HRM, financial management and supply chain management (SCM) systems (Nestell & Olson, 2018). The ERP system might serve as an overall framework or architecture upon which the other systems can integrate. A well-designed ERP system provides the firm's management with at least two benefits. First, it provides a unified view of the business across all functional areas. Second, it contains an enterprise-wide database into which all business transactions are entered, stored, processed, analysed and then reported back to management. It can provide management and staff with timely information that can be used to monitor and control the firm's operations as well as guide strategic planning and decision making (Umble, Haft, & Umble, 2003; Malhotra & Temponi, 2010).

Historically, ERP systems can trace their origins back to the 1960s, with the development of basic in-house inventory management systems for stock control and work-in-progress monitoring. This was part of the evolution of *just-in-time* management systems (see Chap. 8). By the 1970s, with the development of computer systems, more sophisticated *material requirements planning* (MRP) systems were established within large firms. These were used for production line scheduling and the control over the production process. By the 1980s, with the steady improvement of computer technologies these MRP systems had grown into enterprise-wide software systems and databases known as MRP II systems. They were used to link production operations with financial management control. In the 1990s these MRP II systems evolved into the current ERP systems and have continued to develop in terms of their sophistication (Umble et al., 2003; Nestell & Olson, 2018).

9.3.1 ERP Systems for SMEs

Until recently the ERP systems were primarily tools for large firms. However, this has changed with lower cost ERP software becoming available to SMEs. For the smallest firm, the default ERP system can be the accounting software package (e.g. MYOB, QuickBooks, Xero). These systems can be configured to manage payroll, customer invoicing, online banking, creditor management, taxation, point of sale (POS), and cash flow management. If used to build customer and supplier databases and generate regular reports for analysis within EXCEL spreadsheets, these accounting packages can provide many features of ERP reporting and control activities. They are not a substitute for a dedicated ERP system, particularly as the firm grows in size and complexity.

However, according to Olsen and Saetre (2007), the adoption of an ERP system for an SME is not a straightforward process. Standard proprietary ERP systems are designed around best-practice solutions common to most organisations. Yet, they may not be entirely suitable to the specific needs of an SME, with many features that are unnecessary. There is the opportunity to customise most proprietary ERP systems, but care should be taken to avoid having the ERP system dictate the firm's operational and strategic approach to its business model rather than the other way around.

The integration of an ERP system will involve linking up many existing data bases and operating systems. Care needs to be taken to ensure that these existing systems, which have been created for a reason, are not adversely affected, and this will also apply to any disruption to the efficient operation of production, marketing, sales and administrative activities. There is also a risk of buying a proprietary system in that it can place the SME under the control of the software vendor. Yet, if the firm seeks to develop its own in-house bespoke ERP system, the cost may be prohibitive.

> **For example,** … The 'black box' nature of many ERP systems is also a problem, as business processes embedded in the system may not be visible to the user. We have observed that companies have neither the necessary overview of what such systems can offer; nor of the reference models embodied within the systems. In some cases, companies may not even have a clear metaview of their own business (Olsen & Saetre, 2007, p. 56).

Nestell and Olson (2018) summarise the advantages and disadvantages of different types of ERP solution. These are listed in Table 9.2, where it can be seen that there are at least six sources of ERP system solution. According to Nestell and Olson (2018) the first of these, the *customised in-house system*, is useful if the firm wants to use the ERP as a foundation for its long-term competitive advantage. However, this is a traditional and now largely outmoded approach that will be both difficult and very expensive, particularly for most SMEs.

The second option, the *standalone advanced planning system* (APS), is both widely available and may offer SMEs with an interim solution that is less expensive that a full ERP system. They suggest that an APS might be integrated with financial, accounting and other software systems, that can supplement the APS as a planning tool for operations and supply chain management. While it is not a complete ERP solution, it may be a cost-effective way for a small firm to get started with an ERP implementation.

The third option, the *full vendor ERP system*, is likely to be supplied by either Oracle or SAP, which are the global leaders in this type of software. However, while these firms will claim to be able to offer solutions to SMEs, they are essentially

Table 9.2 Advantages and disadvantages of different ERP software solutions

Method	*Advantages*	*Disadvantages*
Customised systems developed in-house	Best fit with organisation's needs.	Most difficult to develop, most expensive and slowest.
Standalone advanced planning system (APS)	Less expensive and much simpler implementation.	Harder to integrate with other applications.
Full vendor ERP products	Relatively fast, less expensive, efficient and easier to upgrade.	Inflexible, and force employees to change work methods.
Selected vendor modules	Less risk and relatively fast, also least expensive vendor approach.	If expanding there will be long runtime and higher costs.
Customised vendor ERP systems	Retains flexibility while keeping vendor expertise.	Slower and usually more expensive.
Best-of-breed approach	Theoretically gains best of all systems.	Difficult to link modules, is slow and needs middleware.

Source: Nestell & Olson (2018)

Table 9.3 Critical success factors for ERP implementation

Critical success factors	*Key questions for consideration*
Have a clear understanding of your strategic goals.	Why is this ERP system needed?
	What specific outcomes and results are desired?
Management support for ERP systems.	Is senior management supporting the system?
	Will they provide leadership to get it implemented?
Excellent project management.	Have clearly defined objectives been established?
	Can you develop work and resource plans plus project monitoring?
Organisational change management.	Is the ERP viewed as just a software tool, or is it seen as a mechanism to change how the entire organisation works?
	Is there an awareness that the ERP will require changes of behaviour and workplace culture?
Implementation resources and processes.	Is there a skilled implementation team available?
	What will be the approach to ensure data accuracy?
	What education and training of staff will be made available?
	Have focused performance measures been established?

Source: Umble et al. (2003)

focused on the large firms with multi-million-dollar budgets for software expenditure. These firms will also have many hidden costs in relation to consulting and annual maintenance contracts, training costs (Nestell & Olson, 2018). At time of writing, Microsoft was offering a "mid-market" ERP software solution known as *Microsoft Dynamics GP*. This was originally developed by Great Plains Software in the early 1990s and was acquired by Microsoft in 2001. The product runs in Microsoft *Windows* and has some customisation potential. Its functionality includes modules for financial management and accounting, supply chain management, purchasing, HRM and production.

The final three options are *selected vendor modules*, *customised vendor ERP systems*, and *best-of-breed* systems. The first of these is essentially purchasing a sub-component of a much larger ERP system, and while this may be less expensive, it can result in a lack of functionality and vendor support. The next option can offer a more tailored solution for the firm, but it will require a significant amount of in-house IT support and competence, which may be unavailable to most SMEs. Finally, the adoption of a 'best-of-breed' ERP system may seem like a good approach, as it involves 'cherry picking' the best modules from a range of systems and configuring them into a final ERP system. However, as Nestell and Olson (2018) state, … "it usually creates more trouble than it is worth."

9.3.2 Implementation of ERP Systems

Table 9.3 outlines a list of critical success factors for the implementation of an ERP system. Also shown are a series of related questions that should be asked and answered for each factor. As can be seen, the ERP system is strategic asset within the business and if properly designed and implemented, it can be a source of enhancing the firm's overall competitiveness. The cost of ERP systems has reduced significantly in recent years and is now within the reach of SMEs. However, the process of ERP system design and implementation is a strategic process and should not be viewed as a simple software application purchase decision. It is important that the implementation of an ERP system be managed by a senior executive within the business, who can work closely with third-party experts who have the necessary experience of implementation in a phased and coordinated manner. Care needs to be taken in the management of existing databases with a degree of manual conversion and proactive management of project risk and internal change (Malhotra & Temponi, 2010). It is a company-wide system and as such it will have company-wide impact (Gonzalez et al., 2015).

> **For example,** … The decision to implement an ERP system in an SME usually has a profound impact on the organization and all members of the supply chain. The ERP implementation should be planned very carefully. The needs and business process meticulously documented. There must be a clear and documented understanding of the impact of an ERP implementation on each business process and on the supply chain (Malhotra & Temponi, 2010, p. 36).

9.3.3 Benefits of ERP Systems to SMEs

Research into the benefits of ERP systems to SMEs suggests that they can be a major source of enhanced productivity and quality. However, as with any complex system, there are a number of factors that may influence the final outcomes. For example, a study of 256 small and large manufacturing firms in South Korea found that the benefits of ERP systems were greater amongst the larger firms. This was explained in relation to the difference in buyer-supplier relationships that the small and large firms enjoyed within their supply chains. Where the large firms have ERP systems that meet industry best practice or common standards, those of the SMEs are often more bespoke in nature. In addition, the SMEs may find that the ERP system they have adopted is designed for the benefit of a large customer further down the supply chain. This can restrict the small firm's ability to deal with a wider range of other customers and suppliers (Katerattanakul, Lee, & Hong, 2014).

As noted above, the implementation of the ERP system is a critical aspect of its ultimate success. Selecting the right ERP software vendor, and their ability to work with the company to customise the system, provide training and support throughout its lifecycle, are all important. This includes the ability and willingness of the vendor to work with the company in co-creating improvements and innovations within the ERP system (Seethamraju, 2015). The role of the firm's senior management is also critical to ERP system success. For example, a study of 352 SMEs in Denmark found a positive relationship between the firm's growth and profitability, and the moderating effect of the perceived complexity of the ERP system. For small, young firms, growth and profitability were better over the short term if the ERP system was characterised by relatively low levels of complexity. However, while there is a need

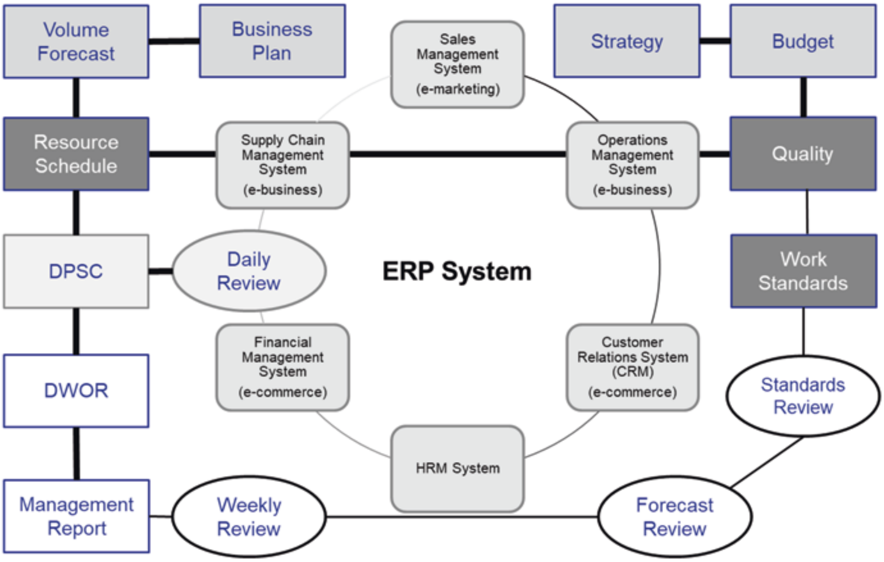


Fig. 9.4 Application of the ERP system within the management system

for firms to adopt more sophisticated ERP systems over time, it may be counterproductive for the firm to adopt systems that are too complex in its year years (Schlichter, Klyver, & Haug, 2018). This finding is common sense, and suggests that an SME should adopt ERP systems that are appropriate to its needs and within the competence of the firm's management and staff to implement, but with the ability to scale them up as the firm's own complexity and size increases.

9.3.4 Application of an ERP System Within the Management System

In Chap. 8 we introduced the *management system applied* framework (see Fig. 8.3). This describes the various elements that comprise the flow of information from the *forecast world* of forecasting, planning and feedback, through to the *real world* of scheduling, control and reporting. That framework is designed to provide a conceptual model of how a management system needs to operate. As discussed above, the ERP system is designed to provide an integrated software suite that can connect the various elements of the management system to efficiently maintain the optimal flow of information between the firm's different functional areas.

Figure 9.4 provides a conceptual model of how the ERP system works within the overall management system. It can be seen that the ERP system connects the various databases and software relating to the sales and marketing, financial management, CRM, HRM, operations management and SCM systems. Each of these sub-systems is part of a wider set of strategies that relate to e-marketing, e-commerce and e-business activities undertaken by the firm. The circular loop connecting these six sub-systems reflects the importance of having the ERP integrate the data that is generated from these activities, and allow it to be stored, retrieved, integrated, analysed and reported in a reliable, accurate and timely manner.

Surrounding the ERP system are the main elements of the applied management system. At the top on the left-hand side are the volume forecast and business plan, which flow onto the resource schedule, daily planning schedule control (DPSC), daily weekly operating report (DWOR), management report and weekly review. On the right-hand side are the firm's strategy and budget, which then flow onto the quality, work standards, standards review and forecast review, before feeding into the weekly review. The relationship between the resource schedule and quality is a key point of contact within the management system, and it is also where the ERP system has important connections across the operations management and SCM subsystems. Another important point of connection is the daily review, which exchanges information to and from the ERP and the DPSC. In turn, this informs the DWOR, management report and weekly, forecast and standards review.

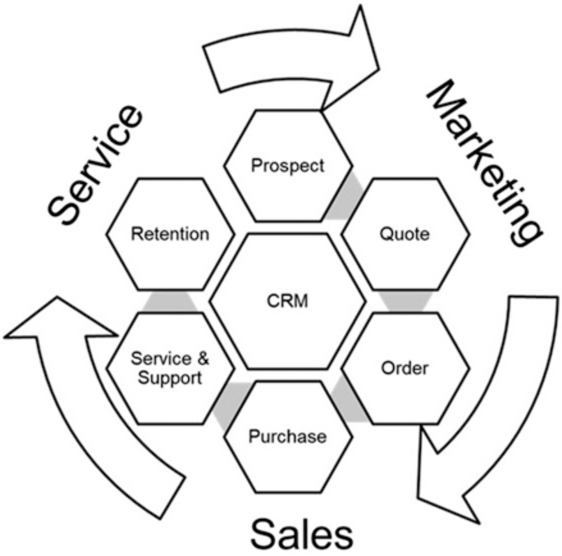
The choice of a given ERP system software should be based on the specific operational tasks and business strategies that are relevant to the firm planning to adopt it. Most ERP system are designed around modules that can be configured to the specific needs of a particular industry (e.g. health care, manufacturing, retailing, airlines). The customisation of an ERP system as part of its implementation is likely to benefit from a review of the firm's existing operations via business process analysis (BPA) and business process mapping discussed in Chap. 8. By first knowing the functional dynamics of the existing business processes, it will potentially easier to know how to configure the ERP system, which should be part of the firm's overall quality management and control mechanisms (Nestell & Olson, 2018).

9.4 Customer Relationship Management (CRM) Systems

Customer Relationships Management (CRM) systems are those tools used by businesses to capture, store and analyse customer information. CRM programs typically comprise operational components that usually involve a computer-based data recording system for tracking customer contacts or transactions. CRM systems can also have collaborative components that can include self-service kiosks via websites or voice mail. They may also have analytical components that allow the system to assess customer behaviour, monitor trends and provide reports on purchase behaviour. The CRM system is part of a wider strategic process that encompasses how the business engages with its customers from the moment of initial contact, through their active patronage of the business, to the relationship that might follow any termination of this patronage (Reinartz, Kraft, & Hoyer, 2004). While CRM systems have traditionally been found within large firms, this has changed in the past 20 years with the emergence of relatively low-cost, CRM systems that are suitable for SMEs (Kontzer, 2005; Alshawi, Missi, & Irani, 2011).

The concept of CRM refers to a process by which the organisation monitors the activities of its customers and uses the data collected in the system, in analysis and

Fig. 9.5 CRM system elements



reporting to maintain a close and continuous monitoring of customer behaviour and how this impacts the firm's sales. It is essentially a strategic management issue that can be enhanced with the application of CRM software systems, and is as much a 'philosophy' as a business process.

> **For example,** … CRM is a strategic approach that is concerned with creating improved shareholder value through the development of appropriate relationships with key customers and customer segments. CRM unites the potential of relationship marketing strategies and IT to create profitable, long-term relationships with customers and other key stakeholders. CRM provides enhanced opportunities to use data and information to both understand customers and co-create value with them. This requires a cross functional integration of processes, people, operations and marketing capabilities that is enabled through information, technology and applications (Payne & Frow, 2005, p. 168).

The basic questions that a CRM system should answer in reference to management of its customers are:

- How well do we understand our customers?
- How can we sell more to our existing customer base?
- How can we add value to our top customers?
- What is our financial exposure to customers?
- How effective are our marketing initiatives?

Figure 9.5 illustrates the basic elements of a CRM system. As shown, the CRM system is configured to track the customer throughout the entire marketing, sales and after sales service cycle. It starts with the profiling of the customer as a prospect, then the stages of quotation, ordering, purchasing, service and support after the purchase, and long-term retention. Because most customers are likely to reorder or repurchase, the system must continue to track the customer and engage them so as to maintain their satisfaction and loyalty. The key measures that should be contained within a CRM system are:

- The cost of acquiring a new customer.
- The conversion rates of the customer throughout the prospect, quotation, ordering and purchase cycle.
- The retention rates for customers once they have purchased.
- The reasons for any loyalty or loss of existing customers, and
- The customers' perceptions of the quality of the products and/or services offered.

Overall, the CRM system represents a combination of business processes and associated technologies that enables the firm to better understand its customers, and to do so from their perspective, understanding who they are, what their needs and wants are, what their purchasing patterns are and how to offer them value (Couldwell, 1998).

9.4.1 Adoption of CRM by SMEs

Research suggests that the top three reasons given by managers from large firms for employing CRM systems are: (i) the need to enhance customer retention and loyalty (94%); (ii) the need to respond to competitive pressures; and (iii) the desire to secure a competitive advantage from superior customer service (73%). When initially implemented, most companies (93%) employed CRM contacts with customers via telephone call centres, with websites and face-to-face contacts coming equal second, followed by email and then fax (Fogarty, 2002). Today, this has reversed, with most large firms engaging with their customers via online, mobile digital platforms as evidenced by the proliferation of corporate mobile Apps, designed to maintain direct and almost continuous two-way communication between the firm and its customers, which provides a substantial amount of data to inform future marketing and sales activity (Weinberg & Pehlivan, 2011).

For small business owners the benefits of CRM systems are often twofold. First, CRM software tools are likely to significantly reduce time by automating customer information data capture, storage, retrieval and analysis. Second, they allow a more rigorous analysis of customer trends and activities to be undertaken as part of a wider strategic marketing effort (Burton, 2004). As noted above, CRM systems are increasingly common within small business, although as with many other technologies SMEs are relatively slow to adopt. For example, in 2005, a study of SMEs in the United States found that only 19% of small firms and 35% of medium sized firms were using CRM systems for sales and marketing (Spinelli, 2006). Nearly a decade later, another study of U.S. SMEs found that CRM adoption rates were around 45% (Nguyen & Waring, 2013). In Australia, research into CRM adoption amongst SMEs suggests that medium sized firms are more likely to have CRM systems (ACMA, 2014). However, for many small firms, their 'CRM' was based on an 'ad hoc' system.

For example, … A variety of solutions were adopted by SMEs to manage their customer data; however, this did not always involve a formal process or specific software, tending more on the ad hoc for some. While some SMEs had information saved in a simple database on the network (such as an EXCEL file), others had adopted a digital solution enabling them to access the information anywhere and at any time … the challenge with digital CRM solutions is that bespoke databases do not always fit with other DCT solutions such as electronic direct mail systems, which can make systems and processes more laborious and hence act as a barrier to the uptake of this DCT (ACMA, 2014, p. 33).

A survey of 102 large companies in the United States found that the biggest challenges to implementing a successful CRM strategy were: cost, dedicating resources, resistance to policy changes, awareness of CRM by top executives, vendor selection, conflicting organisational priorities, and elusive ROI (e.g. justifying the investment) (Fogarty, 2002). In a study of 568 SMEs, also in the United States, found that the main factors likely to determine whether or not a small firm adopted CRM, were the firm's existing IT resources and the mindset of the senior management towards technology adoption. The success of CRM adoption was found to be associated with the firm's IT resources and the level of employee engagement in the process. Further, most of the SMEs used CRM for customer-facing activities relating to sales and customer servicing. Of secondary importance were CRM use for data warehousing, customer intelligence and research, or customer loyalty programs. Relatively few SMEs used the full-power of the CRM software, due mainly to its cost and complexity (Nguyen & Waring, 2013).

Table 9.4 outlines the findings of a study of 30 UK-based SMEs and the factors that influenced their decisions to adopt CRM systems. As can be seen, there were at least four main areas under which these considerations were placed. The first of these was the *organisational* influences, which related to the management's perception as to the benefits of CRM, the company's overall strategic focus on customers, and then the cost of the system, the firm's capacity to implement and operate the system, and the possibility of external pressure from either customers or suppliers. The second area was *regulatory* factors such as competitive pressure, and the need to protect customer data security. The third area was *technical* factors relating to the cost, complexity and level of vendor support, as well as the CRM system's ability to integrate into existing ICT systems. Finally, the last area was *data quality*, which encompassed the need to ensure that data was captured, stored, managed and accessed in a manner that ensured it was fit for purpose (Alshawi, Missi, & Irani, 2011). This study found a high degree of commonality between the assessment process followed by SMEs for CRM adoption, and that used for the adoption of other ICT systems, and the process followed by large firms.

For example, … The findings of this study confirm that except for the organisation size dimension, the majority of factors influencing the adoption of CRM are similar to factors influencing SME adoption of previously studied ICT innovations. Moreover, the study confirms that there is a distinct similarity between the data quality factors that affect SMEs and those that affect large organisations when implementing CRM innovations (Alshawi et al., 2011, p. 382).

Table 9.4 Factors influencing CRM adoption and implementation in SMEs

Organisational	*Regulatory*	*Technical*	*Data Quality*
Perceived benefits of CRM.	Customer/client data security.	Cost of CRM system integration & support.	Data infrastructure & management.
Employee skills & competence in ICT.	Competitive pressure.	Pre-purchase assessment of CRM systems.	Evaluation & management of data quality.
Size of firm may impact CRM adoption.		Technical complexity.	Acquisition of data from internal & external sources.
Cost of CRM systems.		ICT infrastructure & integration.	
Business strategy focused on customers.		Vendor support.	
Pressure from customer or suppliers.			

Source: adapted from Alshawi, Missi, & Irani (2011)

Table 9.5 Key differences between conventional and relationships marketing

Strategy	*Conventional marketing*	*Relationships marketing*
Time frame	Short term	Long term
Marketing framework	Marketing mix	CRM with marketing mix
Price elasticity	Customers are price driven	Customers are value driven
Quality focus	Quality is focussed on output	Quality is focussed on interactions
Customer satisfaction measures	Market share	Customer retention
Customer information system	Infrequent satisfaction surveys	Ongoing customer feedback data
Interdependency between marketing and operations	Limited or not strategic	Substantial and strategic
Role of internal marketing	Limited and not strategic	Substantial and strategic

Source: adapted from Gronroos (1994)

9.4.2 Making CRM a Key Focus for the Business and Building Customer Loyalty

While CRM systems that employ software technologies can be a highly useful tool for enhancing sales and marketing activities, they need to be developed as part of a wider strategy that has been designed for customer relationships marketing and management. Adopting CRM as the key focus for a firm's marketing requires a strategic shift of thinking. Table 9.5 outlines the key differences between conventional marketing and relationships-based marketing. As shown, the transition from a conventional to a relationship-driven marketing business involves taking a long-term outlook and making CRM a central focus upon which strategy is built. The CRM oriented business views customers as valuable assets with whom it must establish long-term relationships that can lead to repeat business and become true partners.

Properly implemented a CRM system can track the customer's engagement with the business and from this can emerge data to allow the *customer lifetime value* (CLV) to be assessed and measured. The true value of a loyal customer, and their repeat business, is an important part of a firm's overall goodwill. Loyal customers represent a cushion of potential sales that if retained are almost like having a healthy bank balance to draw upon. Large companies refer to the life time value of a customer. For example, in the Ford Motor Company estimated that a loyal customer was worth approximately $142,000 over their purchase lifecycle, and Domino's Pizza chain estimated such a customer was worth around $5000 over a ten-year life of a typical franchise (Payne, 2005). However, in assessing CLV, care needs to be taken to consider what is a 'lifetime', which might be just one purchase, such as in the building of house, or the actual person's lifetime, as might be the case for a life insurance policy. Data analysis may also need to consider segmentation issues with different types of product or customer groups, and the frequency, size of purchase and overall loyalty of the customer (Lizotte, 2017).

Small Business CRM Software

At time of writing, there were a wide-range of CRM systems for SMEs, with many offering *cloud computing* solutions as well as in-house platforms compatible with Macintosh, Windows and Linux operating systems. A cross-section of these CRM systems includes:

Active Campaign: is an integrated marketing and CRM suite with a foundation in email marketing, targeted at SMEs, it offers in-house and cloud-based deployment and runs on Mac, Win and Linux.

Salesforce: is an on-demand cloud-based CRM suite for all sized firms with a focus on sales and support with features for sales management, e-marketing, customer service and partner relationship management. It offers in-house and cloud-based deployment and runs on Mac, Win and Linux.

Thryv: is a cloud-based CRM system for small businesses from a range of industries. It offers functions for appointment scheduling, billing and invoicing, contact management, and management of reputation, lead generation and social media. It offers in-house and cloud-based deployment and runs on Mac, Win and Linux.

HubSpot CRM: is a cloud-based CRM system for SMEs designed to track and nurture leads and analyse business metrics. It suits both B2B and B2C CRM in multiple segments. It offers in-house and cloud-based deployment and runs on Mac, Win and Linux.

FreeAgent CRM: is a cloud-based CRM system for firms of all sizes that is focused on building customer relationships. It offers an automatic pairing of the user's email to create and classify leads, provide follow up reminders,

(continued)

perform custom automations and track all interactions with the customer. It offers in-house and cloud-based deployment and runs on Mac, Win and Linux.

Infusion by Keap: is a cloud-based CRM system for small businesses that offers CRM, automated marketing and e-commerce functions in a combined package. Suitable for a range of industries. It offers in-house and cloud-based deployment and runs on Mac, Win and Linux.

Source: Software Advice (2019) www.softwareadvice.com

Many small business owners spend much of their time trying to win new customers or chasing up sales leads from prospective customers. While this is a necessary activity, it is usually five to 25 times more expensive getting a new customer to purchase, as it is to get a repeat purchase from an existing one (Gallo, 2014). For this reason, the loyal customer is valuable and deserves more attention than the prospective customer. A CRM strategy supported by appropriate CRM systems will be an essential aspect of this shift in marketing. Key questions that should be asked are:

- What percentage of customers are repeat customers?
- What is the typical customer's buying cycle?
- How much is a loyal customer worth to the business?
- How much time is spent winning new customers versus nurturing existing ones?

Creating loyal customers requires understanding of the customer buying cycle. This is the sequence of stages through which customers move prior to and after they actually make a purchase. It is important to find out the following things about customers:

1. What motivates them to buy your product or service?
2. What search process they go through to find a supplier?
3. How they learn about your business?
4. Why they chose to buy from you?
5. What their satisfaction was during and after purchase? and
6. What has made them buy again if they are repeat purchase customers?

Knowing these things can help turn suspects into prospects, prospects into customers and customers into advocates who sell your business for you. All of which can help to make running a small business a little easier. Collecting information on your customers purchase behaviour and storing it into a data management and CRM system will help to drive the business and build a solid foundation of loyal customers.

9.4.3 Social Media as a CRM Solution

Social media can provide SMEs with a low-cost entry-level form of CRM, or *e-CRM* (Harrigan & Miles, 2014; Harrigan et al., 2015). Social media takes a variety of forms:

- Social networking (Facebook, LinkedIn);
- Microblogging (Twitter, Tumblr, Medium);
- Photo sharing (Instagram, Snapchat, Pinterest, Imgur);
- Video sharing (YouTube, Vimeo, Periscope, Facebook Live).
- Social review (Yelp, TripAdvisor);
- Community discussion forums (Reddit, Quora).

The use of social media by SMEs is increasing, although the majority of firms remain only modestly engaged and less likely to embrace the early adoption of a wide range of what are ever increasing social media formats. A longitudinal study of Australian SMEs found that social media use over the period 2011–2018 grew from only 18% to 51%. Although the majority of firms (90%) used Facebook in the form of a company Facebook page. Other social media used were Instagram (28%), LinkedIn (24%), Twitter (15%) and YouTube (5%). Use of Pinterest, Blogs and Snapchat were less than 2% (Yellow, 2018).

A research study of social media use by SMEs in the UK found that many firms were actively using this type of online technology as an e-CRM system focused on developing an online community with customers, that could either supplement or serve as a proxy for their actual CRM system. These firms used the social media (across a range of types) to capture customer data and then used it to analyse customer (CLV) and referrals. It was viewed as a useful mechanism to enhance customer loyalty and communicate with customers, as well as collecting valuable psychographic and behaviour data about customers (Harrigan & Miles, 2014).

According to Mahajan (2015), as a market research tool, social media can be used by SMEs in a number of ways. This can include the measurement of web traffic metrics to the firm's website, and the 'scraping' of the internet for comments and reviews that might reveal customer perceptions of the company's reputation. Social media platforms such as Twitter, can also be searched in this way through 'hashtag' searches. Other strategies include data mining via use of key word searches, and even sentiment analysis (e.g. via TweetFeel or Sentiment) that provide data analytics on positive and negative comments.

9.4.4 Developing a Social Media Strategy

In the use of social media Hanna, Rohm and Crittenden (2011) suggest that managers seeking to develop a social media strategy start by *visualising the ecosystem*. This focuses on segmenting the media into platforms that are able to connect with or interact with each other. Before commencing any social media activity, a social media ecosystem mapping process should be undertaken to ascertain which platforms are likely to be best fit for the firm's particular needs. A second issue is for the firm's management to define the key outcomes that it hopes to achieve from the social media strategy, and identify measurable metrics that can be tracked and analysed. Third, before posting content to social media, the business needs to be clear on the message that it wishes to convey and to ensure that this story is developed in a consistent and integrated manner. Finally, the use of social media is not particularly expensive in direct costs, although it will require regular monitoring and management, which is time that needs to be accounted for. Also, a key element of social media is the relative trust and credibility that it can offer in comparison to more conventional paid advertising. Building up this trust and credibility will require care and a commitment to openness and honesty.

It is important to note that the social media sector is constantly evolving and requires a continuous engagement and monitoring by companies seeking to make best use of its potential. This is often challenging for SMEs that lack the necessary human and technical resources to keep fully up to date with this dynamic sector. This was illustrated in a study of 289 Australian and Singaporean SMEs, which found that social media was used as a part of an overall mix of marketing communications activities designed to enhance their firm's reach and to initiate and maintain contact with customers and potential customers (Mazzarol, Reboud, & Clark, 2015).

However, the use made of social media and the benefits gained depended on the nature of the business and the general skills and capabilities of the firm's owner-managers. In professional services firms such as consulting, social media was viewed as a useful part of the firm's overall marketing and customer/client engagement strategy:

> **For example,** … During the interviews, both owner-managers mentioned the importance of E-marketing. They indicated that E-marketing tools, especially LinkedIn, helped their businesses to expose to more professional customers, because LinkedIn was an electronic media which provided a common forum for professional communication and knowledge exchange. Therefore, customers with the same background and professions in LinkedIn might find the consulting services were more valuable for them [Field note, Independent Consulting] (Mazzarol et al., 2015, p. 16).

This also applied to retailing firms such as independent liquor stores:

> **For example,** … Finally, most companies are moving increasingly towards digital marketing: email lists, websites, Facebook pages etc. were generally found to be useful marketing channels by most businesses. While some proprietors admitted not being personally adept at social media marketing, they did recognise its importance and had team members able to drive this work [Field note, Independent Liquor Stores] (Mazzarol et al., 2015, p. 16).

For some owner-managers, the decision to use social media was highly focused and rather than trying to make use of a wide-range of social media platforms, only one or two were employed:

> **For example,** … His business is highly technological based. Therefore, the development of technology would definitely impact his business. He said the changing or uncertain economic times were always a part of his business. The uncertainty always brings challenges and business opportunities. Larry's business has a website. He also uses electronic media, like LinkedIn, Facebook, Twitter and personal Blog, to do marketing. He mentioned that LinkedIn was the best electronic media for marketing [Field note, Independent Consulting] (Mazzarol et al., 2015, p. 16).

9.5 Knowledge Management Systems

Knowledge Management Systems (KMS) refer to those processes and tools that an organisation uses to capture, store and disseminate knowledge or information sources. They can be very simple or highly complex and may or may not use technology, although the use of ICT systems can significantly enhance the effectiveness of KMS. For a small business, the most common KMS system is essentially the wisdom stored in the head of the owner-manager and key staff. However, it is desirable to use KMS architecture to capture, store and retrieve information as the business grows, or to provide some risk management protection against loss of key personnel (Bagshaw, 2000).

For many small businesses this may involve setting up an office filing system that can be readily interrogated and might include storage of files and databases within a computer server or hard drive backup. Where the firm has access to a local area network (LAN) and/or a common computer server, it should be possible to set up an intranet for capturing information. However, many *cloud-based* online sharing software is now available to SMEs at modest cost for this type of project management or file sharing. This includes such tools as: Drop Box Business, Google Drive, Drop Box, Box, Apple iCloud, Egnyte, Sugar Sync, ShareFile, SharePoint and Deep Transfer. Key elements of a KMS system include the mapping of available knowledge (e.g. where is it held), the identification of any gaps in this knowledge, an understanding of how knowledge is created within the business, and a process for knowledge capture and dissemination (Civi, 2000).

9.5.1 The Concept of Knowledge Management

The need for KMS within an organisation is founded on the theory of *knowledge management* that recognises the need for a systematic approach to the capture, storage and dissemination of information and knowledge at the individual, group and company level. Within organisations, knowledge is found in three general forms: (i) *cognitive knowledge*, as found in the mental constructs and theories used to guide thought and action; (ii) *skills*, which is the learned knowledge relating to how tasks are performed, and (iii) *embodied knowledge*, which is the manifestation of this knowledge process via the firm's products and services (Hedlund, 1994). At the individual or personal level, knowledge is found in either a *tacit* or *explicit* form (Polyani, 1962). Tacit knowledge is that found within the experience and wisdom of the individual, while explicit knowledge is that found in codified forms such as models, diagrams, text and other transferrable media.

In order for knowledge to move efficiently and effectively throughout an organisation, systems need to be designed to facilitate the transfer of knowledge from the tacit to the explicit, and from the individual to the group and then across the entire organisation. This process comprises three key stages (Hedlund, 1994):

1. *Articulation and internalisation:* in this stage tacit knowledge is made explicit via codification, which is usually via laboratory notes, written reports, patent disclosures, and presentations. Knowledge typically becomes internalised via the process of codification.
2. *Extension and appropriation:* in this stage the codified knowledge is transferred either via the distribution of research reports, publications, emails, corporate websites, development of training manuals and delivery of formal training programs. It is appropriated by the people who receive the codified information and/or training. An important aspect of this stage is the dialogue that transpires between the person communicating their codified knowledge and the people receiving it. Two-way engagement is the most effective means of ensuring that knowledge has been transferred. It may also assist the originator of the knowledge to enhance their understanding through critical review. This is a standard process in academic publishing of research whereby expert peer review is undertaken to give the authors and their research findings feedback and criticism to assess the validity of the work and enhance its overall impact.
3. *Assimilation and dissemination:* this stage follows on from the second and comprises the wide-spread dissemination of the codified knowledge throughout the organisation via training and extension programs. This can see work practices and routines changed to allow the new ideas and knowledge to become fully assimilated into the workforce and adopted. This is how a best practice benchmarking project might be implemented within a company (see Chap. 8).

The process of how tacit and explicit knowledge is exchanged within organisations is illustrated in Fig. 9.6, which shows the socialisation, externalisation, combination and internalisation (SECI) model developed by Nonaka and Takeuchi (1995) from their study of Japanese firms. This involves the initial *socialisation* phase of the conversion of tacit knowledge to tacit knowledge via direct dialogue, which is how one-to-one mentoring and tutoring or coaching might be undertaken. The next phase is *externalisation* where tacit knowledge is codified into explicit knowledge and transferred via written documents, presentations and other media. In phase three, the process of *combination* takes place, with the explicit knowledge from a range of sources being synthesised into new combinations of knowledge that is in-turn codified. This is how students or academics might read published works of others, and then configure this material into new books or research papers. Finally, the *internalisation* phase involves the individual taking the explicit knowledge that has been read or viewed, and developing from this learning knew tacit knowledge.

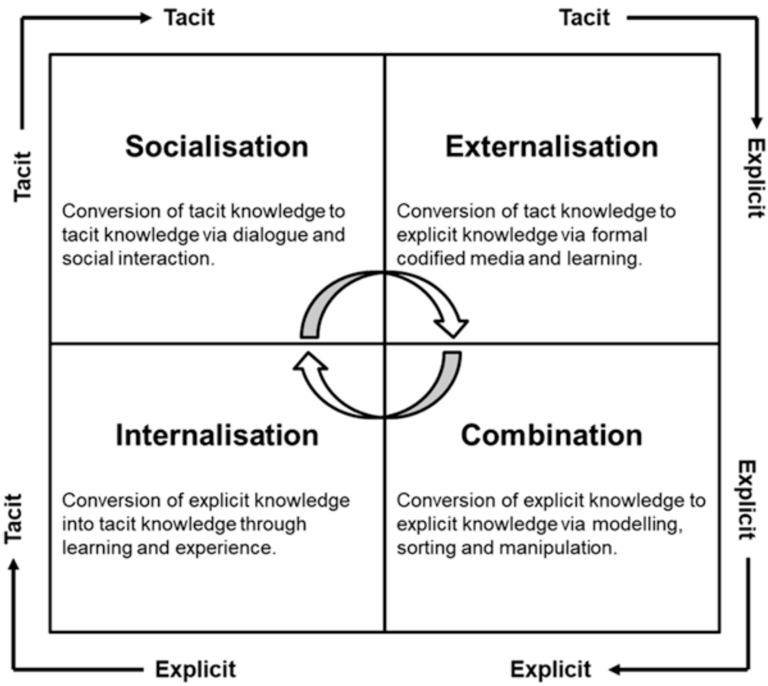


Fig. 9.6 The SECI model of knowledge transfer. (Source: Nonaka & Takeuchi, 1995)

Effective knowledge management requires more than just a KMS technology to be implemented. In fact, many KMS platforms are unable to achieve their full potential because the underlying culture of the organisation is not conducive to the sharing of ideas, communication via constructive but critical dialogue, and openness of information transfer across the enterprise (Neef, 1999). Knowledge management is essentially a person-to-person exchange process that can be supported and facilitated by technology, but that must be founded on a culture of trust and willingness to teach and learn (Coates, 2001). Unfortunately, knowledge is often used within organisations as a tool for power and control (e.g. knowledge = power), this is often a product of the culture that has developed within the company. Instead, the organisation needs to move to the model of *knowledge sharing and usage = much increased power* (Cook, 1999).

9.5.2 The Development of KMS Platforms

As noted above, the technology that comprises a KMS platform is only useful if the organisation's culture, structure and senior leadership is willing to embrace the foundation principles of knowledge management as a process. This requires any KMS system to be designed around the underlying philosophy of knowledge management, and integrated into the firm's HRM, performance management and related systems. According to Ragab and Arisha (2013), at least four approaches have been taken to the design of KMS platforms:

1. *Codification:* this approach focuses on the collection and storage of knowledge in databases that can be actively retrieved. Considered a 'hard' approach, it implies a 'people-to-documents' strategy and requires employees to add data to the KMS system for it to work. This approach can generate a powerful and comprehensive database, but it is heavily dependent on the ability and willingness of employees to continuously contribute data to the system. This may be burdensome and time consuming.
2. *Personalisation:* this approach is considered 'soft' and is designed around interpersonal, face-to-face social interaction. The main tools used here are not technologies but group meetings, seminars, workshops and communities of practice. It relies on a 'person-to-person' knowledge exchange and is facilitated by IT support where the KMS technologies are designed primarily to help connect people and reward them for sharing knowledge. This can take the form of internal corporate wikis or social media that provide online forums for formal knowledge exchange.
3. *People finder:* a third approach recognises the difficulty of collecting and storing tacit knowledge within a database, and instead seeks to map the location of people who might possess this knowledge. It has been described as a "Knowledge Yellow Pages" and comprises a searchable directory that allows the searcher to input key words and then locate selected individuals with such capability or expertise. This type of KMS still requires the regular updating of individual profiles.
4. *Hybrids:* this final approach is one that recognises the need for a more flexible and bespoke KMS suited to the specific needs of the organisation. This can combine different aspects of the previous three approaches, with different data management functions tailored for different types of data. At the minimum, this would recognise the need to separate tacit and explicit knowledge forms with a codification approach for explicit knowledge, and a personalised and/or people finder approach for tacit knowledge.

Like ERP and CRM systems, KMS technologies need to be approached as a strategic asset within the business. They require consideration of the role and outcomes that are expected of them. Ideally, they should be incorporated into the firm's strategic thinking about quality improvements, innovation and best practice benchmarking. An initial mapping of the firm's areas of knowledge should be undertaken. This might focus on at least three areas: (i) individuals with specific knowledge, competencies and expertise; (ii) groups or organisational units that possess collective knowledge, and iii) repositories of codified data that can be accessed, aggregated and shared (Hofer-Alfeis, 2008). Whatever the final KMS platform looks like, it must be able to consistently generate new knowledge, disseminate it throughout the company, and embody it into new products and services (Hedlund, 1994; Bagshaw, 2000). The design of the KMS should focus on:

- *Capability:* identifying and enhancing the overall knowledge and skills within the organisation.
- *Capture:* being able to identify, locate and capture tacit knowledge.
- *Codification:* converting tacit knowledge to explicit knowledge.
- *Connection:* creation of knowledge exchange networks.
- *Co-creation:* fostering the creation of new knowledge.
- *Conversion:* using knowledge for value adding within the firm (Civi, 2000).

The ability of a business to quickly acquire, assimilate, transform and exploit knowledge is recognised as the process of *absorptive capacity* (Zahra & George, 2002). It has been identified as a fundamental ingredient for innovation and successful commercialisation within businesses (Cohen & Levinthal, 1990). Further research has found a strong causal relationship between knowledge management and the firm's success in developing *dynamic capabilities* that are vital to competitive success. This research also highlighted the importance of the ERP system as a key component for linking the firm's KMS to enhanced dynamic capabilities. Also, of importance were internal file sharing, document management, data warehousing, and groupware email systems (Ser & Lee, 2004).

Figure 9.7 illustrates a conceptual model of a KMS platform. As shown, it will need to focus on the central knowledge exchange loop associated with the creation, encoding, sharing, retrieval and application / exploitation of knowledge. This will require two outer components, the first is the identification of the knowledge assets and this should receive inflows from the encoding stage. However, as knowledge is shared and disseminated, this should generate information flows into the database of knowledge assets. In turn, this can direct information to the knowledge creation process. The second component, comprises the learning process that is a critical part

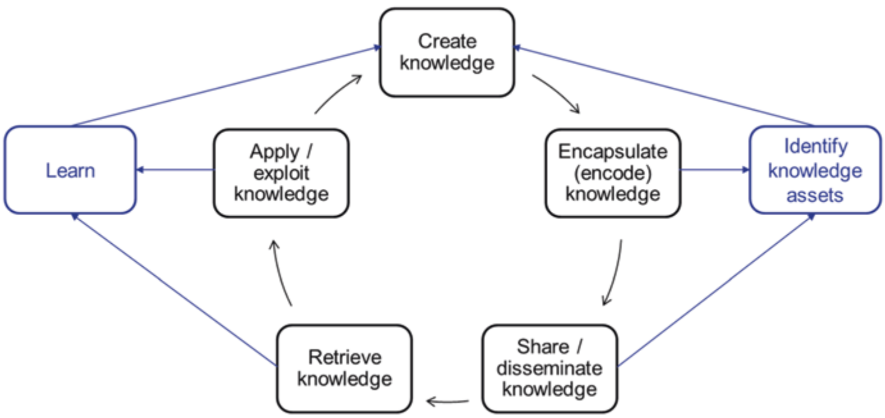


Fig. 9.7 A knowledge management process. (Source: adapted from Tan, 2000)

of the KMS. Here the linkages are between the retrieval, exploitation and creation stages, with the first two providing inputs to the learning process, and the latter receiving inputs from the learning process.

9.5.3 KMS Use Within SMEs

Although the field of knowledge management is well-developed within large firms, this is not the case for SMEs. However, reviews of the research literature into knowledge management and SMEs provide some insights into what is known about SMEs and knowledge management (Durst & Edvardsson, 2012; Cerchione, Esposito, & Spadaro, 2016). These findings are summarised in the following sub-sections.

9.5.3.1 General Perception of Knowledge Management Within SMEs

Not surprisingly KMS systems are less advanced amongst SMEs, and any KMS platforms are typically informal in nature and are rarely supported by dedicated ICT systems (Nunes et al., 2006). Most small firms lack the resources, personnel and specialist expertise required to implement them (Keogh, Mulvie, & Cooper, 2005). Any KMS found within SMEs is usually poorly aligned with corporate strategy (Pillania, 2008). While many SMEs are aware of KMS, few adopt such systems (Radzevicience, 2008). However, firms that have adopted KMS systems and strategies tend to achieve enhanced long-term sustainable growth (Slojärvi, Furu, & Sveiby, 2005).

9.5.3.2 Knowledge Management Implementation Within SMEs

The key factors influencing KMS implementation within SMEs are the firm's strategy and purpose, organisational culture, management leadership and support, and the ability to draw upon the expertise of employees (Wong & Aspinwall, 2005; Shelton, 2001). Most SMEs fall into four types: *unengaged*, *knowledge ownership oriented*, *learning and co-production oriented* or those that focus on *comprehensive KM practices* (Sparrow, 2005). In general, SMEs manage knowledge differently to large firms, with resource constraints a major influence on this behaviour. KMS implementation within SMEs also tends to be both informal and formal in nature, although few have a formal knowledge management strategy or make use of sophisticated ICT technologies (Hutchinson & Quintas, 2008; Edvardsson, 2009). The most common form of KMS adopted by SMEs tend to be relatively simple ICT tools that support internal activities, with knowledge exchange mainly tacit and interpersonal via one-to-one or small team exchanges (Evangelista, Esposito, Lauro, & Raffa, 2010).

9.5.3.3 Knowledge Management Use Within SMEs

The ability for SMEs to access external knowledge plays a significant role (Chen et al., 2006). For SMEs that are focused on value adding this is important. However, SMEs that are cost-focused generally show an ambiguous attitude to knowledge sharing (Levy, Loebbecke & Powell, 2003). The adoption of KMS systems is a valuable asset that facilitates the creation of virtual knowledge sharing networks. This leads to enhanced sharing of ideas, knowledge and experiences in relation to best practice and improvement methods. In turn, this helps SMEs become more competitive (Perez-Araos et al., 2007). Firms that can access all relevant sources of knowledge are more likely to succeed, while those that don't may struggle (Harris, 2008). For SMEs engaged in rapid international growth strategies, the adoption of formal KMS knowledge sharing and assimilation support systems is very important (Fletcher & Prashantham, 2011). The ability of SMEs to absorb and manage knowledge as a prior condition to successful adoption of innovations is heavily dependent on the strategic objectives of the owner-managers, and the firm's organisational culture (Gray, 2006). There is a positive relationship between the use of KMS systems and an SMEs ability to generate innovation (Alegre, Sengupta, & Lapiedra, 2011).

9.5.3.4 Overall Research Findings Relating to Knowledge Management in SMEs

As found by Cerchione, Esposito, & Spadaro (2016) the overall picture of what is currently known about the knowledge management process and KMS use within SMEs can be summarised as follows. While there has been a good deal of research undertaken into the factors influencing KMS adoption and use in SMEs in relation to the relative benefits it offers, there is relatively little research available on the barriers to KMS adoption. However, there is a substantive research that suggests SMEs gain significant benefits from KMS use, with impacts on financial performance, market share, product quality, customer satisfaction, new product development, human resource development, staff satisfaction, entrepreneurial growth, strategic alliance formation and enhanced use of resources. Despite these findings, there is a need for more research into the impact that KMS adoption and use has on strategic alliance formation amongst SMEs. Further research is also needed in relation to how SMEs use KMS tools, ICT support systems and knowledge management practices. The use to which SMEs use strategic networks (e.g. with other SMEs, customers and suppliers) to enhance knowledge management is also an area that needs considerably more research.

9.5.4 Application of a KMS System Within the Management System

Figure 9.8 illustrates the application of a KMS system within the wider management system. As shown, the KMS platform comprises the central cycle of knowledge creation, encoding, dissemination, retrieval and exploitation that were highlighted in Fig. 9.7. However, of importance is that they should be viewed as being integrated or connected with the firm's HRM system and skills flexibility matrix. As explained in Chap. 8, the skills flexibility matrix is a database that contains a list of all the employees within the firm that is matched against all the identified skills, competencies and qualifications that are required within the operational

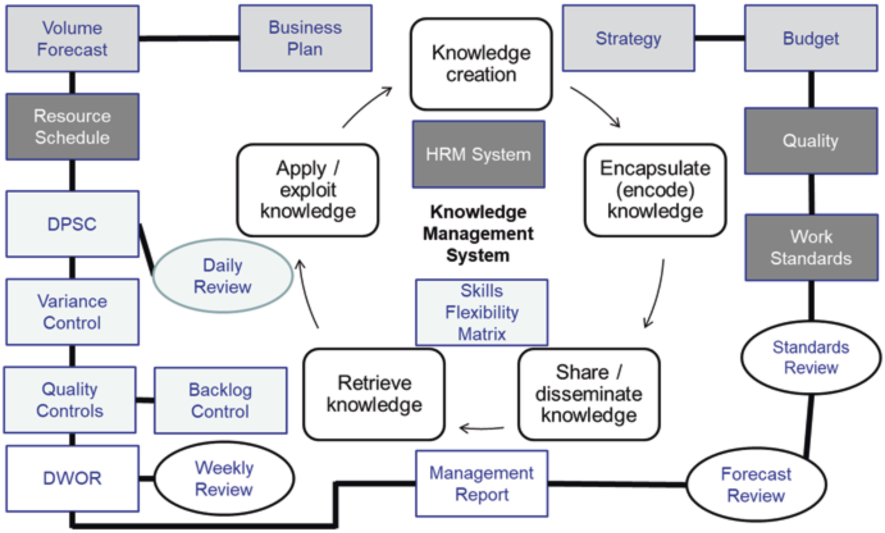


Fig. 9.8 Application of the KMS system within the management system

activities undertaken by the business. It offers management a mechanism to identify employees who are available to take on specific tasks, or to be developed within the firm's HRM training plan. By connecting the HRM and skills flexibility matrix with the KMS, it should be possible to build up a comprehensive picture of the overall level of expertise, knowledge and skills within the firm, where it resides and how it is being preserved and enhanced.

The KMS should be developed in conjunction with the firm's ERP and CRM systems so that data can be shared and accessed for analysis. As shown in Fig. 9.8, the KMS should exchange data with the wider management system via the key contact points of the daily review, weekly review, management report, forecast review and standards review. These reports and reviews should aim to incorporate metrics relevant to knowledge management.

9.5.4.1 Applying Metrics to Measure Knowledge Management

There are a wide range of metrics that have been proposed for the measurement of intellectual capital, and they encompass such things as: *human capital* (e.g. competence, qualifications, skills, experience); *structural capital* (e.g. relationships, alliances, intellectual property, investment in training, customer retention) (Liebowitz & Suen, 2000). However, there is a recognised connection between quality management (e.g. TQM) systems, as discussed in Chap. 8, and KMS systems. To this end, Calvo-Mora et al. (2016) have suggested that the European Foundation for Quality Management (EFQM) excellence model by used as a potential framework for guiding the development of a KMS system. This has nine criteria, divided into two categories:

1. *Enablers:* leadership, people, strategy, partnerships and resources, processes, products and services.
2. *Results:* people, customer, society and business results.

Table 9.6 provides a list of these EFQM criteria and the knowledge management issues and potential measures that might be applied for them. The specific nature of any KMS metrics will depend on the firm's particular requirements. It is likely that most of thee KPIs that might be developed to measure these nine EFQM criteria will be found from within existing areas (e.g. QAMS, HRM, marketing, financial and operations management). The primary objective for the SME owner-manager should be to use the KMS as a means to enhance existing systems rather than create an additional set of complex metrics.

It is recommended that the small business owner start with the nine EFQM criteria, and with the overall focus on knowledge management, draw up a list of potential KPIs for each of them. Once this is drafted, they should look within their existing management control and reporting systems to identify existing KPIs that might

Table 9.6 EFQM Model and knowledge management issues

EFQM Enablers	*KM issues and potential measures*
Leadership	Promotion of empowerment, creativity and innovation, or establishing incentives for people or groups to participate in improvement activities.
People	Identification and classification of employee knowledge and competencies to suit the firm's strategic and operational needs, configuration and delivery of relevant training programs.
Strategy	Development of policy and strategy from evidence-based data, KPIs and research.
Partnerships and resources	How is information and knowledge managed so as to support policy and strategy. What are the key knowledge assets both within the firm and within its networks? What is the quality and effectiveness of the KMS ICT system?
Processes, products and services	How is information managed within the CRM system and KMS system so as to deliver customer perceived value, satisfaction and loyalty.
EFQM results	*KM issues and potential measures*
People	Investment in people through recruitment, training and development, qualifications, involvement in improvement and innovation programs. Employee satisfaction with support for creativity, innovation and improvement.
Customer	Customer loyalty and retention rates, net promoter scores, satisfaction, market share, customer feedback and complaints monitoring, word of mouth referrals.
Society	Corporate image, values congruence with community, formation of alliances and collaboration with key stakeholders over common objectives with shared information.
Business results	Growth in sales, profitability, productivity improvements, number of new customers, number of new products, number of patents filed, return on investment.

Source: adapted from Calvo-Mora et al. (2016) and Liebowitz & Suen (2000) apply to each are. This should involve ascertaining how data for each KPI is collected, where it is stored, its overall quality, and how it might be applied to the KMS system without too much effort. Discussions with employees, customers, suppliers and other relevant third-parties around these issues might also help to build up a comprehensive picture of how information and knowledge flows within the company and across its supply chain.

The business process analysis (BPA) approach discussed in Chap. 8 may also offer a useful way to map the flow of information and knowledge exchange. If this is to be undertaken for quality enhancement and business improvement purposes, it is recommended that an examination of the knowledge management issues be included in this process analysis. The data collected from this will be valuable to help guide the development of the KMS system.

9.6 Developing a Digital Business Strategy

As discussed earlier, the adoption rate of technologies by SMEs generally lags that of large firms. However, for SMEs to remain competitive they will need to embrace technology and take advantage of the opportunities that it offers. The application of ICT by SMEs in the form of ERP, CRM and KMS systems has been addressed in the preceding sections. In this section we turn to the engagement of SMEs with online strategies, specifically those of: *e-commerce, e-marketing* and *e-business* activities.

9.6.1 SMEs and e-Commerce

The term *e-commerce* refers to the use of digital online technologies to manage business-to-consumer (B2C) and business-to-business (B2B) transactions, usually involving the buying and selling of goods and services via the internet (Daniel, Wilson, & Myers, 2002). Historically the growth of e-commerce has paralleled the evolution of the internet and the rise of digital online technologies, which have their origins in the 1980s, but did not really begin to expand until the 1990s with the roll out of fibre optic cables (Baker, 1999). Since that time internet and broadband technologies have increased, as has the proportion of households with internet access and the growth in online consumers.

For example, in 2018 global internet usage as a proportion of the world's population was estimated to be around 55%, with per-capita internet access and use ranging from 95% in North America and 85% in Europe, to 36% in Africa (IWS, 2018). This suggests that around 4.3 billion people throughout the world are online, with many using the internet to search for and potentially buy products and services. Furthermore, the proportion of consumers who are accessing the internet via mobile smartphone platforms is rapidly increasing (Yellow, 2018).

E-commerce is both an opportunity and a threat to many SMEs. While some small firms view the internet as an opportunity to expand their market reach nationally or internationally, many others, such as small retailers, view the rise of e-commerce as a threat. This is due to customers purchasing online rather than via traditional 'bricks and mortar' shops (Mazzarol et al., 2015). There is also the concern that many small business owners have in relation to the threats of cyber-crime. This can take the form of unlawful access to company data, in particular customer information, as well as the risk of digital virus or worm infestation, malware, denial of service attack and fraud. The cost of protection against this type of attack is also an issue found to be of concern to many SMEs (Rahman & Lackey, 2013).

9.6.1.1 A Strategic e-Commerce Model for SMEs

For SMEs seeking to develop e-commerce strategies Fig. 9.9 illustrates a model provided by Tan, Sharma and Theng (2009) from their study of small online retailers in the United States. Firms were classified into those seeking robust growth *gazelles*, those that are enterprising but focused on lifestyle *gophers*, and those that have no aspiration for growth, *mice*. For the *gazelles* the key attributes for any growth strategy are the owner's commitment, the firm's ability to provide content for online sales, its ability to control its online operations, form partnerships and integrate its marketing channel strategies via different media (e.g. online and physical).

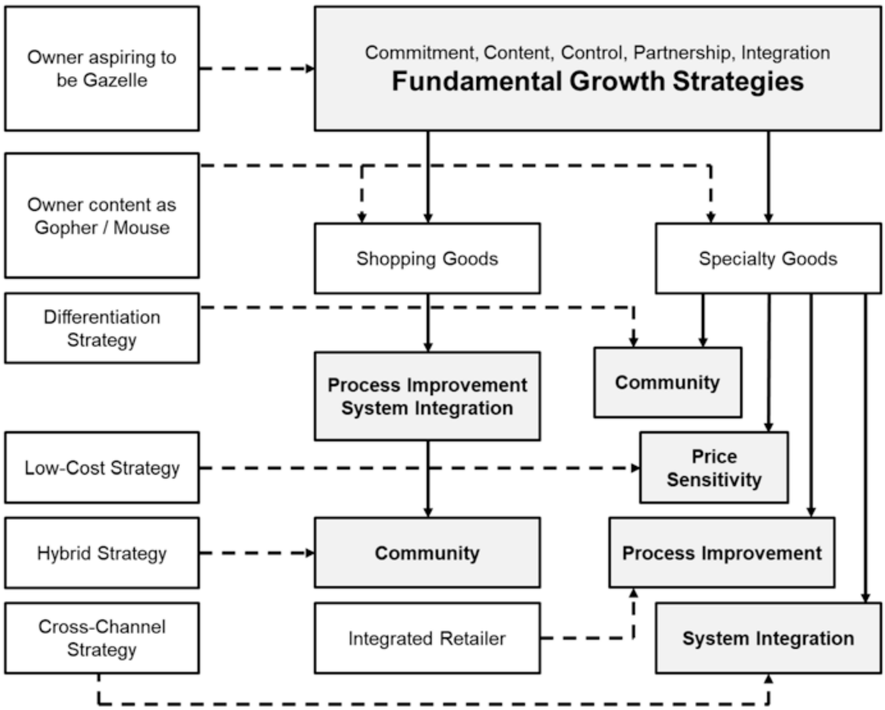


Fig. 9.9 Strategic e-commerce management model. (Source: Tan et al., 2009)

Overall growth via e-commerce as outlined in Fig. 9.9 involves segmenting products and services into either 'shopping' or 'speciality' goods. The first of these comprise goods that are relatively available via a range of both offline and online sources, and where customers can make easy comparisons over quality, price and style. Examples, might be groceries, food or drink products and consumer products, that have limited differentiation and can be purchased from a variety of suppliers. Retailing of 'shopping goods' generally requires a greater investment in developing online marketing and sales systems, as well as building up the retailers own brand awareness amongst customers, and the management of CRM systems and social media to help attract and retain customers.

By comparison, 'speciality' goods are those that are more unique and valuable, such as prestige brands, luxury items and customised consumer durables. Here, the retailer's strategy is targeted at differentiation addressing niche communities that will be attracted to purchasing such goods online. Consideration will need to be given to price sensitivity as it may be important to choose either a niche low-cost or differentiation strategy depending on the type of target customer and the product/service mix being offered. While the retailer of 'shopping' goods is commonly involved in investing in both process improvements and systems integration, the 'specialty' goods retailer may invest in either one or both. This reflects the reduced overall scale of 'specialty' goods target markets, and depending on whether they are pursuing a differentiation or low-cost strategy, such retailers will focus either on enhancing their quality and exclusivity, or competing primarily on lower pricing. Firms engaged in cross-channel strategies of 'specialty' goods are likely to invest more in systems integration of their internal and external ICT systems (Tan et al., 2009).

The key lessons from this e-commerce model for SMEs of all kinds can be summarised as follows.

- *Develop the e-commerce strategy around the firm's corporate strategy and business model:* SMEs need to build any online business model around a well-developed strategy that addresses their aspirations for growth, if they are seeking a *gazelle* status, or a more modest and sustainable ambition.
- *Consider the product/service mix and target market needs:* SMEs need to examine the nature of their product/service mix that they will be seeking to trade online. This will require careful market research and a decision to trade 'shopping' or 'speciality' goods.
- *Choose the generic positioning strategy:* Depending on the type of goods to be sold, a decision over whether to follow a differentiation, low-cost or hybrid strategy will need to be made. The first of these is likely to be more appropriate for 'speciality' goods targeted at niche market segments. This usually means that the products will be of high value and less price sensitive. However, a low-cost strategy can be pursued, but the choice of online selling should be assessed so as to ensure that it offers a sustainable cost-effective business model.
- *Approach hybrid strategies with care:* Hybrid strategies are complex and require a wide range of products with appeal to a broader community.

- *Cross-channel strategies can be expensive:* Cross-channel strategies area also potentially complex and may require greater investment in the development of ICT systems such as the CRM and ERP.

9.6.2 SMEs and e-Marketing

The term *e-marketing* refers to the use by firms of ICT to undertake marketing and promotion activities that complement e-commerce and e-business strategies (Mazzarol, 2015). The development of an e-marketing strategy within an SME should be undertaken in conjunction with the development of the firm's overall marketing strategy, e-commerce strategy and with a consideration of how it can be integrated into the CRM system. In many cases it is essential to the design of the firm's overall business model (Corley, Jourdan, & Ingram, 2013).

Research into the use of e-marketing by SMEs suggests that the investment small firms make into e-marketing can have significant benefits in the form of new business generated and lower cost of goods sold. This reduced transaction or selling costs, will enhance profit margins and market share, while also helping to boost the firm's brand equity. Also, of importance is the investment SMEs make in both pre and post-sales marketing activity (Eid & El-Gohary, 2013).

A study of 1002 SMEs and their engagement with e-marketing in Australia found that 47% were receiving payments online and 36% were taking orders online. Only 33% of firms engaged in this process of e-commerce and e-marketing made the majority of their totals sales online. Further, despite the view that online marketing and sales offers the SME an opportunity to engage globally, only 9% were specifically targeting international customers, and only 24% reported making overseas sales. The majority (85%) were engaged in e-marketing for local customers. When asked why they had commenced e-marketing activities, the top three reasons given were: i) to provide a better customer service (74%); ii) to improve delivery (62%); and iii) to handle customer and supplier requests (59%) (Sensis, 2017).

As noted earlier, there is an opportunity for SMEs to use social media to support CRM activity, or even serve as a proxy form of e-CRM (Harrigan & Miles, 2014). Depending on the nature of the firm's products or services, social media can provide SMEs with an opportunity to get substantial media reach at relatively modest cost. However, the e-marketing strategy needs to be approached with the same principles as the firm's general approach to marketing strategy (see Chap. 5).

9.6.2.1 Targeting Online and Mobile Consumers

It should also be acknowledged that younger demographic consumers are relying increasingly on mobile smartphones and tablets to access the internet and undertake online purchasing. For example, Australian research suggests that 92% of consumers primarily use desktop and laptop computers for accessing the internet, but 92% also use smartphones and 61% tablets. In terms of age groups, 91% of people aged between 18 and 29 years, and 94% of people aged 30 to 39 years used smartphones as their main device for online activity (Yellow, 2018).

Table 9.7 Preferences for device when purchasing online and key benefit sought by gender and age – Australian consumers

	Total	*Male*	*Female*	*18–29*	*30–39*	*40–49*	*50–64*	*65+*
Ordered goods and services online	89%	87%	91%	92%	90%	91%	90%	82%
Preferred device:								
Smartphone	25%	23%	28%	35%	36%	29%	18%	7%
Computer	55%	60%	50%	42%	42%	52%	64%	76%
No preference / can't say depends	20%	17%	22%	23%	22%	19%	18%	17%
Key benefits sought:								
Best deal	62%	61%	63%	62%	65%	71%	61%	51%
Fastest delivery	10%	11%	10%	18%	17%	8%	6%	2%
Support local brands	10%	11%	9%	6%	5%	3%	16%	19%
Can't say depends	10%	17%	18%	14%	13%	19%	17%	29%

Source: Yellow (2018)

Table 9.7 lists the online purchasing patterns of a large sample of consumers in Australia. It can be seen that the majority of those surveyed reported having purchased goods or services online during the previous 12 months. It is worth noting that online purchasing behaviour was relatively uniform across all age groups, although older people aged over 65 years, were slightly less likely to have purchased online, even though the majority reported having done so. The preferred device for online purchasing was still the desk top or laptop computer, even amongst younger age groups, although smartphones were increasingly important. This suggests that SMEs seeking to develop e-marketing strategies should ensure that their websites are suitable for use across a wide-range of platforms, and even consider developing a smartphone App if the market environment warrants it. Also, worthy of note, is that the most attractive aspect of purchasing online was to secure the 'best deal'.

With regard to the issues described earlier in relation to Fig. 9.9, this pattern of consumer online purchasing, suggests that an SME should consider not only the channel management plan it needs to follow in relation to its approach to e-commerce, but also the investigation of customer perception of value as it develops its e-marketing strategy. So, attention needs to be given to identify if the goods and services being promoted are 'shopping' or 'specialty' in nature, and whether the target customer is seeking the lowest prices, or a value-added offer, best addressed via a differentiation strategy. Depending on what emerges from this analysis, the final e-marketing execution will need to encompass the brand image being created, the level of customer engagement that is both desirable and possible, and the potential to employ smartphone Apps and/or social media as a means of both promotion and e-CRM activity.

9.6.3 SMEs and e-Business

The term *e-business* refers to the application of digital ICT systems to automate and manage online, production, customer engagement and internal management processes (Mazzarol, 2015). What distinguishes e-business strategy from e-commerce and e-marketing, is that it focuses beyond the market facing promotion, buying and selling activities and takes a more strategic perspective of the entire business model.

> **For example,** … achieving business goals in which technology for information exchange enables or facilitates execution of activities in and across value chains, as well as supporting decision making that underlies those activities (Holsapple & Singh, 2000, p. 159).

Amit and Zott (2001) identified four major sources of value creation in e-business strategies for companies regardless of size. These are summarised as follows:

1. *Novelty:* firms that adopt e-business models secure access to new markets, B2B and B2C transaction structures and content, and opportunities for new ways to create value through exploitation of digital technologies.
2. *Lock-in:* e-business systems that involve building strong connections between customers and suppliers with standardised or proprietary technologies, can create high switching costs that serve to lock-in these relationships. In turn, these connections help to create positive network externalities.
3. *Complementarities:* a well-designed e-business system will help to generate co-specialisation of assets within the firm and its supply chain. This can impact products and services, online and offline assets, and across technologies and activities within the firm and its network partners.
4. *Efficiency:* the use of e-business systems offers the potential to lower transaction costs, increase speed of transaction, ease of use and enhance decision making through greater access to timely and accurate information.

An examination of American and European case studies found support for these four value creation sources and highlighted the potential of e-business strategies as a source of competitive advantage.

> **For example,** … Our paper suggests that the emergence of virtual markets opens new sources of innovation (e.g. business model innovation) that may require a parallel shift in strategic thinking towards more integrative, dynamic, adaptive, and entrepreneurial strategies (Amit & Zott, 2001, p. 516).

Despite the potential value of e-business strategies to SMEs, the majority of small firms continue to lag behind their larger counterparts. Among the potential barriers to SME engagement with e-business are a lack of awareness amongst small business owners of what e-business technologies can do, and how to apply them. In addition, most SMEs have relatively small and often niche markets, in which customer and supplier engagement is typically direct and face-to-face. Another issue for SMEs is the concern by owner-managers of the potential risks that might impact their firms

Table 9.8 Key drivers and inhibitors for e-business in SMEs

Drivers	*Inhibitors*
Reduced operating costs.	Implementation costs.
Reduced sales and purchasing costs.	Need for clear return to investment data.
Improved range and quality of service to customers.	Concerns over confidentiality and fear of cyber-crime.
Faster speed of delivery.	Lack of knowledge about technology.
Finding suppliers.	Lack of ICT skills and strategy.
Avoiding the loss of market share.	Lack of compatibility with existing systems, or lack of ICT systems capacity.
Market intelligence.	Lack of trust in external ICT systems vendors.
Improved trading relationships.	Limited in-house ICT knowledge.

Source: Adapted from Levy et al. (2005)

by applying e-business technologies. This can involve cyber-crime, data privacy, and loss of control to either larger suppliers or customers within integrated and proprietary e-business suites. Many SMEs also lack the necessary skills and competencies in the implementation and management of ICT systems that e-business activities require. The cost of e-business systems is also a barrier to many small firms, and such systems many require the business to replace all their existing systems causing unwarranted disruption (Taylor & Murphy, 2004).

9.6.3.1 Drivers and Inhibitors of e-Business

Table 9.8 lists some of the drivers and inhibitors to the adoption of e-business by small firms as identified in research studies (Levy, Powell, & Worrall, 2005). It can be seen that the main drivers were a desire to lower costs, speed up transaction times and expand market access, while the main inhibitors were related to cost of technology, lack of capacity in existing systems, concerns over security and lack of experience and skill in the use of such technologies.

From a strategic perspective the most valuable aspect of e-business found in this study was the opportunity it offers for product development, diversification of market access, market development and market penetration (Levy et al., 2005). For small business owners who fully exploited the internet and ICT systems for e-business and e-commerce, the decision to engage with this technology was a strategic one to which they were prepared to make substantial and long-term commitments.

9.6.3.2 E-Business Within Supply Chains

One of the main areas in which e-business is growing is in the management of supply chains where large 'focal' firms, such as manufacturers or retailers, manage their suppliers through the integration of online procurement systems. This typically requires an integration of e-business software, including the ERP and CRM systems, across the supply chain. Where a buyer is a larger firm, the SME suppliers are typically required to adopt the ICT systems of the major customer. The same can apply in the case of large suppliers working through a network of small retailers.

A study of the use of e-business in supply-chain management was undertaken with SMEs in the UK to ascertain the perceived risks that owner-managers had towards this application of technology (Caldwell, Harland, Powell, and Zheng, 2013). The study identified at least six key areas of concern:

1. *Customer dependency:* The first risk related to the fear amongst the SMEs that they would become too dependent on a single large customer once they had integrated their e-business suite with that of their major customer. In most cases this was a larger firm that dominated the supply chain.
2. *Cash flow crisis:* The need to integrate the small firm's accounting software with that of their large customer was promoted by e-business advocates as offering 'seamless' transactions and 'paperless' invoicing and payments. However, in reality there continued to be a lot of manual management of the payments systems within the larger firms and the integration of the financial management systems between the firms had not eventuated.
3. *The loss of critical mass:* The introduction of e-business across the various supply chains examined in the study threatened to see an overall decline in the number of firms remaining in the industry sector. This was due to the exit of small firms that did not want to, or could not, join the supply chain systems. For the remaining SMEs, there was a concern that the sector would shrink and result in a few, albeit larger survivors, with negative impacts on the vibrancy and competitiveness.
4. *Cannibalisation of existing business systems:* Another concern amongst the SMEs was the way that the e-business supply chain model pushed the suppliers away from smaller, but more customised and higher profit margin production orders, and towards larger, but lower margin commodity-type orders.
5. *Loss of personal contact:* The e-business supply chain system operated via impersonal and often automated online *e-auctions*. This risked a loss of access to more personalised negotiations with customers and the opportunity for innovation.
6. *Loss of transparency:* A further concern held by the owner-managers was the loss of transparency in the negotiation of supplier-buyer contracts. For most SMEs, their previous experience had been to deal personally with buyers and communicate face-to-face. However, the e-business online procurement system denied them this opportunity for feedback and removed some of the transparency in how final procurement decisions were made.

> **For example,** … It's only when you meet people that you know what they are about. If they seem like they really know their stuff, if what they say – a delivery, say – actually happens, then you build up confidence and they will buy from you. You can't portray confidence over the Internet (Caldwell et al., 2013, p. 706).

Other research has found SME owner-manager to be concerned about e-business engagement with other firms from the perspective of potential cyber-security issues

(Chong et al., 2014). This has also applied to the adoption of cloud computing by SMEs, where cyber-security and the general reliability of the systems has been identified as a key concern (Gupta, Seetharaman, & Raj, 2013). However, in general, SMEs can gain significant benefits from e-business engagement once the owner-manager has overcome their initial fears.

> **For example,** … There was obvious trepidation, moving from a traditional selling storefront to a pure online operation. However, it has been relatively painless and the business is thriving. We are getting new customers from all over the place. The website has helped, but you still need to be efficient and knowledgeable of what it can do. (Jules, owner/manager, Enterprise B) (Jones et al., 2014, p. 297).

9.6.4 Connecting e-Commerce and e-Business to e-Knowledge Management

Holsapple and Singh (2000) propose taking a knowledge management approach to the design of e-business and e-commerce systems. As shown in Fig. 9.10, they suggest that knowledge management and associated KMS systems, should be viewed as 'underpinning' the firm's entire value chain, and also being "instrumental in achieving various business effects" (p. 161). This view is based on the assumption that knowledge management is critical to success and that information flows throughout the firm, and across its supply chain and stakeholder networks is essential to enhancing value.

Within the model illustrated in Fig. 9.10 is the central pyramid of e-commerce, c-commerce, e-business and e-knowledge. Holsapple and Singh (2000) describe *c-commerce* as 'collaborative commerce', which they attribute to the Gartner Group (1999). The difference between e-commerce and c-commerce is the focus information exchange.

> **For example,** … the most commonly emphasized view of e-commerce is electronic support of trading. Conversely, for c-commerce the clear emphasis is on electronically supporting information exchange to foster collaborative business activities, with some relationship to the other three classes (Holsapple & Singh, 2000, p. 156).

By integrating knowledge management strategies with the firm's e-commerce and e-business strategies, the development of a c-commerce and e-knowledge strategy also becomes more attainable. This strategy can then be used to configure the KMS, ERP and CRM systems to ensure that information exchange between suppliers and customers, and across the functional areas within the business, is appropriately recognised, valued and managed. This approach should focus on configuring these technology platforms to support the five foundations of:

1. *Enable:* The ICT system should enable the firm to track, record, analyse and manage its e-commerce, c-commerce, e-business and e-knowledge strategies.

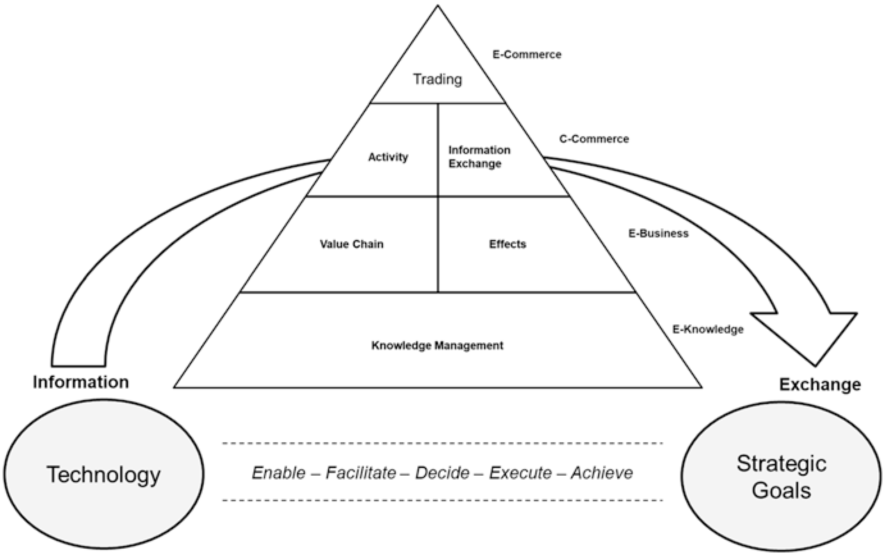


Fig. 9.10 Relationships between e-commerce, c-commerce, e-business and e-knowledge. (Source: adapted from Holsapple & Singh, 2000)

2. *Facilitate:* The system should help to facilitate knowledge exchange within the business and across its supply chains and wider stakeholder network.
3. *Decide:* The system should provide the firm's management with timely, accurate and reliable information to help it to make better strategic decisions.
4. *Execute:* The system should provide for the efficient and effective execution of the firm's e-commerce, c-business, e-business and e-knowledge strategies.
5. *Achieve:* The system should assist the firm to achieve its strategic goals.

9.6.5 Applying Technology to the Value Chain

As has been discussed above, the decision for an SME to engage in e-commerce, e-business strategies, and then implement CRM, ERP and KMS systems is, or should be, a strategic one. The effective use of technology within any business is its ability to add value through achieving the many 'drivers' listed in Table 9.8. Walters and Lancaster (1999) have outlined an e-business value chain framework that can be applied to small businesses seeking to make best use of technology. Figure 9.11 illustrates this framework, which consists of six stages linked by ICT systems within the business.

In the first stage the owner-manager reviews the value chain or supply-chain relationships with their leading customers and key suppliers with a view to understanding how and why they purchase and their purchasing and delivery patterns.

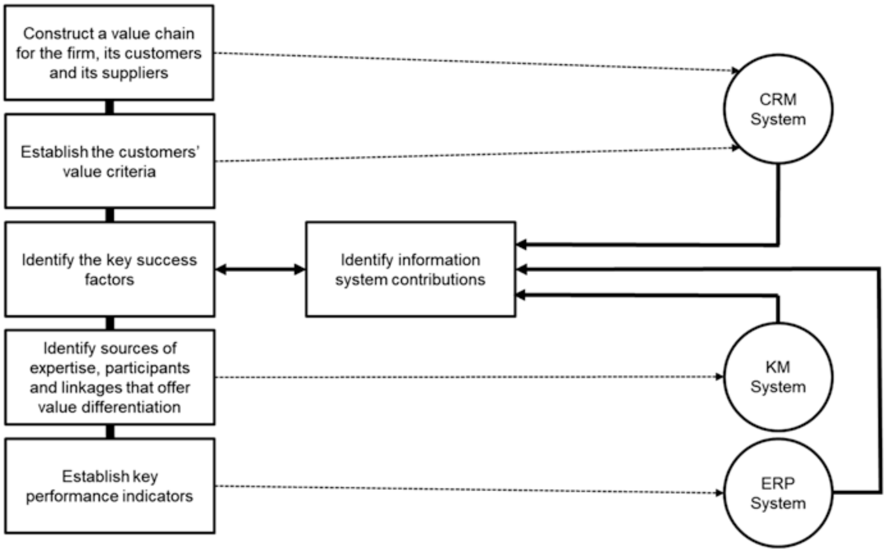


Fig. 9.11 The e-business value chain. (Source: adapted from Walters & Lancaster, 1999)

The outcome of this analysis is the ability to establish the customer's value criteria (e.g. the key factors motivating their buying behaviour). As shown in the diagram, a well-designed CRM system will prove highly valuable in both collecting information on customer purchasing patterns, but also to validate assumptions via market research or data analysis.

In the third and fourth stages the owner-manager identifies the key success factors that have driven or are likely to drive the business in relation to this particular market segment or customer group. The owner-manager needs to identify the most appropriate information systems that can inform future decision making in relation to keeping them informed of both customer behavioural trends and internal business operations likely to impact on the firm's value chain. As shown in Fig. 9.11, the CRM, KMS and ERP systems all feed into the owner-manager's reporting system to provide a regular updating of selected KPI.

Fourth, the owner-manager needs to identify sources of expertise both within the company and within its strategic networks that can assist in enhancing value to the customers and allowing the business to differentiate itself against competitors. A KMS system can be a valuable tool for feeding information on such expertise and where it can be sourced. Finally, the owner-manager should identify KPIs that they can build into their reporting and the firm's ERP system is a good source of such data. A well-designed ERP system should be able to provide financial and non-financial data to the manager in a timely manner.

Fig. 9.12 Aligning technology with business and organisational strategy. (Source: adapted from Walters & Lancaster, 1999)

9.6.6 Applying the e-Business Value Chain to the Management System

Technology is only a tool or a means to an end; it is not an end in itself. The full value of any technology can only be realised if it is integrated into the overall strategic direction that your business is to take. In order to get the best from your business it is important that your business strategy moves from an emphasis on mere cost reduction and efficient administration to the creation of customer value through innovation within an integrated value chain. The organisational or management strategy you employ also needs to move from a centralised, internally focused management style, to one that is outward looking, willing to delegate tasks and responsibilities to a team and to instil in all employees a strong sense of customer commitment (Walters & Lancaster, 1999).

As shown in Fig. 9.12, any small business owner-manager will need to move their firm's information management strategy from an emphasis on internal cost control, administration and cash accounting, toward an emphasis on decentralisation, customer commitment and value delivery in their business activities. This information strategy will be enhanced by the use of ICT systems that allow the owner-manager to monitor data and keep a check on the internal operational issues thereby allowing more attention to be paid to external, customer related issues (Walters & Lancaster, 1999). At least four key areas will need to be addressed in the design and configuration of ICT systems within the business as outlined in Chap. 8 in relation to the core elements of a management system: forecasting, planning, control and reporting. Each of these is discussed below with reference to technology use.

9.6.6.1 Technology and Forecasting

Any accurate budgeting will rely upon setting clear cash flow forecasts and these will be greatly enhanced by having access to good market intelligence. A CRM system that links to a database can help to make forecasting future sales trends more accurate by monitoring customer purchase behaviour. The timing of invoicing and contract renewals is usually made easier by the use of computer-based systems that allow pre-set triggers or flags designed to get the paperwork underway early and efficiently processed.

9.6.6.2 Technology and Planning

The collection of data in computer-based systems allows enhanced data analysis using spread sheets and graphic displays via charts. The maintenance of a set of internal KPI and key performance benchmarks from industry will enable you to set clear work standards, and is also likely to enhance the process of resource scheduling. As data is collected via the DPSC and reported via the management reporting or ERP system it should be easier for you to review standards and plan for future growth or business expansion.

9.6.6.3 Technology and Control

Using a computer spreadsheet for managing the DPSC will enable data to be gathered, stored, retrieved and analysed more easily. The development of a set of simple KPI that are stored electronically and reported weekly will assist in strengthening your overall control and scheduling tasks.

9.6.6.4 Reporting

The ability of computer-based systems to generate timely and accurate reports will depend on how well they have been designed and set up, and also how well trained you or your employees are in their use. Information from the DWOR that is fed to the weekly or monthly management report should be based on a standard set of KPI and these should be collected regularly via the DSPC and accounting package.

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10 Debt Versus Equity

10.1 Introduction

> Loan rejection rates were down in a majority of countries … and survey data from across the OECD suggest that access to finance is becoming less problematic for SMEs. Despite these positive developments, structural problems to access external sources of finance persist, especially for young firms and start-ups, micro-enterprises, and innovative ventures with an unproven business model. These businesses often lack assets that can be easily used as collateral. Although these firms are often well endowed with intangible assets, many challenges persist to use these assets to obtain SME financing (OECD, 2018a, 2018b, p. 3).

Financing a small business venture requires the owner-manager to determine the amount of capital that will be required to achieve the level of activity and growth within the business over its early years. How large this amount of capital is will depend on the nature of the business, its industry dynamics and the ambitions or goals set for it by the owner-manager. Many small firms are established with relatively small amounts of capital. They also manage to trade successfully for long periods without seeking external funds from banks or venture capital. In this chapter, we examine the financing of a new small business venture.

10.2 The OECD Scoreboard of SME and Entrepreneurial Financing

In 2012 the OECD commenced the publication of an annual scoreboard on SME and entrepreneurship financing (OECD, 2012a, 2012b). This comprises a number of indicators with data collected from a range of countries drawn from within the

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Table 10.1 Core indicators of the OECD

	Core indicators	What they show
1.	Share of SME loans in total business loans	SME's access to finance compared to larger firms.
2.	SME short-term loans in total SME loans	Debt structure of SMEs; % used for operations versus % used for expansion.
3.	SME loan guarantees	Extent of public support for SME finance.
4.	SME guaranteed loans	Extent to which such public support is used.
5.	SME direct government loans	Extent of public support for SME finance.
6.	SME rejection rate	Tightness of credit conditions and willingness of banks to lend.
7.	SME loans used/SME loan authorised	Sometimes used in addition or instead of the rejection rate to gauge credit conditions. A decrease indicates that conditions are loosening.
8.	SME non-performing loans/ SME loans	When compared to the ratio of non-performing loans (NPLs) for all business loans, it indicates if SMEs are less creditworthy than larger firms.
9.	SME interest rates	Tightness of credit conditions and willingness of banks to lend.
10.	Interest rates spread between large and small enterprises	Tightness of credit conditions; indicates how closely interest rates are correlated with firm size.
11.	Percent of SMEs required to provide collateral on their last bank loan	Tightness of credit conditions.
12.	Venture capital and growth capital	Ability to access external equity for start-up, early development and expansion stages.
13.	Asset-based finance	The take-up of non-bank finance instruments such as leasing, hire purchase, factoring and invoice discounting by SMEs.
14.	Payment delays	Cash flow problems; difficulty in paying and being paid.
15.	Bankruptcies	Rough indicator of the impact of a crisis, cash flow problems.

Source: OECD (2012a, 2012b)

OECD. These indicators are listed in Table 10.1 along with their meanings. The data for the *OECD Scoreboard* is drawn from a range of sources across participating countries. At time of writing this data was available for the period 2007 to 2016 and therefore offers a longitudinal assessment of the impact of the GFC. It also provides a valuable source of information on government policy and its impact on SMEs and entrepreneurs, as well as cross-country comparisons.

The OECD notes that the ability to make reliable global comparisons of this kind is challenging due to a range of factors. Amongst these is the different ways that each country defines what an SME or small firm is, as well as the sheer logistical problems of collecting reliable data from a large number of countries. For this reason, the *OECD Scoreboard*, while able to provide a valuable overall picture, has some limitations when inter-country comparisons are made.

10.2.1 Key Findings from the OECD Scoreboard on SME Financing

Over the period 2007 to 2014 the *OECD Scoreboard of 2016* analysis suggested that the impact of the GFC, whilst severe, has largely abated as the years have passed (OECD, 2016a). This has had a generally positive impact on SME financing with 59% of countries showing rising volumes of lending to small firms. However, for most SMEs across the OECD, credit remained tight. On a more positive note the rate of business bankruptcies declined over the period for the majority (80%) of countries. Despite this, around 44% of countries showed a rise in the number of non-performing loans (NPL).

Another noticeable trend found in the *OECD Scoreboard of 2016* was the increased use of alternative financial instruments by SMEs. This included the use of crowdfunding, factoring and *business angels* (discussed below). The provision of informal venture capital investors or *business angels* offers a source of funding for young, innovative, high growth firms. This type of financing also offers the potential for these *angel* investors to also provide mentoring, networks and strategic guidance to these small, entrepreneurial firms (OECD, 2016a).

Government policy responses to the GFC, and the subsequent requirement for greater economic stimulation, has been to help ease access to finance, particularly for SMEs. In general, the SME sector is heavily reliant on bank debt financing. As discussed below, this has some positive and negative effects. A key problem is the limitation that this can place on firm's seeking growth, but lacking sufficient borrowing capacity. Throughout the world government policy has been targeting ways to increase the level of equity financing available to SMEs. This typically involves ways to stimulate venture capital investment and public listing on the stock exchange. Assisting SMEs to gain access to funding for international expansion and securing access into global supply chains is also an area of focus for government policy (OECD, 2016a). Although the *OECD Scoreboard of 2016* was generally positive about the global trend in SME and entrepreneurial financing to that time it did raise a note of caution.

> **For example,** … SME access to finance will remain a concern in the years to come. Despite recent improvements in SME lending, financial conditions often remain tight and many SMEs continue to face credit constraints. A number of factors persist which could jeopardise the economic recovery, with potential repercussions on SME lending. Furthermore, many financial institutions continue to deleverage and, due to tightened regulatory requirements, this will likely impact small businesses disproportionately. Governments should continue to monitor closely SME access to finance and take actions which enable them to access a broader range of financing instruments. (OECD, 2016a, p. 27)

These predictions have largely come true and the *OECD Scoreboard of 2018* has shown that over the period from 2014 to 2017 the median level of growth in new lending to SMEs across 15 countries declined from an annual rate of 2.6–5.6% (OECD, 2018a, 2018b). Not all countries experienced negative trends, with only 15 out of 25 nations reporting this, and 24 out of 35 countries reporting growth. Many factors influenced these trends. In some countries (e.g. Australia, Austria, the Czech

Republic, the Netherlands and the United Kingdom) there was a general decline in the demand for credit. In other countries (e.g. Greece, Slovenia, Portugal), the banks were reportedly more risk-averse, due to a high proportion of non-performing loans within the SME sector. Declining lending to SMEs within some countries (e.g. Russia and Brazil) was attributed to poor macro-economic conditions.

According to the OECD (2018a, 2018b), the overall trend from 2007–2016 has seen a steady decline in short-term lending and concurrent increase in long-term lending. Other good indicators have been an improvement in credit conditions, and a decline in the number of SME bankruptcies. In fact, from the peak of 2009–2009 during the height of the GFC, the number of small businesses declaring bankruptcy has steadily declined across all 36 OECD countries (OECD, 2018a, 2018b).

10.3 Sources of Entrepreneurial Capital

Access to financing is one of the most significant challenges facing entrepreneurs (OECD, 2009). Entrepreneurial capital – for the formation of new business ventures – is usually available from at least three sources:

- *Bootstrap financing*: The funding provided from the entrepreneur's savings and what can be retained through cash flow management and retained profits.
- *Debt financing*: The funding borrowed over the short and long-term from banks, other financial institutions and credit cards.
- *Equity financing*: The funding obtained from informal and formal investors who take part ownership in the business for a return on capital.

Each of these sources has quite a different dynamic and requires the entrepreneur to consider different issues. As the venture grows, it will continue to rely in retained profits and combinations of debt and equity financing, depending on the nature of the business and how large it seeks to grow.

It is important to note some basic differences between SMEs and large firms in relation to financing. Compared to large firms, most SMEs rely more heavily on *bootstrap* financing in the form of personal savings and retained profits. As a general rule, SMEs retain a higher proportion of earnings, which they use as working capital and to fund future growth (Keasey & McGuinness, 1990). SMEs also obtain more funding from private debt and equity markets than large firms that generally operate within the public domain of the stock exchange (OECD, 2004). SMEs also don't generally seek equity financing. This is due in part to the cost and difficulty of securing equity financing for a small firm, but also the desire by many entrepreneurs and small business owners to retain control over their venture and to not dilute equity control (Hughes, 2001).

Checklist for Bootstrap Financing

- *Implement proven market ideas*. This will assist in getting sales moving quickly.
- *Look for a quick break-even*. The project or new venture should break-even and return a profit as quickly as possible. If not, the business will be forced to seek alternative sources of capital.
- *Look for high gross profit*. The higher the profit margin of a new product or service, the more retained earnings that can be generated.
- *Sell directly*. The bootstrap process is assisted if the product can be sold directly by personal selling. This assists sales growth and allows control of cash flows.
- *Keep the team lean.* Bootstrap financing does not usually permit the entrepreneur the luxury of hiring a large management team. The company must get what it can from the existing staff with everyone mucking-in.
- *Control growth.* Because capital is limited to cash flow, the firm cannot afford to allow expansion to get out of control. Live within your means is the rule.
- *Focus on cash flow*. Cash is king, as this feeds any growth.
- *Cultivate banks early*. Learn how to deal with bankers and what they want before you need them.

Source: Stevenson, Grousbeck, Roberts, and Bhide (1999).

10.4 Bootstrap Financing

Bootstrap financing involves raising capital from internal sources. It can encompass personal savings accumulated by the entrepreneur, money borrowed from family and friends, or funds accumulated from trading (retained profits). An important part of bootstrap financing is the ability to retain earnings within the business for working capital. The concept of *working capital* refers to the cash and other short-term assets (e.g. receivables) that can be applied to pay short-term liabilities. A lack of working capital can be a serious problem for even the best business with good products and healthy profit margins.

A common cause of small business failure in the initial years after start-up is a lack of working capital. This is caused by such things as the lag between when money can be recovered from customers and put at bank, and the need to pay creditors, employee wages, taxes and overhead costs such as rent payments. During the GFC many SMEs found it difficult to secure finance from banks or private equity sources. As cash flow became squeezed with the slowing down of the economy this impacted their ability to maintain sufficient working capital to remain solvent (OECD, 2009). Historically, a lack of working capital has been identified as a major source of business bankruptcies in Australia (ABS, 2002).

The majority of small businesses start-up with funds derived from personal sources (Productivity Commission, 2015). In the 1990s research in Australia found that approximately 59% of financing for new small business start-ups came from the personal savings or borrowings of the founders (ABS, 1998). Subsequent research over the period 2007–2011 found that this pattern had not changed, with 66% of new business start-ups reporting that they had sought external finance for their venture (Productivity Commission, 2015 p. 122).

10.4.1 Benefits of Bootstrap Financing

The important benefit of bootstrap financing is that it costs little or nothing. Use of bank or venture capital financing will incur a cost of capital requirement on the business. However, the small business owner that uses the company's own cash for growth avoids this cost (Stevenson et al., 1999). Further, the owner-manager can have total control over the funds and their use. There are also no applications to worry about and, for many owner-managers who have been rejected by banks, this is important. Finally, many banks and venture capitalists have minimum amounts of money that they will lend. Use of the firm's own capital or money drawn from the entrepreneur's savings or from family and friends carry no such minimums. However, if borrowing from family or friends, it is important that the owner-manager deal with this money in a professional manner; it should be correctly recorded and repaid. Seeking legal assistance in drawing up a loan agreement may be worthwhile (Fraser, 1999).

10.5 Debt Financing

Debt financing is that which is obtained from banks and related financial institutions on either a short or long-term basis. The main characteristic of debt financing is that it is money obtained from a lender at a cost, usually associated with an interest charge on the repayments. The lender is keen to see the loan principal repaid, but also seeks to make money from the interest charges. Such debt financing is also secured – particularly long-term debts – by legal contracts that offset the lender's risk against assets owned by the borrower.

A study undertaken by the European Commission (2001) found that debt financing comprised the majority of funding used by SMEs. Half of these firms had bank loans or overdraughts, about 40% had some form of leasing finance and 11% were employing debtor financing or *factoring*. Only 9% reported using equity investment. The OECD *Scoreboard* of SME and entrepreneurial financing reports that over the period from 2007 to 2016 the share of SME loans as a proportion of total business loans across 37 countries was around 40% (OECD, 2016a, 2018a, 2018b). As noted above, the general trend was away from short-term to long-term lending.

> **According to the OECD**, … Various factors may play a role. Recent improvements in cash flow and profitability may be allowing small firms to rely on internally generated revenues for their day-to-day operations, thus leading to a decline in external short-term financing. In addition, some SMEs may want to borrow on longer terms as interest rates decline, so as to 'lock-in' low rates. Finally, the recovery in corporate investments has been relatively weak and uneven since the financial crisis. (OECD, 2018a, 2018b, p. 2)

Most debt financing in Australia is undertaken by the major banks and takes the form of credit cards, short and long-term loans, and overdraughts. The majority of debt financing for SMEs is undertaken by banks on the basis of loans secured against the family home.

> **For example**, … Most lending to new businesses in Australia is collateral based (often secured against the personal real estate of the business owner). There is evidence that banks adopt a relatively formulaic approach to lending and are less willing to lend on the basis of business prospects alone, but there are no impediments to lending on such bases other than the need to provide additional capital for prudential regulation purposes. Declining rates of home ownership amongst younger Australians present a challenge for collateral-based business lending models in the future. (Productivity Commission, 2015, p. 177)

In France, the micro firms (e.g. those with fewer than 10 employees) appear to have the most difficulty in securing bank financing. A study by the *Observatoire du financement des entreprises* published in 2014 found that the micro-business sector was highly turbulent with one-third of businesses failing after 3 years from start-up and half of them failing within 5 years. Bank financing was made more difficult due to the lack of working capital and equity in the firm, with one-third of micro-businesses having either zero or negative equity. Many of these firms also faced cash flow problems. However, most French micro-businesses used overdrafts to finance their cash flow, these were found to be relatively easily established and flexible, with benefits to both the banker and entrepreneur. Despite this, overdrafts were generally more expensive than conventional loans (OECD, 2006).

10.5.1 Benefits of Debt Financing

Debt financing requires the entrepreneur to guarantee the debt and thereby risk the potential loss of not just the borrowed amount but also of their assets (e.g. home). It also has the cost of interest payments that must be made. Despite these shortcomings, debt financing has several benefits when compared to equity financing. Megginson, Byrd, and Megginson (2000) identify at least four main benefits:

- lower cost of capital;
- greater borrowing ability;
- no loss of equity or profits; and
- no loss of control.

10.5.1.1 Lower Cost of Capital

The majority of debt financing is less expensive than the equivalent cost of raising equity – despite the interest payments. Further, the interest charges that must be paid on the money borrowed are a tax deduction to the business, thereby reducing the overall burden to the entrepreneur.

10.5.1.2 Greater Borrowing Ability

In many cases the entrepreneur may be able to secure more of the total proportion of required capital from debt financing than through equity arrangements with venture funding sources. If the entrepreneur can secure the loans against other assets (e.g. property), then they can borrow substantial amounts of money. By comparison, many venture capitalists will be reluctant to take more than a proportion of the total equity in a business, and will usually seek to feed the capital to the business over time with a view to monitoring progress.

10.5.1.3 No Loss of Equity or Profits

A further reason for the attraction of debt financing is the fact that the entrepreneur does not risk losing control of the business or any profits that are made. Debt capital is a fixed cost and does not erode the profits generated by the business. By comparison, equity partners may be seeking to share in profits. Debt funding sources also do not seek to take equity in the firm and are only concerned with recovering their principal and any interest charges.

10.5.1.4 No Loss of Control

Just as debt financing does not erode the equity held by the entrepreneur, it also does not reduce the level of control the owner has in their business. Most venture capital investors will seek some influence in the management of the company, usually a seat or seats on the board and a veto over major decision-making such as capital expenditure or significant shifts in strategy. This level of influence is reasonable given the fact that venture financing involves the part ownership of the company and its associate risk sharing. However, many owner-managers resent such control and prefer to remain totally in control of their firms. While carrying some level of interference from mortgage holders and other major creditors, debt financing is less likely to see the entrepreneur losing control over the company unless they default on debt repayments.

10.5.2 Short-Term Debt Financing

Short-term debt financing consists of loans that must usually be paid within 1 year. The majority of this type of debt is self-liquidating, meaning that it repays itself over time. It is therefore used to finance such things as trade debtors or trading stock. Common types of short-term debt include: trade credit, overdrafts, accounts receivable, floor plans, bridging finance, commercial bills and import-export finance (English, 1998).

10.5.2.1 Trade Credit

Trade credit is where suppliers offer the firm the opportunity to secure goods or services without immediate payment. The longer the credit terms can be extended, the more attractive it is to the firm. This can be of particular assistance to retailers or manufacturers that need to acquire stock and who may experience long time delays before making sales. However, care must be taken to ensure that the business has the necessary cash flow to pay trade creditors when required. It is important for owner-managers to watch their level of *creditor strain* (e.g. the amount of trade credit owed by the business beyond reasonable terms). The amount of trade credit being used by small firms has increased significantly in recent years. For example, in Canada during 2000 nearly 40% of the outstanding debt owed by SMEs was in the form of trade credit (OECD, 2006). It is also a major source of financing for Australian businesses with many SMEs using it to fund operations through customers paying a proportion of cost of the goods or services in advance to help the firm commence the work, and then making progress payments until the work is completed (Productivity Commission, 2015).

10.5.2.2 Bank Overdraft Facilities

Overdraft facilities are a common means of short-term debt where the firm secures a certain amount of credit from the bank within their company cheque account. The bank will normally set a limit on the overdraft in a similar way to a credit card limit, and may either secure the loan against assets in the business or not. The advantage of overdraft facilities is that they only become drawn when the money is required and interest is only paid on the money drawn not the entire loan. The cost of maintaining an overdraft facility can be high with establishment fees and administration charges. Approximately half of all SMEs in the European Union have some form of overdraft facility (OECD, 2006).

The Real Cost of Borrowing Money

Once, when my mother mentioned an amount and I realised I didn't understand, she had to explain to me: 'That's like three Mercedes.' Then I understood. – Brooke Shields.

The final cost of borrowing money often involves much more than just the interest rate. A variety of other monetary and non-monetary costs should be considered in determining the real cost of borrowing. For example, a loan that requires you to maintain certain financial ratios may be unrealistic for your particular business. Your checklist for reviewing the costs of a bank loan should include:

- direct financial costs, such as interest rates, points, penalties, and required account balances;
- indirect costs and loan conditions, such as periodic financial reporting, maintenance of certain financial covenants, and subordination agreements; and
- personal guarantees needed to obtain the loan.

Source: CCH Business Owner's Toolkit, www.toolkit.cch.com.

10.5.2.3 Factoring

Accounts receivable financing – also called *factoring* or *debtor financing* – is another form of short-term debt. In this method, the accounts receivables ledger is essentially purchased by a bank or specialist factoring company that advances a percentage (usually up to 80%) of the total outstanding invoices. With *factoring*, the lender secures the firm's debtors and provides a cash advance. Banks are a common source of this type of funding and usually insist on the firm having a system of debtor management before securing the loan. Factoring companies generally buy the debtor account at a discount and advance a proportion of the money up front, and the remainder – less fees and commissions – upon receipt of the money from the firm's debtors.

Factoring is not suitable for all firms and is usually appropriate for trade debtors rather than debts owed by the general public. There has been an increase in the use of factoring since the 1990s. For example, in 1998 the total amount of factoring funding provided across the European Union was €29.6 billion, while in 2004 this had grown to €61.3 billion. This compared to €70 billion in 1998 and €81.9 billion in 2004 within the US (OECD, 2006). In Australia, total debtor financing in 2015 was estimated to be worth over AUD $60 billion (DIFA, 2015). According to the OECD (2018a, 2018b), in 2016 the total volume of factoring deals for SMEs was up across two-thirds of the 34 countries surveyed within their global network. Along with leasing and hire purchase, factoring has become a common source of financing for SMEs.

10.5.2.4 Floor Plan Loans

Typically used by retailers or wholesalers, this type of financing involves securing cash advances against high value stock (e.g. cars, boats, caravans) that can be placed on the showroom floor until sale. Once sold, the money is repaid to the lender plus any interest or commissions (English, 1998).

10.5.2.5 Bridging Finance

This type of loan is common within the property development industry. It involves borrowing money for a short time until the proceeds of another sale can be released or until alternative financing of a more permanent nature can be secured.

10.5.2.6 Commercial Bills

Issued for periods ranging from 14 to 180 days, a commercial bill is a written promise to pay the business an amount of money on a particular date. The bills are sold on the short-term money market and cash is issued to the business after sale. Such bills are available from financial institutions and incur fees for their services (English, 1998).

10.5.3 Intermediate-Term Loans

Intermediate-term loans are so called because they offer financing over a period from 1 to 10 years' duration. These loans frequently have the requirement to be paid back in large instalments over a short time period and can incur higher rates of interest. Examples of this are personal loans, hire purchase agreements and leasing.

10.5.3.1 Personal Loans

While most personal loans are used for individual household needs, it is common for small business owner-managers to acquire such loans for the financing of business activities. Personal loans frequently finance motor vehicles and office equipment.

10.5.3.2 Hire Purchase and Leasing Agreements

Finance companies rather than banks are more likely to provide hire purchase deals, and such agreements can carry high costs. One negative aspect of hire purchase is that the ownership of the property or goods purchased under the agreement remains with the lender until the payments have been made. A lease agreement is beneficial to the small business as it does not tie up large sums of money for capital items. A lease – while technically not debt – is a contract that permits the owner-manager to use someone else's property (e.g. land or equipment) for a period of time and at a determined cost, and operates much like a debt contract. Leasing is attractive because the lease payments are tax deductible, and it often allows the firm to acquire assets that would be difficult to finance via other means (Megginson et al., 2000). Leasing and hire purchase agreements have grown steadily around the world as a source of financing for SMEs (OECD, 2018a, 2018b).

10.5.4 Long-Term Loans

The long-term loan generally has a period of contract lasting in excess of 10 years. Because such loans are so long term, it is usual for the bank or other financial institution to require the business to demonstrate that it has a good track record of trading and is stable. Such loans also require collateral, usually in the form of a mortgage against property or other assets. Should the business go bankrupt, the lender or mortgage holder can step in and take control of the business and seek to recover its money from the sale of assets (Hodgetts & Kuratko, 2001). Banks provide much of the mortgage lending, but finance companies and mortgage brokers are also common sources. Repayment of the mortgage requires principal plus interest, and interest rate terms can be both fixed and variable. It is possible to secure a second or even a third mortgage on the same property so long as there is sufficient equity available (English, 1998).

Table 10.2 Comparison of auction versus price posting strategies in P2P Lending

	Auctions	Posted prices
Initial interest rate:	Chosen by the borrower.	Pre = set by Prosper.com
Contract interest rate:	Prevailing interest rate at the end of the auction.	Initial interest rate.

Source: Wei and Lin (2016)

10.5.4.1 Peer-to-Peer Lending

A new emerging source of debt financing is peer-to-peer (P2P) lending. This is currently still in an early stage of development, but has been growing strongly in recent years with around USD $8.9 billion P2P loans issued in the United States in 2014 alone (Wei & Lin, 2016). In Australia, P2P lending is still evolving and in 2015 was estimated to be worth less than AUD $25 million, although it is expected to grow strongly (Productivity Commission, 2015).

P2P lending typically operates via an online platform that represents a market place for matching borrowers to lenders. At least two approaches can be taken to P2P lending. The first is that of an *auction* or *posted prices*, much the same as occurs within real estate markets. Most P2P online lending platforms adopt one of these two strategies (Wei & Lin, 2016).

As shown in Table 10.2, there are different characteristics of the *auction* versus *posted prices* strategies in P2P lending. In the case of the *auction* model the borrower can have more control over the setting of the interest rate, but this will be finally determined as a result of the auction process and therefore it might be possible to secure a lower rate or have the rate negotiated up by the lenders. By contrast the *posted prices* approach uses an intermediary such as Prosper.com who set the rates, usually based on their assessment of the borrower's credit worthiness. Under this model the broker (i.e. Prosper.com) predetermines the rate for the loan and the borrower has to accept or reject the offer. Once agreed all potential lenders use this rate for their loans (Wei & Lin, 2016).

The emergence of new forms of debt financing such as P2P lending is that it will require government regulations to ensure that it protects both the lenders and the borrowers. In Australia, this is something that the corporate regulator, the Australian Securities and Investments Commission (ASIC) is currently undertaking.

> **For example**, … ASIC has recently been working with peer-to-peer (P2P) lenders to develop appropriate regulation. Entrants in the nascent Australian P2P lending market submit that regulation is valuable in ensuring the industry begins with and maintains high standards. Existing regulation is not seen as an inappropriate barrier to entry, but rather a mechanism for ensuring new operators are competent. (Productivity Commission, 2015, p. 182)

P2P lending can operate in either a wholesale or retail market. The *wholesale* model is targeted at professional and sophisticated investors and are currently not regulated in Australia. However, the operator does require a Financial Services License, and may also require an Australian Credit License. Their role is to act as a broker between the investors and the borrower. This is the most common form of P2P lending currently operating in Australia (Productivity Commission, 2015).

The *retail* model of P2P lending is open to the general public and managed via the *posted prices* system described earlier. This type of P2P lending model requires much greater regulation and licensing of the operator. Within Australia this will also require the P2P lending scheme to be registered as a managed investment scheme with ASIC and the issuing of product disclosure statements for investors (Productivity Commission, 2015).

10.6 Securing Debt Financing

As discussed above, debt financing can be sourced from a variety of providers. In Australia, this can include major banks, credit unions and building societies (including customer-owned banks), foreign subsidiary banks and bank branches, and other banks such as community banks (Productivity Commission, 2015). However, the main source of debt financing for SMEs has traditionally been banks (Storey, 1994). This is the case in Australia and also in the European Union (EU) where around 79% of debt financing for SMEs comes from banks (OECD, 2009).

Entrepreneurs, particularly small business owner-managers, frequently view bankers as lacking sufficient understanding of their business, being inflexible and lacking creativity. Like many entrepreneurs, the owner-manager views him or herself as a *possibility thinker* while the banker sees him or herself as *bringing realism to the situation* (Petty & Upton, 1997). A major cause of failure in bank loan applications by small firms is the existence of information asymmetries, where the information available to owner-manager and banker are not identical (Binks & Ennew, 1996). As noted earlier, there is a tendency for banks to view start-ups and small firms as being risky.

To approve a loan the banker usually requires at least two sources of repayment. The first is a primary source of repayment such as cash flows from trading. The second is a guarantee against the possibility of business failure or collateral. Banks frequently adopt a *carcass mentality* when assessing business loan applications considering what the firm will be worth if liquidated. By comparison, the small business owner-manager adopts the most optimistic outlook (Petty & Upton, 1997). Much has been made of the need for entrepreneurs and bankers to be better able to understand and appreciate each other's perspectives (Larry, 1990; Lister, 1991).

The importance of a good business plan to achieving bank financing has also been highlighted (Bardell, 1988; Landsberg, 1986), as has the need for cash flow projections to be prepared by professional accountants (Nichols, 1991). However, service-based firms and those engaged in high technology industries lack the tangible assets available to manufacturers or other capital-intensive industries. Such firms are likely to find it more difficult meeting bank risk assessment criteria when seeking funding (Taylor, 1989). Banks are beginning to consider cash flow and the valuation of intangibles in their assessments of business loan applications but

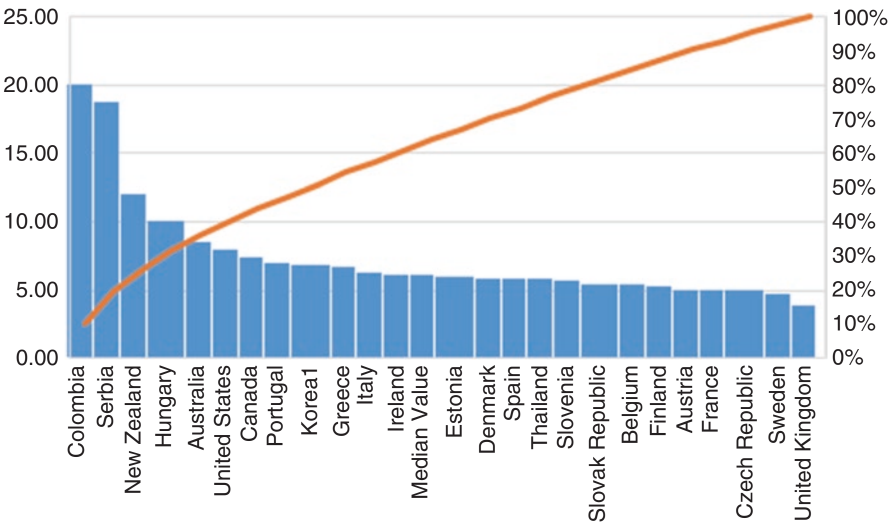

Fig. 10.1 Average bank interest rates for loans to SMEs 2007–2014 selected countries. (Source: OECD, 2016a)

difficulties remain. Most banks will seek assurance in the form of loan security such as personal property such as housing or land.

10.6.1 Business Banks

A range of sources can provide financing for entrepreneurial ventures. Business or commercial banks are the most commonly used and offer entrepreneurs a comprehensive range of services. One of the most frequently-used bank services is an overdraft facility. This represents a flexible line of credit enabling the business to overdraw accounts to an agreed limit over a particular period of time. The bank will usually require some form of security and this is often real estate or some other form of tangible business asset. Banks also offer tailored business loans comprising specific sums of money over given time periods and secured against tangible assets. Such loans are frequently employed to finance the purchase of new plant, equipment or other fixed assets. Interest only repayments are sometimes negotiated by businesses to ease the impact of the loans on cash flow.

As shown in Fig. 10.1, over the period 2007–2014 interest rates charged by business banks for loans to SMEs have averaged at around 5.41% across many countries (OECD, 2016a). The United Kingdom has maintained one of the lowest rates at 3.7%, while Columbia has had one of the highest levels at 20.7%. In Australia, this rate of interest on SME business loans has been running at an average of 7.5%. Bank lending to SMEs generally requires collateral and more than half of all loans issued by banks across most countries are secured against collateral assets such as property. However, the OECD (OECD, 2016a, 2016b, 2016c) notes that collateral requirements for SME loans amongst banks vary considerably country by country, with "no discernible pattern".

> **For example**, … Differences in businesses' access to credit across different economies are influenced by a range of factors such as macroeconomic conditions (that can affect the supply and demand of credit) and government policies around taxation and SME finance. The extent that countries embrace innovative lending models (such as P2P lending) can also have an impact. (Productivity Commission, 2015, p. 189)

It should be noted that over the period from 2013 to 2016, interest rates for SMEs declined in all but two of the 36 countries that comprise the OECD. These were Ireland and Switzerland. In 2016 France had the lowest average interest rate charged to SMEs at 1.5%, and Chile had the highest, at 9.25% (OECD, 2018a, 2018b).

10.6.2 Factoring, Leasing and Financing Companies

In addition to the business banks there are specialised factoring companies that offer accounts receivable financing or *factoring*. These firms acquire a business debt and take the responsibility to collect it. The money released by this transaction can be used to pay suppliers. Factoring companies usually provide finance for between 80% and 100% of approved debtors, less any charges. Large firms frequently use factoring to assist in their financing of large projects as they can increase their liquidity over the short term. The process can also free up staff who might otherwise be involved in the collection of account receivables. A business that has reliable customers who simply pay their bills slowly – e.g. printers who supply government agencies – can take advantage of factoring to speed up cash flow.

For ventures with higher risks than many conventional banks will accept, a finance company is an alternative. These firms can provide finance in the form of leases and hire purchase agreements for plant and equipment at higher than average interest rates. While such companies often require less collateral security than banks, they take a stronger interest in the ability of the client firm to repay the loan. Such loans are also likely to carry higher interest and charges than might be the case with banks. In 2015 it was estimated that total debt financing via *factoring* in Australia was over AUD $60 billion (DIFA, 2015).

In addition to *factoring* other asset-based financing for SMEs and entrepreneurial firms can include leasing and hire-purchase financing. *Leasing* usually involves the business acquiring an asset (e.g. motor vehicle, plant and equipment) and renting it with finance from the leasing company. This usually takes place over a specific time period and may result in the business having the option or obligation to own the asset at the end of the contractual period. Although leasing is not strictly a debt financing structure it has some similarities. According to the OECD (2016a) *factoring* and *leasing* have become the most widely used forms of asset-based financing among SMEs. Over the period 2009–2014 *factoring* as a source of financing grew at a compound annual rate of 13% (OECD, 2016a).

10.6.3 Insurance Companies and Merchant Banks

Insurance companies and merchant banks can also be sources of funding. Insurance companies have offered financing through the security of life insurance policies with a cash value for many years. More recently, such firms have obtained banking licenses. Merchant banks are another useful source of venture capital and can assist in a variety of other financial arrangements such as restructuring and amalgamations. As with venture capitalists, the merchant banker will be more concerned with the overall potential of the small business as a sound investment than with its collateral security. A down side for such banks is that they will seek to secure part-ownership of the business, thereby diluting the owner's equity and control.

10.6.4 Trade Creditors

Faced with difficulties in obtaining finance, many entrepreneurs seek to raise funding from other sources. This can include securing trade credit from suppliers or government agencies in the case of exporters. In Mexico, around 60% of the financing received by SMEs is sourced from suppliers as trade credit (OECD, 2016a). It is also an important in Australia and has been estimated by the Reserve Bank as being worth around AUD $80 billion in 2013 (Fitzpatrick & Lien, 2013). Throughout the OECD almost half of all countries provide trade credit to assist exporters (OECD, 2016a).

Trade credit is important to SMEs with around 28% of all liabilities taking that form within Australian small businesses (ABS, 1997). However, it is generally easier for larger firms to negotiate trade credit terms with suppliers than SMEs as they have greater bargaining power (Fitzpatrick & Lien, 2013). What is not commonly appreciated is that, if the business is unable to secure funding from either debt or equity to provide its working capital requirements, the only source of financing available is usually trade creditors. When a business experiences rapid growth without sufficient working capital to fund its operations, and cannot obtain additional funding from other sources, it invariably increases its *creditor strain*, i.e. the time taken to pay the suppliers.

While the process of straining creditors is frequently viewed as a legitimate business practice among some entrepreneurs – that is, receive money quickly and pay creditors slowly – it is a risky strategy. Once a business gets a reputation for being slow to pay, it is likely that trade creditors will begin to raise the cost of doing business with them and key suppliers may suddenly refuse to provide goods or services at critical times, thereby placing increased strain on the venture.

However, late payment to trade creditors is a fairly common problem. For example, a survey of 211 small firms in the United Kingdom found that 89% reported paying their suppliers late, with 13.3% indicating that this was a common occurrence. Average creditor days were 46.3 and average debtor days were 52.6. Interestingly, large firms were the worst offenders in paying their smaller counterparts slowly (Peel, Wilson, & Howorth, 2000).

It is worth noting that cash flow is frequently ranked as being among the top three problems facing small firms in the quarterly *Sensis Small Business Index* (Sensis, 2017). Cash flow management is a critical area for successful financing of a small firm (Rowan, 1994). Credit management techniques designed to speed up the collection of payments from customers and to reduce bad and doubtful debtors – e.g. checks on credit worthiness and tighter credit policies – are likely to ease cash flow problems for small firms (Peel et al., 2000).

10.7 What Are Banks Seeking?

Entrepreneurs and small business owner-managers frequently accuse the banks of being unwilling to lend to them or of placing unfair restrictions on how much funding they will supply. The level of hostility toward banks among the small business community is often high. However, banks remain a most important source of financing for the majority of small firms. It is therefore desirable that entrepreneurs and owner-managers understand what bankers are seeking and respond by preparing themselves and their firms appropriately.

What Banks Look For

Most banks and other financial institutions to which the small firm is likely to turn for debt financing will seek the following:

- *Credit history*. What is the credit history of the borrower?
- *Cash flow*. How has the business been trading over recent years?
- *Collateral*. Are there tangible assets to secure the loan?
- *Character*. Who is borrowing the money and do they have a good track record in business?
- *Documentation*. Can the borrower provide business and personal financial records, income tax returns, and a business plan to support any claims?

Source: CCH Business Owner's Toolkit, www.toolkit.cch.com.

Unlike venture capital, the banker is not seeking to achieve rapid return on investment and an early exit strategy. Most banks want clients and are usually seeking to establish and maintain a long-term relationship with the borrower. Bankers are generally highly risk adverse by nature, and are keen to see a steady and reliable repayment plan with security against possible business failure or default of loans. Banks are seeking evidence of a business having an established financial track record. When approaching a bank for financing, it is important to prepare a full financial history for presentation. According to some accountants, the borrower should prepare financial records displaying up to 3 years if available (Martin, 1999).

The lending criteria used by different banks is subject to substantial variation. However, most banks will be seeking evidence of the same key things. This includes a track record of good cash flow to allow for repayments plus adequate shareholder funds or working capital that can cover any short-term cash requirements and ensure solvency. The bank will also be interested in the reputation and trading history of the business and the management team. This includes no evidence of having been at default on other loans. Finally, they will want to know how the money is to be used. While some banks may be less concerned with this than others, it is more likely that money will be lent for capital equipment or new product or market expansion than repayment of pre-existing business debts (Cattani & Mills, 1998).

10.7.1 How to Deal with the Bank

A study undertaken in the United Kingdom in the 1990s into banks and small business owner-managers found that while most banks were seeking to enhance their relationship with their small business clients, dissatisfaction continues to exist on the part of the small businesses (Gammie, 1995). This study highlighted several things that small business owner-managers should do to improve the relationship between themselves and their bank.

10.7.1.1 Keep the Bank Fully Informed

The first recommendation was for the owner-manager to keep the bank fully informed of their overall financial position. This was particularly important with respect to cash flow and its management. It is often too late when the business has already started to experience cash flow problems to go to the bank seeking additional funding. Openness and honesty in dealing with a bank is important.

10.7.1.2 Accept Advice and Build a Relationship

A second recommendation was for the small business owner-manager to be more willing to accept advice from the banker. While many small business owners feel that banks are unhelpful and can offer them little but money, the majority of business bankers are experienced professionals with the ability to make recommendations that can help a small business. Relationship banking has emerged in recent years as a major channel for most business banks.

The *Relationship Manager* is typically a personal business banker who is trained to work closely with their clients to assist them in business development. It is an expensive channel for most banks to operate and many banks require that client accounts be over a certain size before providing a relationship manager, however, alternative models can apply. Some banks use a structure involving banker support delivered via telephone and other indirect means for small accounts, and personal relationship managers for larger accounts.

10.7.1.3 Negotiate Carefully

A third recommendation was for the owner-manager to negotiate carefully with the bank over charges, seeking clear explanations as to what the total cost of the bank services would be. Once again, the key was to maintain a close working relationship with the bank and engage in regular dialogue and openness. Banks want the business of small firms and operate in a highly competitive market environment. The owner-manager should see their business as important and not feel afraid to shop around for banking services if required.

It has been argued that shopping around is sometimes counterproductive because bankers may become annoyed if they are put to a lot of trouble for nothing (Cattani & Mills, 1998), but this ignores the highly competitive nature of business banking. It is sometimes advisable for the business owner-manager to regularly tender out the banking contract, allowing various banks to bid for their business. While they may not change banks, this helps to keep them informed of the competitiveness of their own bank, and allows their banker to realise that their accounts should not be taken for granted.

10.7.2 What Information Should Be Presented to the Bank?

Each bank will have its own particular lending criteria and will generally outline the type of information that a small business owner seeking funding should prepare when making an application. It is best to talk to the bank well in advance, and ensure that all the necessary information is prepared prior to actually seeking the funds. Cattani and Mills (1998) outline a detailed list of the documents and information that is likely to be important for a banker to see when seeking to secure funding.

10.7.2.1 Personal Profile of the Owner-Manager

The banker may be less interested in the owner than a venture capitalist, but they still want to know whom they are dealing with. A brief resume should be included in any presentation to the bank. This resume might be only 1–2 pages in length, but it should outline educational qualifications, professional training, past work experience (in particular management experience), and other relevant achievements. Personal references from employers may also be useful if the owner has a limited history of operating their own business.

10.7.2.2 Information on the Company

A brochure or other information on the company and its products or services is useful in providing the bank with an understanding of how long the firm has been in business, the scale and scope of its activities, and the overall quality of its operations. This information might also include a list of customers and biographical details on any board members or directors. This can assist in giving the bank a sense of the reputation the company has within the market, and within the wider community. High profile customers and directors or board members can enhance the image for the firm.

10.7.2.3 Evidence of a Good Credit Rating

If the company has previously had borrowings from other financial institutions and has established a good credit rating, it will be useful to include in the application letters of reference from other banks stating that payments on past loans have been regular and reliable. Where possible the names and address of the company's lawyers or accountants should be provided.

10.7.2.4 Proof of Company Ownership or Registration

Where the business is a private company, there may be some requirement by certain banks for the owner-manager to prove that they own the company, and share certificates or registration documents will need to be shown. If company-owned assets are to be used as collateral, there may be a requirement to provide proof of ownership. This may involve an audited set of accounts or a statutory declaration listing assets and liabilities.

10.7.2.5 Financial Statements

The most crucial information for most banks will be the company's accounts, and the three key documents will be the balance sheet, profit and loss account, and cash flow statement. At least 3 years of accounting information should be provided if such information is available. Where a substantial amount of funding is being sought, it may be prudent to have these audited by a charted accounting firm or certified accountant and approved by the company board of directors. Doing this in advance may avoid the trouble of having to respond to a request from the bank at short notice, or having to submit to the bank auditing the books themselves.

10.7.2.6 Future Earnings Potential

The company budget for the forthcoming year and sales or cash flow forecasts should also be included in the documents provided to the bank. Letters of contract or order book data demonstrating agreements may support these forecasts. This may require the owner-manager to provide documentation that shows contracts with suppliers and customers. It may be necessary to defend cash flow and earnings forecasts, so the owner-manager should be ready to explain how they have derived these figures.

10.7.2.7 Business Plan

The longer-term outlook for the business will interest the banker as much as the venture capitalist. The owner-manager seeking debt financing should provide an up-to-date business plan that clearly outlines where and how the new capital expenditure will be applied, and the anticipated revenue and expenditure over a period of up to 3–5 years. Such formal business planning should be viewed as being of benefit to the company – regardless of whether the bank lends or not. If the plan is a genuine attempt by the owner-manager to map out a future for their business, rather than a cynical exercise in raising capital, it is likely to stand out and reassure the bank that the debt will be repaid.

10.7.2.8 Feasibility Assessments

If the funding being sought from the bank is to be used for a major business expansion, it is likely to be useful for the owner-manager to demonstrate the feasibility of the project or programs being financed. For example, the purchase of capital equipment should be evaluated to demonstrate that returns on investment will be achieved and that growth plans can be fulfilled. Market research studies or information would also be appropriate here if they assist in demonstrating the merits of an expansion program.

10.7.2.9 Security or Collateral

Finally, the owner-manager is likely to need evidence of security or collateral against which a loan can be secured. While not all debt financing is secured by a mortgage, the majority of long-term debt will require security of some kind. This usually involves property or such fixed assets as plant and equipment. If a personal home is to be used to secure a mortgage, the documentation should include proof of ownership and recent valuation certificates if possible. It should be remembered that banks and other financial institutions are unlikely to lend against the full value of any collateral, and assets worth substantially more than the loan may need to be pledged. This is often viewed as unfair by small business owner-managers, but this is often beyond the control of the individual banker.

It should also be noted that, while the size of a firm's balance sheet and shareholder equity may be attractive, these items alone might be insufficient to secure significant funding from a bank. The banker will be interested in how the money will be applied and how repayments will be achieved. Care should be taken to ensure that the size of the borrowing is appropriate for what is required. Over borrowing only raises the level of debt held by the business and places excess interest burdens on the company. Negotiate the deal over interest charges and fees. It is frequently within the banker's power to reduce interest charges and fees to secure a competitive loan. The world of small business banking can sometimes be a buyers' market if the owner-manager operates a quality company.

Assessing Funding Requirements

The key elements for assessing the funding requirements of a small business are:

- *Net fixed assets:* fixed assets less depreciation;
- *True working assets:* stock + debtors – creditors + creditor strain, e.g. day's payable over 60 days; and
- *Equity:* share capital + retained profits.

The external funding requirement calculation is:

- Net fixed assets + true working assets – equity

For example:

Net fixed assets $275,000.
True working assets + $70,000.
Less equity ($120,000).
External funding needed $225,000.

Note: As a business increases its operations due to growth, it will need more working capital (true working assets) and, unless it can increase equity through share capital and retained profits, it will need to source funding from external sources – usually in the form of debt.

10.8 Equity Financing

Despite the best cash flow management, and even with support from a banker, most entrepreneurs usually reach the limits of bootstrap or debt financing over time. To fully expand the business, they require large sums of money that must come in the form of equity capital. Equity financing – or venture capital (VC) – is often difficult for small firms to acquire as it tends to involve higher risk, than debt financing, and because the owner is forced to dilute their equity and to share control with other investors. According to the OECD (2018a, 2018b) entrepreneurs seeking exits from their business ventures are more likely to do so via mergers and acquisitions (e.g. trade sales), than by public listing on the stock market through an initial public offer (IPO). This is due in part to the difficulties that an IPO poses for the majority of small firms. In fact, the total number of IPOs across both the United States and Europe has been steadily declining (OECD, 2018a, 2018b).

Venture capital investments in the United States in 2015 were estimated to be worth around USD $59.7 billion, which comprised 85% of all VC investments

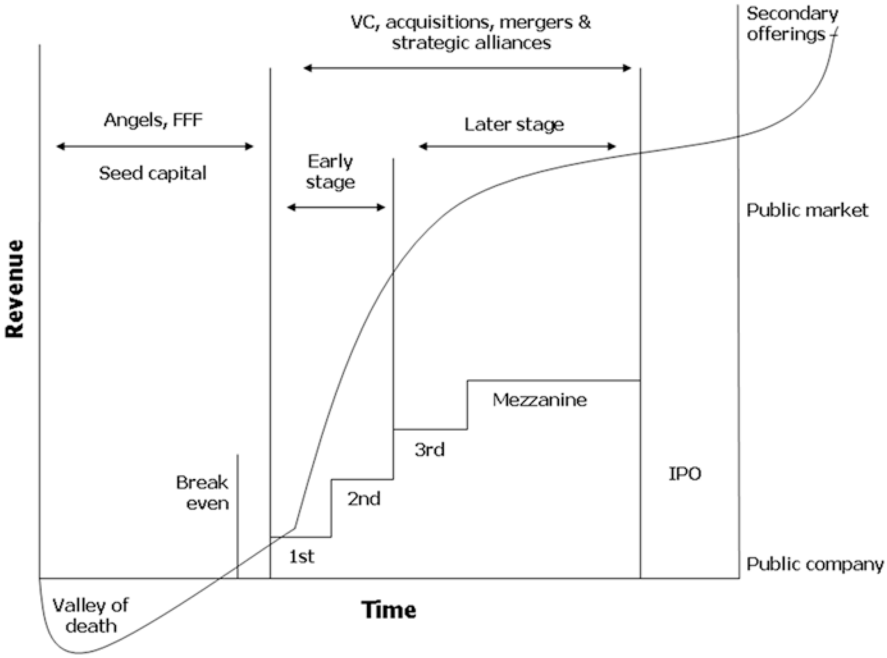

Fig. 10.2 The financing lifecycle. (Source: Cardullo, 1999)

across the entire OECD group of companies. By contrast, the total VC investment in the European Union was USD 4.2 billion for the same year (OECD, 2016b). In Australia, the amount of VC investment during 2015 was only around AUD $8.8 million (ABS, 2016). While the United States and Israel have VC industries that comprise respectively 38% and 33% of their national GDP, this is a rare situation. For most countries, VC financing comprises less than 0.05% of GDP (OECD, 2016b). As such, VC is a highly-specialised form of business financing with its own dynamics.

Figure 10.2 illustrates the financing lifecycle through which small firms typically pass if they follow a VC-funded growth path. As shown, there are several distinct stages that the firm must pass, commencing with early stage seed capital funding, then moving on to early stage and later stage VC funding until it is either sold to a larger organisation via a trade sale or listed on the stock exchange via an initial public offering (IPO).

10.8.1 Seed Capital Funding—Family, Friends and Fools

Initial funding for small firms typically starts with the personal savings of the owner-manager and perhaps the provision of loans or other borrowings from family and friends. These informal sources of equity financing have been found to be among the most important to small firms, particularly highly innovative SMEs. The fast growing, high technology or high innovative firm is inherently risky and may not find it easy to attract debt financing from banks. Small firms are also often too small to secure investment from formal venture capital funds (OECD, 2004).

The most common type of initial equity capital accessed by small firms is private equity. This is typically supplied by the *Three Fs* – namely family, friends and fools (FFF) – who provide informal funding to the business and usually don't seek substantial returns or demand high levels of due diligence. This type of funding may only be a few thousand dollars. The reference to *fools* is not meant as a derogatory term, but it reflects the fact that such investors don't normally undertake much due diligence prior to making their investments.

10.8.2 Business Angels

Once the business needs larger amounts of investment, the owner may need to turn to more substantial sources of equity funding which is frequently supplied by business angels. These are typically wealthy individuals willing to invest their money into business ventures in the expectation that a better-than-average return can be obtained. The term 'business angel' was reported to have originated from the United States theatre when Broadway musicals – frequently high risk and cash starved – were saved from disaster by wealthy private investors who appeared like angels from heaven to provide much needed funding to allow new shows to go on (Oats, 1992).

In recent times the business angel is a wealthy private investor who puts up early stage financing to assist entrepreneurs to develop ventures that might otherwise fail to attract formal venture capital. They are considered one of the most important sources of risk capital available to early stage technology companies (Dwight, 1999).

Such people can be difficult to find and usually don't advertise their interest in offering money for venture capital. Most business angels operate via a network of accountants or lawyers who refer them to entrepreneurs. Social contacts can therefore become highly important in this process. Most business angels don't wish to run the business, but can demand a lot of the entrepreneur's time in keeping them informed and happy.

> **Business angels may be defined as**, … high net-worth, non-institutional, private equity investors; that is, individuals who have the desire and sufficiently high net-worth to enable them to invest part of their net worth into high risk – high return entrepreneurial ventures in return for a share of voting control, income and ultimately capital gain. (Hindle & Wenban, 1999)

Business angels have been identified as the largest single source of risk capital for entrepreneurial companies (Wetzel & Freear, 1994). In the US, angels have been estimated to finance 30–40 times as many early stage companies as formal venture capital funds (Gaston, 1989; Van Osnabrugge, 1998). Within Australia, business angels were estimated in the 1990s to contribute about $9.3 billion in investment capital (Coopers & Lybrand, 1997).

The typical business angel is a middle-aged male of high net worth with annual income of around $180,000 and personal wealth of around $2 million. They are likely to have 10–14% of their investments within small entrepreneurial ventures, and usually invest an average of $200,000 in each deal (Hindle & Wenban, 1999). Business angels are often engaged in investments that are close to home, or located in their local region or city and in industries that are familiar to them (Wiltbank & Sarasvathy, 2002). In the US, it is sometimes said that business angels operate within a radius of 50 miles (80 km) of their homes. They will also frequently ask for a seat on the board so as to closely oversee the work done by the team (OECD, 2006).

Angel investors have been identified as playing three broad roles within the ventures in which they invest. The first is a strategic one, providing guidance to the entrepreneurs seeking to develop the venture. The second role is an operational one, frequently networking the venture to a wider market or management talent pool, and assisting the entrepreneurs in finding additional resources. Finally, the angel can play a personal role guiding the entrepreneur as a mentor or friend (Sapienza & De Clercq, 2000).

However, while business angels are an important source of financing for entrepreneurial investments, it is difficult to get reliable information on their activity due to differences in definitions and data collection methods. While business angels are commonly described as wealthy private individuals who invest part of their personal assets in a start-up and also share their personal management experience with the entrepreneur, definitions from different sources vary (OECD, 2009).

The business angels' market is much larger in some countries than others. For example, in 2014 it was estimated that there were around 316,600 active business angels who each invested an average of USD $328,500. Over the period from 2012 to 2014 a total of USD $24.1 billion of business angel investments were made in the United States (OECD, 2016b). By comparison total business angel investment from the EU, UK, Canada and Turkey in the same time period was a total of only USD $408.9 million (OECD, 2016b). The USA has been noted as a larger and more vibrant business angel market than EU or most other countries for some time (OECD, 2009).

A study of 15 business angels located in Western Australia found that the typical profile of an 'angel' in Perth was 50–59 years of age with an above average level of education – usually a postgraduate degree. These people had invested in an average of 12 deals, contributing between $50,000 and $100,000 to each venture. Key motivations for such investments were to make money, but also to contribute to the development of a worthwhile venture and assist the local economy. The idea that a venture might be 'fun' was also a consideration. However, levels of direct involvement in the management of the ventures in which such investments were made were generally quite low, although these angels did serve as a 'sounding board' for the entrepreneurs in whose businesses they had taken equity (Callahan & Mazzarol, 2003).

This is a similar profile to that found in other countries where the typical business angel is a middle-aged male, with above average education and past experience in business or management. Such individuals also have high net-worth from a financial perspective. However, there is now evidence of a gradual change in the profile of business angels. For example, in the United Kingdom the proportion of women who are business angels has increased significantly over the past decade, although it still remains are only 14%, and the median age is slowly falling from the mid-50s to the mid-40s. This is a similar pattern as found in the United States where around 26% of business angels are women (OECD, 2016a).

10.8.3 Crowdfunding

As with P2P lending in the debt financing area, a new developing in equity financing is *crowdfunding* or crowd-sourced financing. This occurs when a business or entrepreneur raises capital from a large number of investors to either launch a new venture, or commercialise a product. It is usually undertaken via online platforms and has been popularised through the activities of crowdfunding online entities such as Kickstarter, Quirky or Indiegogo. The volume of online fundraising and *crowdfunding* activity around the world has doubled over the period from 2013 to 2016, with China, the United States and the United Kingdom demonstrating some of the highest levels of activity (OECD, 2018a, 2018b).

According to the Australian Productivity Commission (2015), *crowdfunding* typically takes four major forms:

1. *Donation crowdfunding*: where the money is donated to a project without any anticipation by donors of getting a return.
2. *Reward crowdfunding*: where the providers of the funding receive a benefit, usually in the form of a product or service generated with the money. This can occur with music or artistic projects where the musicians give those who provide funding special editions of their new album, or seats at their performances.
3. *Debt crowdfunding*: this is a similar model to P2P lending but takes place on a large scale, such as retail P2P lending.
4. *Equity crowdfunding*: in this case the investors acquire shares in the business and receive dividends and capital gains.

Crowdfunding is becoming a mechanism for business angels to find investment opportunities. For example, in the UK a survey of business angels found that around 45% had invested through crowdfunding platforms. However, these investors were typically younger and less experienced business angels (Wright, Hart, & Fu, 2015). In Canada and the United States *equity crowdfunding* requires investors to be high net-worth *accredited investors*, who are similar to business angels (OECD, 2016a, 2016b, 2016c).

10.9 The Nature of Venture Capital

While there is no clear definition of the term venture capital, there appears to be at least four common elements associated with most venture capital deals (Barnett & Mazzarol, 2002a):

- The investment in the venture is facilitated by equity or equity related instruments.
- The investment in the venture involves higher than average risk.
- The investor adds non-financial value to the venture by the provision of management skills or advice.
- The purpose of the investment is to secure above average returns through capital appreciation.

Venture capital providers come in a variety of forms but their role is to invest in new and rapidly growing smaller companies by taking an equity stake in the venture. In return for their investment, it is common for venture capital providers to also seek some control or influence over the management of the business. This is one of the major issues for entrepreneurs, who often fear losing control over their business as venture capital providers seek to control the direction of the company. It is important to note that venture capital investment is largely private, and can be both formal and informal in nature. The following quotation from Kenney (2001) provides a good definition of the nature of the venture capitalist and their motivations:

> **The venture capitalist** … the venture capitalist aims to invest in newly established firms capable of growing quickly and thereby creating capital gains of at least ten times their investment in less than five years. The difference between venture capitalists and bankers and other investors is that the venture capitalist actively monitors the venture and assists in its growth. (Kenney, 2001)

As illustrated in Fig. 10.3, the decision-making process undertaken by formal venture capital providers is rigorous and can involve a high level of rejection at any stage during the evaluation process. In fact, the screening process employed by

Fig. 10.3 The venture capital screen. (Source: Teten & Farmer, 2010)

venture capital firms typically involves reviewing 80 opportunities, selecting only 20 to hold initial meetings with the management teams, then weeding this list down to short list of about 4 deals, subjecting three of these to due diligence reviews before finally selecting one deal (Teten & Farmer, 2010).

One perspective describes venture capital financing as a dynamic process that adapts and shifts in response to the surrounding environment and changing nature of industry (VCJ, 1987). Another view sees it more as a process involving the investment of financial resources into the business venture at various stages of its development cycle, and in which the investor accepts high relative risk in expectation of significant capital gain (Golis, 2002). Venture capital is frequently viewed as relating to a particular class of financial asset associated with unlisted or non-public share capital (Smith, 2000).

The non-public nature of venture capital financing highlights the importance within the venture capital process of the investor. This individual – the venture capitalist – plays a critical and largely non-financial role in assisting newly emerging companies to grow and develop (BVCA, 2001). This non-financial function is a process of screening and monitoring fledgling firms, as well as providing financing (Anand & Galetovic, 2000). Whereas the typical investor in a publicly listed company is seeking an income yield that complements capital gain, the VC investor is motivated almost exclusively by capital gain (Wright & Robbie, 1997).

Venture capital is therefore a process involving relatively high risk, due to the fact that the business venture into which the capital is being invested is usually unproven or underdeveloped either in terms of its commercialisation or market growth. Further, there is usually no immediate mechanism for the disposal of the investment, as is typical within the public share market. A key element of the venture capital process is the VC investor who adds value to the venture, and partly mitigates his or her investment risk by playing an active role in the management of the venture to some degree and in some direct capacity (Leonard & Swap, 2000). Their main investment objective is to achieve returns on the investment by capital appreciation. It should be noted that while VC investors are commonly perceived to be professionals managing venture capital funds, the term can also be used to describe any person or corporate entity that makes an investment involving risk and early stage business ventures.

10.9.1 Formal Venture Capital Financing

By contrast with business angels, the venture capitalist is usually a professional funds manager who is willing to invest in a business if the returns are high enough. Returns of about 25% are usually expected, although some may demand ROI of as much as 50 or 60%. As professionals, these venture capitalists will demand good management from the entrepreneur and will usually put a higher priority on this than the product or market potential (Mason & Stark, 2004).

The amount of venture capital available within an economy varies considerably from country to country. Table 10.3 lists the venture capital investments made across a number of selected countries in 2015. It can be seen that the United States remains

Table 10.3 Venture capital investments 2015 – selected countries

Country	US $	Country	US $	Country	US $
Greece	0	Norway	$62.20 m	Switzerland	$289.29 m
Slovenia	$1.50 m	Portugal	$65.08 m	South Africa	$352.72 m
Czech Republic	$1.85 m	Belgium	$68.30 m	France	$757.86 m
Estonia	$4.12 m	Ireland	$84.03 m	Germany	$958.47 m
Luxembourg	$5.94 m	Denmark	$86.34 m	United Kingdom	$951.93 m
Slovak Republic	$9.91 m	Finland	$118.19 m	Korea	$1087.46 m
Poland	$21.72 m	Austria	$122.87 m	Japan	$1105.29 m
Hungary	$27.67 m	Spain	$173.55 m	Israel	$1165.00 m
New Zealand	$43.59 m	Netherlands	$180.50 m	Canada	$1825.63 m
Italy	$51.33 m	Sweden	$180.84 m	Total Europe	$4220.13 m
Russian Fed.	$59.00 m	Australia	$288.49 m	United States	$59,698.50 m

Source: OECD (2016b)

the world's largest and most vibrant VC market, with nearly USD $60 billion invested. This is more than 14 times the size of all the venture capital invested within Europe during the same period. As noted above, only relatively few companies receive venture capital financing and it is rarely issued to start-up ventures, although Austria and Sweden are exceptions (OECD, 2016b).

Finally, the largest source of equity capital is the public equity market. This requires the entrepreneur to prepare their company for public listing on the stock exchange. They will therefore become exposed to high levels of government regulation and scrutiny. Many entrepreneurs fear potential loss of ownership or control through such a process. However, this is usually the only way a company can get access to substantial capital funds.

10.10 The Venture Capital Process

As a process, venture capital financing can be viewed as moving through several distinct stages that broadly equate to the developmental cycle of the business venture (see Fig. 10.2). Each stage usually requires increasing levels of investment and involves differing levels of risk and return. Although there remains some debate within academic circles as to the number of stages within the venture capital process, five distinct stages can be identified, namely (Barnett & Mazzarol, 2002b; Golis, 2002; Humphrey, 2000):

1. *Seed capital* – typically $50,000 to $500,000 applied to R&D, prototype development and incorporation costs.
2. *Start-up capital* – typically between $500,000 and $2 m, applied to commencement of initial commercial operations.
3. *Early expansion capital* – typically between $2 m and $10 m, applied to marketing and market development, plus the building of a management team.

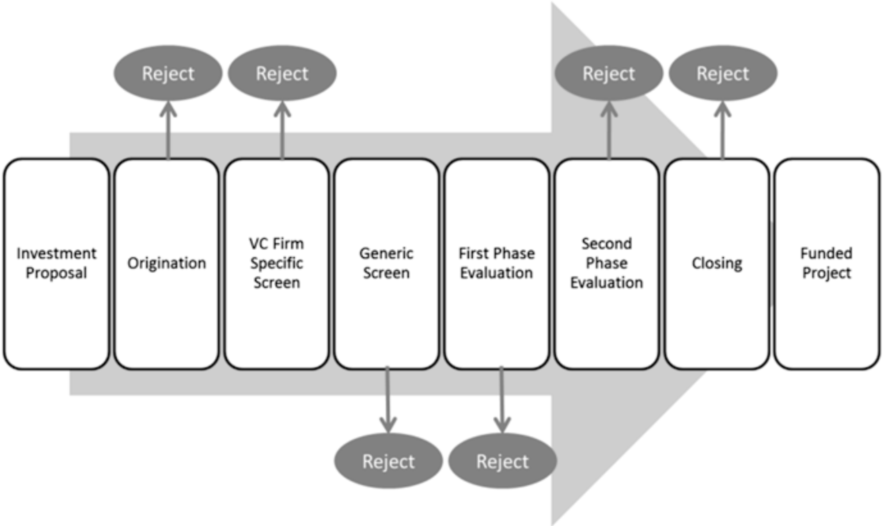

Fig. 10.4 The venture capital process. (Source: Fried & Hisrich, 1994)

4. *Development capital* – typically between \$2 m and \$10 m, used for market expansion and adjustments to the product design or process re-engineering.
5. *Mezzanine capital* – typically between \$10 m and \$50 m, used for IPO and related expenses, acquisitions or major capital funding.

As illustrated in Fig. 10.4, the process that occurs within the VC firm when dealing with an investment deal takes at least eight stages. If the proposal survives the initial screening it will be moved into a more rigorous multi-stage process of screening with the possibility of rejection at each stage. This process involves increasing time and costs to the two parties seeking to negotiate the deal, and requires a willingness to share information and build trust and common purpose. The deal can be rejected at any stage and requires patience and a willingness to seek mutually beneficial "win-win" outcomes by both the investor and the investee.

10.10.1 The Nature of Venture Capitalists

The typical venture capitalist is a member of a small, independent partnership with a professional staff of between six and 12 people, including a few general partners and a small number of associates who are venture capitalists in training. Venture capital firms are small. Studies undertaken in the US in the late 1990s found that a typical venture capital partnership managed between US\$50 and US\$99 million in assets. Nearly three-quarters of all venture capital firms managed between US\$25 million and US\$250 m in assets (Onorato, 1997). In comparison, in 1996 the average US commercial bank had a portfolio of more than US\$481 m, and the 100th largest bank had more than US\$7 billion in assets (Berlin, 1998).

The venture capitalist doesn't make his or her investment all at once. Instead, funds are always provided in stages, and the entrepreneur receives only enough funding to reach the next stage. Each stage has well defined performance objectives, and more funds are provided if performance objectives are met. If performance objectives are not met, the venture capitalist must make a decision. Should the portfolio firm's strategy be reconsidered? Should the firm's management team be changed? And, in the worst case, should funding be cut off completely? Even if the venture capitalist decides to provide more funds, the entrepreneur will pay a price. The venture capitalist inevitably demands a larger share of the firm's stock in return for additional funding to meet some objective (Berlin, 1998).

10.10.2 The Nature of Venture Capital Investors in Australia

In 2015 there were around 121 active venture capital and late stage private equity (VC&LSPE) managers operating in Australia, managing 210 VC&LSPE investment funds (ABS, 2016). The VC&LSPE managers in Australia are professional investors who are either individuals with high net-worth, or institutional investors such as superannuation (pension) funds (Jones, 2008).

Figure 10.5 illustrates the general operation of the Australian venture capital sector. The VC&LSPE managers control the venture capital investment through two types of investment vehicles: direct and indirect. The first of these invests directly into investee companies, while the second pools funds and then places the money into the direct vehicles. Investors place their money into either of these two vehicles

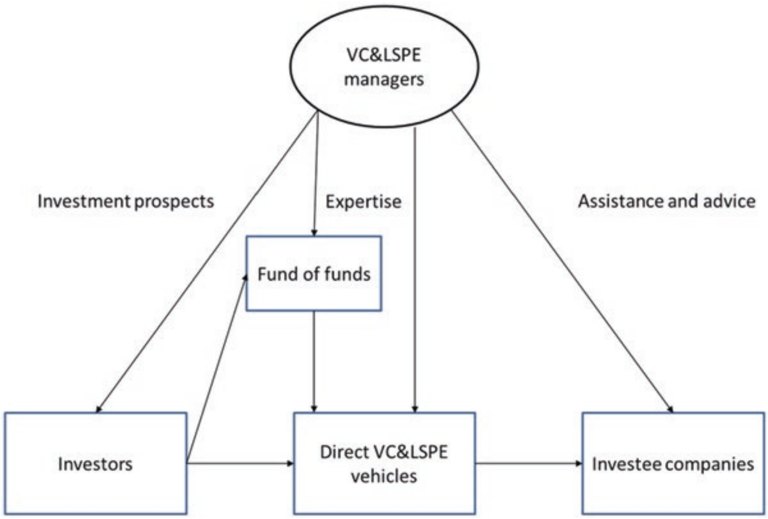

Fig. 10.5 The venture capital and late stage private equity (VC&LSPE) sector in Australia. (Source: ABS, 2016)

and rely on the VC&LSPE managers for their expertise in managing the investment and getting an attractive return on the funds committed. The investee companies that receive this venture capital rely on the VC&LSPE mangers for assistance and advice to help them secure the funding they need, and assist with strategic decision making required to enable the business to grow. It is worth noting that the majority of VC funding (68%) in Australia is sourced locally with 42% sourced from superannuation (pension) funds (ABS, 2016).

Pitching for Venture Capital

According to recent analysis of the climate for hunting venture capital financing in North America, the following things should be considered when pitching for venture capital.

Leave the shot gun at home:

Don't waste time using a scatter gun to target every VC in town. Target your approach carefully and approach those funding providers who are most likely to support your kind of deal. In doing so:

- ensure that you know as much about this VC as you can *before* you make your pitch;
- tailor the pitch to suit their track record of doing similar or previous deals; and
- seek to sell your deal to them as a compliment to their existing investment portfolio.

Don't sell your technology:

The focus should be on the financial deal and the benefits to the VC, and *not* on the product or how smart it is. Focus the pitch on the 5 Ps:

1. *People.* Who is behind the company and who will run the venture?
2. *Product.* What is the product and why is it so good for the market?
3. *Problem.* What is the problem that this product or technology solves?
4. *Placement.* Where will the product be initially placed (target market) and is there a lead customer(s)?
5. *Plan.* How will all this work, how will you go to market, and how will you manage growth?

Timing is everything:

Make sure that your venture is ready to go to market and that you have the product, the team and the customers ready – or nearly ready – before making the pitch. Long lead times for R&D may not be attractive, and time-sensitive technology needs to be ready to go to ensure that its window of opportunity is not closing or closed.

Source: Watson (2003).

10.10.3 What Do Venture Capital Investors Look For?

A study of venture capital investors found that the top five things that they looked for when deciding whether or not to invest in a deal were (MacMillan, Siegel, & Narsimha, 1985):

10.10.3.1 The entrepreneur's Personality

Of importance was the entrepreneur's personality, in particular whether or not they seemed to be capable of sustained, intense effort and had an ability to evaluate and react to risk. Also important was their ability to explain their venture or business model clearly and understand its detail. Finally, they needed to have a personality that was viewed as compatible with the venture capital investor to allow for a good working relationship.

10.10.3.2 The entrepreneur's Experience

Of importance was the entrepreneur's experience, and specifically whether they were thoroughly familiar with the target market and had demonstrated leadership ability as well as a relevant track record. Also, of importance was whether the entrepreneur was either referred by a trustworthy source or had a reputation for past success.

10.10.3.3 Characteristics of the Product or Service

The third factor was the product or service being developed. This included whether the product was proprietary or able to be formally protected via patent, and if it had been sold into the market. It if had not been fully commercialised, it was important to determine if there was a working prototype and if the technology was 'high-tech' in nature. The ability to protect the IP rights associated with the product or secure the proprietary rights of the product was of the most importance in this area.

10.10.3.4 Characteristics of the Market

The fourth consideration was whether there was evidence that the target market was likely to enjoy significant rates of growth, or if the new venture would stimulate an existing market. Also, of importance was if the industry was familiar to the venture capital investor and the anticipated reaction from competitors.

10.10.3.5 Financial Considerations

The fifth area of consideration was the financials associated with the venture, in particular the ability of the investment to return at least 10 times the capital contributed within 5–10 years. The ability to have the investment taken public – or some exit strategy – was also of importance.

10.10.4 Deal Structures

In order to do a deal over securing finance, the entrepreneur needs to understand three key things: (i) they must understand their business; (ii) they must understand the viewpoint of the venture financier; and (iii) they must understand what their own needs are in relation to the money being sought.

10.10.4.1 Understand the Business

This is usually transmitted via a business plan. Such a plan should demonstrate to the reader that the entrepreneur understands:

- the amount of funds required (both the absolute amount and the timing of the requirement),
- the level of risk associated with the venture (both the absolute level of risk and the factors that determine risk), and
- the timing and potential magnitude of returns.

10.10.4.2 Understand the Viewpoint of Financiers

Different sources of funds have different needs and expectations. Banks will view things differently from venture capitalists. Entrepreneurs should consider:

- the size of the returns expected,
- how much risk will be tolerated?
- the size of funds that can be supplied,
- when 'returns' will be expected, and
- the degree of control that will be expected.

10.10.4.3 Understand the Entrepreneur's Own Needs

The entrepreneur should also assess their own needs from any financing deal. How much control do they want or will they agree to give up? How will their control be exercised and how much finance do they need? What risk will they tolerate?

10.10.5 Preparing a Terms Sheet and Structuring the Deal

An essential element in the structuring of a venture capital deal is the preparation of a 'terms sheet', which is a document that outlines the details of how the deal will be structured. While a terms sheet is not generally a legally binding document, it does provide the basis for future legal agreements and is often the first step in setting up the deal. The contents of a terms sheet can vary from deal to deal as a result of differing legal environments. However, according to the National Venture Capital Association (NVCA) in the US, a typical (Series A) terms sheet might contain:[1]

[1] See www.bvca.co.uk for a 'guide to venture capital term sheets.'

1. *Offering terms.* These detail the closing date for the deal to expire, who the investors will be, the amount of money to be raised, the price per share, the pre-money valuation of the share capital, and the capital structure of the venture before and after financing.
2. *Charter of shareholder rights.* This outlines any dividends policy the venture will adopt and liquidation preferences in the case of dissolution, including what might happen in a merger. Also, included in the charter would be the voting rights of shareholders, the provisions to protect their shareholdings in the case of liquidation, and details of things such as anti-dilution provisions, conversion options and redemption rights (allowing the investors to force the company to redeem their shares at cost plus and dividends).
3. *Stock purchase agreement.* This specifies any representations and warranties made by the company to the investors, conditions of closing the deal, who the legal counsel is handling the deal, and any costs associated with settlement.
4. *Investor rights agreement.* This outlines the rights of the initial investors in terms of their shareholding should the company list on the stock market via an IPO. It also outlines the rights of shareholders to have seats on the company board and their right to access company information. It might also contain details of employee stock options, key person insurance and the frequency of board meetings.
5. *Right of first refusal/co-sale agreement and voting agreement.* This describes the right of initial investors to have the right of first refusal with respect to any shares of capital stock that might be sold by the founders of the company. It also details the composition of the board of directors, and might specify the chairperson, CEO and any representatives of the founders or other investors.
6. *Drag along provisions.* Where 75% or more of the shareholders agree to sell the company at a given price, the remaining shareholders will agree to also selling under the same conditions.
7. *Other matters.* The terms sheet might also outline the rights of the founders to have their stock bought back by the company should they choose to exit as well as how preference shares will be handled.
8. *Confidentiality and expiration.* There should also be a statement agreeing that all parties will work in good faith during the execution of the deal and not seek to gain benefit by selling company stock at an advantage. The need to maintain confidentiality will also be noted along with a date when the terms sheet expires.

10.10.6 Exit Strategy

It is important to remember that, while the venture capital investor is taking equity in the business, they will generally want to have a clear exit strategy. This should be determined in advance of any investment deal and might include a range of options including a merger or trade sale to another company, or seeking to publicly list the business on the stock market. According to the Australian Venture Capital Association Ltd. (AVCAL), during the period 1997 to 2000, of 335 venture capital exits: 31% were write-offs, 31% were trade sales, and only 3% were public floats (Golis, 2002, p. 235). In 2008–2009 the value of exits from trade sales, IPOs and buybacks was $682 million (ABS, 2010). This indicates not only the risks associated with venture capital, but also the preference many VCs have for trade sales. Public listings are generally complex, involve high costs and require careful timing.

An alternative to an IPO is the 'back door listing', where an existing listed firm is identified that has lost most of its value and can be acquired as a shell company without going through the rigors of a new listing. The shell company is essentially taken over by the newly emerging venture through a recapitalisation of its stock and with the consent of the existing shareholders of the shell. Within Australia, the typical shell company for a backdoor listing will have a market capitalisation of approximately $300,000, and following the deal the new venture would be worth over $5 million (Golis, 2002).

10.10.7 Due Diligence

Prior to the venture capital investor settling, they will want to subject the deal to a process of due diligence. This typically involves checks by accountants and lawyers working for the VC who will examine the financial status of the venture, the validity of any patents or other IP, and even the backgrounds of the management team and employees of the business. Due diligence might also involve interviews with leading customers and key suppliers (McKaskill, 2006).

The range of things that might be examined in a due diligence process includes (Camp, 2002):

- *Annual company reports* and shareholder meetings minutes;
- *An audit of computers*, software and websites including computer security and back-up policy;
- what are the core competencies of the business and how vulnerable they are through loss of key personnel;
- *Engineering, R&D and IP policies* including patents and their currency;
- *plant & equipment,* fixtures & fittings, and property – and in particular, condition, security and title ownership;
- *Financials & accounting* – including bookkeeping, creditor/debtor policy, bad debts and contingent liabilities, previous audits, banking and cash flow management, working capital requirements and use of factoring, and mortgages and unsecured loans;
- *Human resources* – including absenteeism, staff turnover figures, skills, training and development, outstanding workers compensation and superannuation claims;
- *legal issues* relating to insurance policies and outstanding claims as well as legal contracts with third parties;

- *Management structure* – who are in the management team, their roles, responsibilities and their performance measures, and whether there a succession plan for any loss of key personnel;
- production and operations – specifically the quality of products, any dependence on key suppliers, and the efficiency of systems; and
- *Sales & marketing* – including the existence of registered brand names or trademarks, direct marketing and ecommerce strategies, leading customers and the risks associated with the loss of any key customers.

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Cash Flow, Profit and Working Capital

11

11.1 Introduction

> It is estimated that cash flow problems cause half of all small business failures in the UK. Several approaches to tackling such issues exist, but they all have their pros and cons. (Toogood, 2011, p. 41).

While many small businesses start up with only bootstrap financing, it is usually necessary for them to expand their operations and invest in both new capital equipment, employees and marketing or advertising activities. The expansion – even modest expansion – of a small firm can place a strain on the firm's resources and it is possible for a small business to overtrade and find itself in a financial crisis even though sales are increasing. This chapter explores the importance of understanding the working capital cycle and the need to monitor the break-even sales within the firm while understanding the importance of 'gross' rather than 'net' profit. It should be noted that the purpose of this book is not to cover financial accounting issues in any detail as this would be beyond its scope. Instead this chapter aims to provide an overview of key financial management concepts considered important to the successful operation of the small business.

11.2 The Basic Financial Reports

Before examining the key issues relating to the financial management of the small firm, we need to examine the so-called 'holy trinity' of accounting that includes the three principal reports: the profit and loss statement, balance sheet, and cash flow statement. An understanding of these documents is important to allow the owner-manager to understand the basic information emerging from their businesses accounting systems. Table 11.1 provides a summary of the three reports that make

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Table 11.1 The 'holy trinity' of financial reports

Financial reports	*What they show*
1. Balance sheet	Provides a cross-sectional snapshot of the firm's net worth.
	Assets – Liabilities = Owner's equity
2. Profit & Loss statement	Provides a picture of the firm's past trading history.
	Income – Expenses = Net profit
3. Cash flow forecast	Provides a forward estimate of the firm's expected sales income and expenditures.
	Debtors – Creditors = Net income

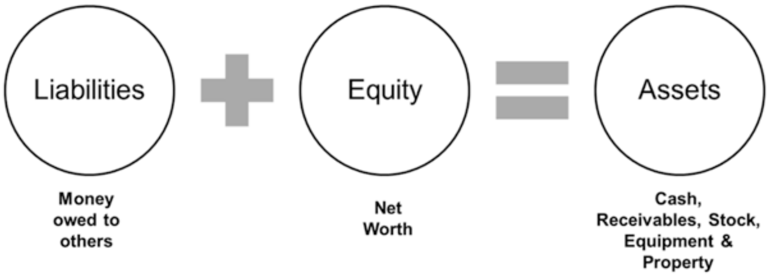

Fig. 11.1 The balance sheet. (Source: Shultz, 2006)

up the 'holy trinity' of financial reports. It explains what each provides to the small business owner-manager, and the key information contained within them. In the following sub-sections, we look at each of these in more detail.

11.2.1 The Balance Sheet

One of the most important financial reports for a business is the balance sheet. This seeks to report the net worth or value of a business. However, for many small business owners the balance sheet is one of the most confusing documents, full of hidden mysteries. A common question asked by owner-managers is 'why does the balance sheet have to balance'? The balance sheet examines the business at a given point in time and seeks to illustrate to the reader three key pieces of information: assets; liabilities and owner's equity (Trimming, 1988).

As illustrated in Fig. 11.1, the balance sheet is broadly comprised of three elements. The first of these is 'liabilities', which is money that is owed by the business to others. The second is 'equity', which is the net worth of the business. Finally, there are 'assets' – the cash, money that is to be paid or 'received' from others (e.g. customers), plus stock, plant and equipment and property.

A comparison of balance sheets over time shows the overall performance of the business. By analysing the firm's balance sheet, the owner-manager is better prepared to make decisions about the overall strength of their firm. The balance sheet shows the amount of cash and liquid assets that are available at a given point in time, and it accounts for money that is to be paid to the firm in the future from customers and other 'accounts receivable'.

In addition to these short-term assets, the balance sheet also provides information on the long-term assets that the business has. This is important because a business only has assets because they are the resources it needs in order to undertake its work. Offsetting these assets are the firm's liabilities, which can be both short- and long-term obligations. Liabilities are needed to fund the assets. If the business lacks equity it will need more liabilities in order to fund its assets (Shultz, 2006).

11.2.1.1 Assets

An asset can be defined as a resource that is available to the business that can be used for future activities (Kenley, 1989). Assets can be *fixed* or *current* in nature. A fixed asset is one that cannot be converted into cash or consumed within a trading period (typically 1 year). Fixed assets are typically land and buildings, machinery, plant and equipment, and capitalised leases. A current asset is one that can be converted to cash or consumed in the trading period. Current assets include such things as cash, short-term investments or marketable securities, accounts receivable and prepaid expenses. Current assets are usually presented first in a balance sheet, followed by the fixed assets (CCH, 2006).

The current assets are important because they show the firm's working capital (liquidity). Inventory is included in current assets because the stock held there can be sold for cash within the operating period. Ideally, the firm should not carry too much stock within its inventory, because this can tie up cash and impact on its liquidity. Included in current assets can be prepaid expenses, which are items such as insurance where the item has been paid for up front but not yet consumed (Tarantino, 2001).

Fixed assets are also called non-current assets, because they are things that are durable (e.g. plant and equipment) and are not consumed during the firm's normal operating cycle or 'current' period. However, because these assets age or wear out, they are subject to a process of depreciation, whereby they are gradually devalued over time until they are written off.

In addition to plant and equipment, the business may have property within its non-current assets. Property generally does not depreciate like a motor vehicle might. In general, land will appreciate in value while the buildings on the land will depreciate. Other assets that might be found in the balance sheet are intangible assets such as patents.

11.2.1.2 Liabilities

By contrast, liabilities are financial commitments or obligations that the business owes to outside parties (Kenley, 1989). As with assets, liabilities are divided into current and long-term categories. Current liabilities include accounts payable, notes payable, income and sales taxes payable, and interest payments on loans. Long-term (non-current) liabilities include long-term debts (e.g. mortgages), capital leasing items, and deferred income tax obligations. Within the balance sheet, current liabilities are presented before long-term liabilities (CCH, 2006).

You should think of current liabilities as those obligations that the firm must pay for from its current assets during the normal operating cycle. For example, the money that must be paid to trade creditors (e.g. suppliers), or other expenses accrued during the previous trading period. It might also include tax liabilities (e.g. GST) and any short-term credit the business might have (such as credit card debts). The firm's non-current liabilities will not need to be paid off during the normal operating cycle or current period. However, debts such as mortgages taken out over property, leases on equipment, or director's loans used to fund the business will usually incur interest charges.

11.2.1.3 Equity

Equity (owner's equity, shareholder's equity or net worth) is usually the amount of capital invested in the business, plus any retained profits (or accumulated losses). The owner's equity is equal to the value of the firm's assets less its liabilities, thereby resulting in a *net worth* position (CCH, 2006). When presenting equity in a balance sheet, the value of share capital or stock is typically shown. This might be displayed as common or preferred stock, plus retained profits. The need for a balance sheet to *balance* relates to the requirement for the bookkeeping process to balance what a business owes (e.g. liabilities), and what it owns (e.g. assets). A small business funds its assets from the combination of owner's equity and any liabilities. There needs to be a balance between the total assets on one side, and total liabilities, and any owner's equity on the other (Jamieson, 1999).

11.2.1.4 Balance Sheet Example

Table 11.2 illustrates the balance sheet of XYZ Company. It can be seen that XYZ Company has total assets of $1 million, and total liabilities and equity of $1 million. A further analysis of the balance sheet shows that the firm has total current assets of $970,000, plus $50,000 in fixed assets (e.g. equipment and furniture), less depreciation of $20,000, providing $30,000 in total non-current assets.

Making up the firm's current assets are cash, accounts receivable, inventory and pre-paid expenses. It can be seen that XYZ Company does not carry a large amount of stock in relation to the other items within the current assets. However, it only has $260,000 in cash available and is waiting to receive $580,000 from its customers. It has also pre-paid some expenses. XYZ Company also has $600,000 in current

Table 11.2 Balance sheet – XYZ Company

Current assets		*Current liabilities*	
Cash	$260,000	Accounts payable	$350,000
Accounts receivable	$580,000	Accrued expenses	$190,000
Inventory	$10,000	Income tax payable	$10,000
Prepaid expenses	$120,000	Short-term notes	$50,000
Total current assets	$970,000	Total current liabilities	$600,000
Non-current assets		**Non-current liabilities**	
Equipment, furniture	$50,000	Mortgages	$100,000
Less: Depreciation	($20,000)	Shareholders equity & retained earnings	$300,000
	$30,000		
Total assets	$1,000,000	Total liabilities & equity	$1,000,000

Source: Tarantino, 2001

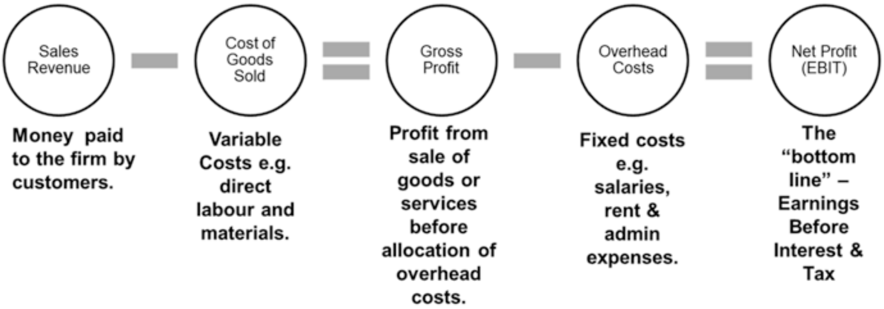

Fig. 11.2 The profit and loss statement. (Source: Shultz, 2006)

liabilities, plus $100,000 in long-term debt (mortgages). The current liabilities are made up of $350,000 in accounts payable that it owes to creditors such as suppliers. There is also $190,000 in accrued expenses. These are the opposite of prepaid expenses and may include such things as wages or interest that were not paid in the previous period and will need to be paid in the current period.

The company also has a tax liability of $10,000, and short-term notes issued of $50,000. A short-term note (short-term paper) is a form of debt that can include treasury bills, commercial bills issued by banks as a low-risk form of investment, or such things as promissory notes, bills of exchange and certificates of deposit.

Owner's equity and retained earnings make up the balance of $300,000 within XYZ Company's balance sheet. It can be seen that, if the firm wishes to reduce its liabilities, it will either have to sell some of its assets, increase its shareholder equity through additional investment, or build up its retained earnings.

11.2.2 The Profit and Loss Statement

The profit and loss (P&L) statement, or income statement, provides an overview of all income and expenditure throughout the accounting period. In essence it provides data on the activities that have taken place between the balance sheets that report at specific points in time (Trimming, 1988). A P&L statement typically provides a list of all sales revenues and other income; it will then involve the deduction of variable costs or costs of goods sold, selling, general and administrative expenses, any interest expenses and income taxes paid, plus depreciation[1] and amortisation[2] expenses.

As illustrated in Fig. 11.2, the P&L statement is comprised of five key elements. The first is the sales revenue or money paid to the firm by its customers. Second are the variable costs, known as cost of goods sold, that are deducted from the income.

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[1] Depreciation involves a process where the cost of an item such as plant or equipment is gradually converted into a capitalised cost using one of several methods, e.g. diminishing value method, prime cost method. See www.ato.gov.au/business for more details.

[2] The deduction of capital expenses over a specific period of time. Similar to depreciation, it is a method of measuring the consumption of the value of long-term assets like equipment or buildings.

What remains is the firm's gross profit, and from this is deducted the overhead or fixed costs, leaving the 'bottom line' or net profit. The firm's net profit is also referred to as earnings before interest and tax (EBIT).

The P&L statement is a valuable tool for showing the firm's performance over a given time period. It can break the income and expenses down into major categories, and can be used to identify areas of cost and profitability. A regular monitoring of the P&L on a monthly or quarterly basis gives the small business owner the ability to take corrective action (Tarantino, 2001; Shultz, 2006).

11.2.2.1 Cost of Goods Sold

The P&L statement can be used to track income across a series of time periods. It allows the owner-manager to review income and both variable and fixed costs. An important cost to monitor on the P&L statement is costs of goods sold (COGS), which is a summary of all the costs of making sales during the accounting period. The calculation of COGS is generally undertaken by recording the cost or value of any opening stock held within the firm's inventory adding any new purchases of stock, then deducting the cost or value of inventory held at the end of the trading period. The firm's gross profit is therefore the total income in sales less COGS (CCH, 2006). It is important to note that items included in the COGS figure must be directly involved in the generation of a sale. Items such as stock held in inventory or delivery fees that are related directly to the sale would be included in COGS. However, costs such as salaries, advertising or lease payments on motor vehicles would not be included as these items need to be paid regardless of whether or not a sale is being made.

COGS is important because it helps to define the gross profit generated by the business and, as we will see, gross profit is a most important consideration in small business finance. Items not included in COGS are generally fixed costs or overheads, and these are recorded in the P&L statement as expenses. Once these expenses have been deducted from the firm's gross profit, the net profit can be determined. Table 11.3 shows the P&L statement of XYZ Company. It can be seen that the firm has generated total sales revenue of $1.5 million, with COGS of $500,000,

Table 11.3 Profit and loss statement – XYZ Company

Sales revenue	$1,500,000
Less: Operating expenses (COGS)	$500,000
Gross profit	$1,000,000
Less overhead costs:	
Administration and salaries	$500,000
Depreciation	$20,000
Earnings before interest and tax (EBIT)	$480,000
Interest charges	($20,000)
Income tax payable	$110,000
Net income	$350,000

Source: Tarantino (2001)

leaving a gross profit of $1 million. We can use these figures to calculate the firm's gross profit margin. The gross profit margin is 66.7%. This can be calculated as follows:

As we will discuss later, the conversion of gross profit to a percentage of sales pro-

$$\textbf{Gross profit margin} = (\textbf{Gross profit} \times \textbf{100}) \div \textbf{Sales}$$

vides the opportunity to compare trends. This can be done with all the figures in the P&L, and also with the balance sheet.

Also shown in the P&L statement of XYZ Company is its overhead costs. This is comprised primarily of salaries and administrative costs plus depreciation expenses. A more detailed breakdown of such expenses would be normally undertaken. The overheads of this firm represent 33.3% of sales revenue, and EBIT is 32% of sales. Once interest charges and income taxes are removed, the firm's net income is $350,000. Therefore, the net profit margin is 23.3%.

11.2.3 The Cash Flow Statement and Forecast

Cash flow is the lifeblood of a small business, and monitoring the firm's cash cycle and forecasting future cash flows are critical to survival. A cash flow statement reports the sources and uses of cash during a defined time period. It usually examines the cash flow from operations, investments and financing (Tarantino, 2001; Shultz, 2006). Forecasting and monitoring cash flow is an important management tool for the small business to know how the firm is performing. Any variance between forecasts and actual cash flows will require urgent attention.

As illustrated in Fig. 11.3, there are five main elements to include within a cash flow statement. The first of these are the accounts receivable, which are the monies owed to the firm by its debtors (e.g. customers). The second are the accounts payable, which are the monies owed by the firm to its creditors (e.g. suppliers). When the accounts payable are deducted from the accounts receivable, what is left is the

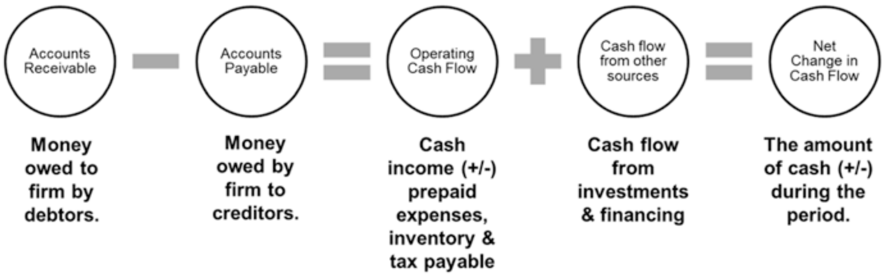

Fig. 11.3 The cash flow statement. (Source: Shultz, 2006)

operating cash flow. This can also include prepaid expenses, inventory and taxes payable, plus cash at bank. Added to this is the fourth element, which can be any cash from other sources such as investment income. Together this represents the firm's overall cash flow position and shows whether this has become positive or negative over time.

11.2.3.1 Cash Flow Statement Analysis

The cash flow statement shows how much cash is available within the business, plus the sources and uses of this cash. Preparing a cash flow statement involves at least four steps (Anthony & Reece 1989):

1. Review the firm's balance sheets and enter the beginning and ending balances. Note any changes in the amounts shown for each account item.
2. For each account item other than cash, examine the factors that might have caused the changes, noting whether the changes were caused by cash injections due to trading, investment or borrowing. Reference will need to be given to the P&L statement.
3. Once these changes in the account items have been assessed and classified, the debits and credits can be totalled and compared to see that their net amount is equal to the total change in cash as originally shown in the balance sheets.
4. The cash flow statement can then be prepared from the worksheet prepared to record the items in Step 2. This should itemise anticipated net cash flows from operating activities (e.g. sales), cash flows anticipated from investment activities (e.g. purchase of plant and equipment), and cash flows anticipated from financing activities (e.g. loans).

Table 11.4 shows the cash flow statement for XYZ Company. Three sources of cash flow can be found within this business: i) cash flow from operations; ii) cash flow from investments; and iii) cash flow from financing.

Cash flow from operations is the most common source of cash for a small business. As can be seen from Table 11.4, the XYZ Company had $350,000 brought in from its P&L statement (see Table 11.3). The firm's cash flow from operations is also affected by such things as changes to assets and liabilities. Here it can be seen that XYZ Company has generated $57,000 in cash from its operations once these changes are factored in, and after depreciation has been added back. It should be noted that the accounts receivable is cash outflow because the money has not yet been received. On the other side, accounts payable is cash inflow because the money has not yet been paid and so it is held at bank.

Cash flow from investments is cash outflow from the purchase of new assets and any inflow if these are sold. In Table 11.4 it can be seen that XYZ Company spent $10,000 on the purchase of new plant and equipment. Cash flow from financing includes cash obtained from long- or short-term loans, or the sale of any equity in the business. Any payment of debt or dividend payments to shareholders is recorded as an outflow. From Table 11.4 it can also be seen that, after the purchase of fixed assets and the payment of $40,000 in mortgages, the total change in the cash position is only $7000.

Table 11.4 Cash flow statement analysis – XYZ Company

Cash flow statement		
Net income from P&L		$1,500,000
Changes in assets and liabilities:		
Accounts receivable	($320,000)	
Inventory	($5000)	
Prepaid expenses	($10,000)	
Accounts payable	$20,000	
Income tax payable	$2000	($313,000)
Operating cash flow before depreciation		$37,000
Depreciation		$20,000
Cash flow from operations		$57,000
Cash flow from investments		
Purchase of property, plant and equipment	($10,000)	
Cash flow from financing		
Mortgage	($40,000)	
Change in cash position		$7000

Source: Tarantino (2001)

11.2.3.2 Cash Flow Forecast

The cash flow forecast or sales forecast is an integral part of the small business owner's financial management and is the starting point of any future budgeting (Rowan, 1994). This involves the assessment of how many sales can be made in a given period, the cost of sales, and the allocation of funds to overheads and how much is left at the end. Cash flow analysis on a monthly basis can help the owner-manager monitor their working capital requirements. Budgeted amounts can be established to achieve break-even, and each month the target figures can be compared against the actual figures. Any variance of an adverse nature should suggest the need for urgent corrective action (Bland, 2006).

Preparing a cash flow projection involves a good deal of judgement and some guesswork. While it may not be possible to predict the future when preparing an estimate of future sales, it is most important that the forecast is not too optimistic or too pessimistic. Overly optimistic sales forecasts can prove disappointing and may lead the business to hold onto unused inventory. Pessimistic forecasts can result in the owner-manager failing to hold sufficient inventory, which can be just as problematic.

In preparing the cash flow forecast the owner-manager should commence with the previous year's sales figures as shown in the profit and loss account. They should consider whether the previous year was above or below average and what the future outlook is for their industry or market. If there are several years of sales trends the owner should look for trends. Future new products or markets should be factored in, along with the emergence of any other significant developments likely to impact on sales (Bangs, 1994).

With a view to their overall contribution each product line or service area should be separately broken down in terms of the sales activities that each makes to the firm and the trends in these areas. The owner-manager should look for opportunities to raise prices or lower expenses so as to achieve an increase in gross profit margins. Also, the company should prepare a debtor matrix that plots each customer against the time taken to collect money from them. Ideally the owner-manager is seeking to get each customer to reduce the total number of debtor days (e.g. days taken before it receives payment).

Preparing a cash flow forecast requires the owner-manager to refer back to their previous year's sales trends and examine the future expected sales trends factoring such things as price rises, fluctuations in the economy and the activities of competitors. The strategic environmental analysis discussed in Chap. 4 and the market research and sales forecasting outlined in Chap. 5 play an important role in helping shape the cash flow or sales forecast.

Where the business has a trading history it should be possible to review past sales trends and make a judgement on future anticipated sales. It should be recognised that sales can be boosted significantly by advertising and promotional activities and enhancements in the firm's sales management systems. For start-up firms the preparation of a reliable cash flow forecast can be more difficult. In this case the owner-manager may try to determine industry benchmarks if these can be found, or simply prepare a high and low forecast and make adjustments over the first year of trading.

11.2.3.3 Cash Flow Budget

The cash flow forecast is used to prepare a cash flow budget or operating budget which is used as a principal tool in controlling the business. The cash flow budget outlines the anticipated income and expenditure over the trading period which is usually a six- or twelve-month period. It is principally designed to ensure that the business has sufficient income to cover its expenses and must incorporate any major expense that may fall due during the trading period (CCH, 2006). According to Anthony and Reece (1989) at least two approaches can be used in the preparation of a cash flow budget:

1. Using the balance sheet and P&L statement develop a forecast estimating how cash will be used in the future operations of the business.
2. Analyse future business or market plans that have cash flow implications and try to forecast where each source of cash will come from and how it will be used.

The first approach is similar to that described in the preparation of a cash flow statement in the preceding section. The second approach requires consideration to be given to the lag effect of accounts receivable, which may involve a delay in payments from customers. It is advisable to review the debtor's ledger to see how long it has been taking to collect payments from customers following initial sales.

In addition to reviewing the timing of sales receivables from customers, the owner-manager should also examine the timing of accounts payable to suppliers. By examining the timing of income and expenditure on a month by month basis the owner-manager can determine with some accuracy the cash flow requirements of their business. This is most important in ensuring that they will have sufficient working capital within the firm to allow it to continue trading.

11.3 The Working Capital Cycle

The small business owner-manager seeking to gain control over their firm's finances needs to understand both the working capital cycle, and how to prepare and use a cash flow forecast. As explained above working capital is the assets and liabilities necessary for the daily operations of the business. It is usually comprised of debtors and prepayments (e.g. accounts receivables), stock or inventories held and creditors and provisions (e.g. accounts payable).

As shown in Fig. 11.4, the working capital cycle refers to the flow of cash and other liquid assets through the business during the course of its regular operations. Sales receipts generate cash inflow that must be applied to the firm's operations at different stages of the production process. Some funds must be allocated to purchasing raw materials from suppliers. As these raw materials are converted into product during the production process, more cash is needed to pay labour and other variable costs. Once the product is finished, it must be marketed and sold. This requires further cash to cover selling and distribution costs.

It can be seen from Fig. 11.4 that until income is received from sales the firm will need working capital to furnish the necessary cash to pay for the other operations throughout the production process. The owner-manager must determine how much

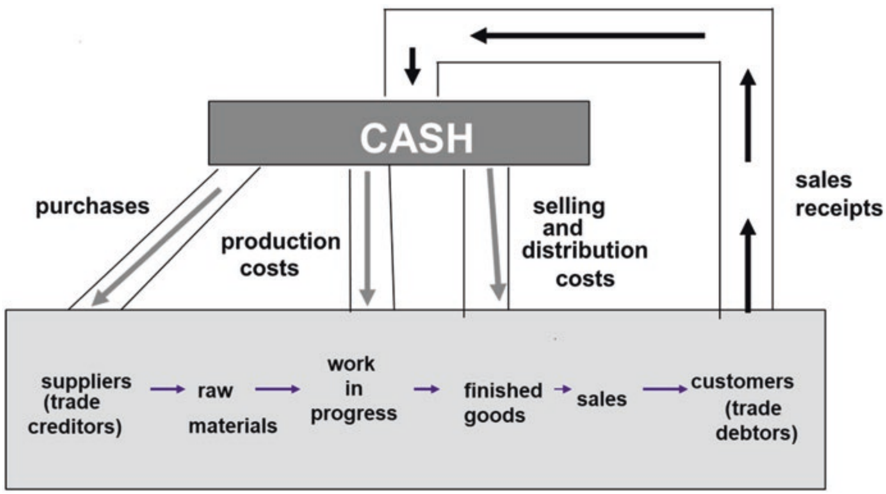

Fig. 11.4 The working capital cycle. (Source: Snaith & Walker, 1999)

working capital they need. This requires them to determine their working capital requirement.

11.3.1 Working Capital Requirement

The importance of cash flow to the business has been highlighted. It can be the most important element in the survival of a small business particularly in its early years. The owner-manager must therefore monitor their cash flow carefully and control the flow of cash in and out of the business. Cash flow is associated with the amount of working capital available in the business.

In seeking to determine the amount of working capital required by the firm to achieve its operational goals, the owner-manager should start to identify all operating expenses and examine the timing of when such payments are due. These should then be matched against projected sales forecasts, taking into consideration any cyclical or seasonal fluctuations in business over the course of the year.

The Importance of Working Capital
Working capital is a most important element in managing the financial side of a business. Proper management of working capital requires ongoing attention to the granting of credit to customers, subsequent debt collection and efficient stock control, while at the same time obtaining favourable payment terms from suppliers. It is under-funding of initial working capital requirements that are the cause of many failures for new businesses starting up.
Source: Jamison (1999, p. 7).

Having identified the working capital needs through this process of matching expenses against cash flow, the owner-manager should prepare a worst-case scenario and determine the amount of cash required for covering emergency periods when there is a slump in sales. It has been suggested that a buffer of 90 days should be planned for and this may require keeping sufficient cash at bank, or negotiating a suitable overdraft facility from the bank to cover such contingencies (Shakespeare & Gallop-Goodman, 2000).

To understand the reason why working capital is such an important concept, we can examine the financial operating cycle of a small business in more detail. Figure 11.5 provides an illustration of how this works. As we have seen, the balance sheet contains the assets of the firm which can be employed to undertake its work to generate sales. These assets are made up of the owner's equity and any retained profits, or the 'net worth' plus any liabilities (current and non-current).

The assets are deployed and the P&L statement reports how the income was allocated across variable and fixed costs to produce the net profit. This profit can then be allocated to one of the three elements within the balance sheet. It can either be used to purchase more assets, to repay any liabilities owed by the business, or distributed to the owners in the form of dividends.

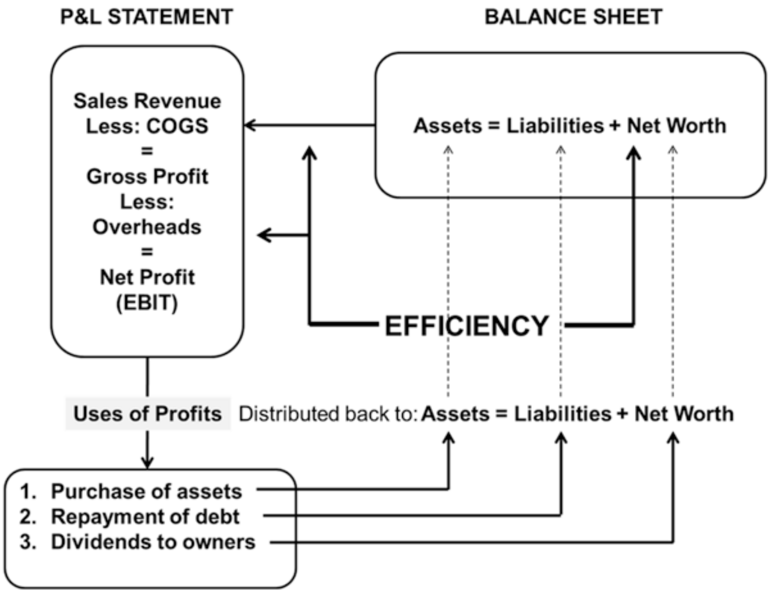

Fig. 11.5 The financial operating cycle. (Source: Sgambelluri, 2010)

If the owner-manager chooses to draw out the profits and distribute them as dividends rather than invest in assets or repay liabilities, the business will be unable to grow. Further, if it needs more assets, particularly working capital, the business will be forced to take on additional liabilities. It is also important that the business is managed efficiently and, as we will see later, it is important that the owner monitors how well the firm is using its assets and generating profits.

11.4 Assessing Financial Performance

The capacity of a small business to successfully survive and grow is likely to depend on how well the owner-manager can assess their financial performance and then take appropriate action when required to correct things. As discussed in Chap. 10, small business owners should monitor their cash flow and profitability, and put in place key performance indicators (KPIs) that can allow them to monitor and control finances more readily.

Some warning signs for a business in possible financial crisis are (Cunningham, 1998):

- Too many overdue debtors who are paying beyond 45 days or excessively generous credit terms to customers who represent a significant part of the firm's business.
- Rising work-in-progress that is not being billed on time.

- Dwindling cash reserves that are gradually being replaced by increased creditor strain or increasing overdraft facilities.
- Inadequate control of purchasing leading to rising expenditures and lack of discounts for larger or bulk ordering from suppliers.
- Poor relationships with suppliers leading to lack of adequate discounts on purchases.
- Rising stock levels with increasing carrying costs while sales are static.
- Lack of control over cash flows so that the owners are unsure what it owes to creditors and what it is owed by debtors.

At least four important areas must be considered in assessing the financial performance of a small business. The first is the liquidity of the business, particularly the working capital required to keep the firm's operations going and to allow for expansion or growth. The second is the overall solvency of the business. Here the attention needs to be given to the balance of assets to liabilities. A third area of concern is the overall efficiency of the business, which is essentially about how well the owner-manager is running the venture. Finally, there is a need to examine the firm's profitability. Over the longer term the most important issue in any business is how much profit can be made. A small business that has good profitability will be a good investment for the time, effort and financial investment put into it by its owners.

11.4.1 Liquidity in the Small Business

It is important for any business to have sufficient liquid assets to cover all short-term or *current* liabilities. However, this is particularly important in the case of small firms that may operate with modest cash balances in their bank accounts. A small firm's liquid assets (also known as current assets or working capital) comprise such things as cash, work in progress, debtors/accounts receivable or stock. Liquidity ratios allow the owner-manager to determine if they have sufficient working capital in the business to meet its liabilities. There are a series of measures that an owner-manager can employ to monitor the liquidity within the firm. These are discussed in the following sub-sections.

11.4.1.1 Current Ratio Analysis

The current ratio is a measure of the current assets to current liabilities within the business. The current ratio for a typical small business is ideally going to be about 1.5–2, but if it is less than 1 the firm's current liabilities are greater than its current assets and that means the business will not have sufficient working capital to cover its cash flow needs. A business in this situation might be relying too much on borrowings or 'creditor strain' (e.g. delaying payments to suppliers) to fund all the businesses operations. This is not a good situation to get into and can be a cause of serious problems if not addressed.

Current Ratio Calculation
Current ratio = Current assets ÷ Current liabilities
Where:
Current assets = Cash plus those assets that will be converted to cash or consumed in the coming year or operating cycle.
Current liabilities = Liabilities that will be converted to cash or consumed during the coming year or operating cycle.

11.4.1.2 Quick Ratio Analysis

If the firm's current ratio is greater than 2, it may still not be making the best use of its working capital. Under these circumstances the firm's cash may not be best used, for example, it might be carrying too much stock or inventory levels for the trading cycle, or its debtors might be paying too slowly.

To examine how 'liquid' a business is requires an examination of the amount of cash that is available at the bank. Other current assets such as stock or work in progress might be difficult to sell in a hurry and cannot be used to pay wages or suppliers bills. The 'quick ratio' looks only at cash at bank and debtors (accounts receivable) and excludes stock or work in progress.

Quick Ratio Calculation
Quick ratio = Quick assets (e.g. cash & debtors) ÷ Current liabilities

Ideally this should be about 0.7 to 1, but this can vary from industry to industry. If the analysis finds that the current ratio is rising but the quick ratio is static, this may be an indication that the business is carrying its debtors for too long. In this case the owner-manager should look at their accounts receivable and prepare a debtor's matrix, which is a cross-tabulation of each customer and how long it is taking to recover payments from them (e.g. 30, 60, 90, 120 days). Attention should be given to finding ways to reduce the time that it is taking to collect payments from customers.

11.4.1.3 Defensive Interval Ratio Analysis

The defensive interval ratio is an estimate of how many days a business can survive if no more cash flows into it. Most businesses work on a period of between 30 and 90 days, although each firm is likely to have different conditions that may depend on its industry and how the business is managed. It is not a commonly used ratio but may be of value when a business is experiencing financial problems.

Defensive Interval Ratio Calculation
Defensive interval ratio = Quick assets (cash/debtors) ÷ Daily operating expenses

11.4.1.4 Net Working Assets Ratio Analysis

The net working assets ratio is a measure of the overall working capital in the business that is required to support its sales activity. It is common for small firms to get into trouble financially when sales activity picks up but working capital levels are insufficient to cover the operating expenses. This is often called over trading and is a common cause of failure among small businesses.

This ratio is useful to show how much working capital is needed for each $100 of future sales. Sales growth is often funded from either the firm's cash at bank or bank borrowings so this ratio can be useful in estimating how much extra cash is likely to be needed to finance a major growth in sales activity.

Net Working Assets Ratio Calculation
Net working assets ratio = (Stock + Debtors – Creditors) ÷ Sales × 100

11.4.2 Solvency Measures in the Small Business

When a small business has more liabilities than assets it is technically insolvent and this is likely to force its closure. Under such conditions the closure of the business would result in the owner not having sufficient funds to repay all creditors and employees. This could force them to sell personal assets in order to repay these debts. It is also illegal for the directors of incorporated entities to trade while insolvent and so the owner-manager should pay particular attention to this aspect of their business. Two key issues that should be considered in relation to solvency are gearing and interest cover.

11.4.2.1 Gearing

The relationship between the money a business has borrowed and the total capital within its balance sheet determines the overall gearing of the firm. Where a business has high levels of borrowings (e.g. bank loans, overdrafts, lease agreements, hire purchase agreements for cars) and low levels of capital (e.g. shareholders equity, reserves), the business will be highly geared.

Most small businesses are highly geared because the owner is often using the company to fund lifestyle and any profits are removed from the business as dividends. This means that the balance sheet is typically undercapitalised. According to one senior business banker as many as 80% of small businesses in Australia are technically insolvent if their balance sheets are examined. However, they continue to trade by using the owner's personal home or other assets as equity. This might be necessary in the early stages of after start-up, but is a risk to the owner-manager over the longer term.

Calculating the Level of Gearing
Gearing = Total borrowing ÷ Total capital

By knowing how heavily their business is geared the owner-manager can determine how much they can afford to borrow. It is generally accepted that a bank would not like to lend more money to a business than has been invested by the owner-manager. This means that the bank may look at a ratio of a dollar of equity for a dollar of debt. The bank is often reluctant to lend to highly geared businesses.

However, if the firm's cash flow and profits are stable the owner-manager may be able to afford to carry higher levels of gearing. Attention should be given to retaining profits in the business rather than paying out dividends if the owner-manager is planning to grow or anticipating the need to borrow money. Building up the balance sheet in the business will make it easier for the firm to borrow in the future.

11.4.2.2 Interest Cover Analysis

When a small business suffers from a financial loss it will most likely experience a rise in its level of gearing. This can be examined using a measure known as interest cover and can be calculated fairly easily.

Calculating the Level of Interest Cover
Interest cover = EBIT ÷ Interest
Where: EBIT = earning before interest and tax.

This measure can provide a means by which the owner-manager can determine how easily they will be able to pay interest on any borrowings. Ideally the ratio should be over 4 but if it is lower than 2.5, they might need to consider what could happen to the business should interest rates rise suddenly.

11.4.3 Efficiency Measures in the Small Business

In it important for the small business owner to monitor how efficiently they are making use of their firm's working capital, and how quickly they are able collect revenues from debtors in order to pay creditors. Also, of importance is how fast their stock or inventory levels are turning over. Even the firm's cash at bank should be used as efficiently as possible. A series of efficiency ratios are used to measure these things. These are discussed below.

11.4.3.1 Debtor Turnover Ratio Aanalysis

The debtor turnover ratio or debtors as a percentage of sales measure is an indicator of how many times unpaid debt is turned over within the business. It can be calculated relatively easily by dividing debtors by sales. This can be estimated using an average of debtors' days payable for a given period. This can also be calculated by dividing sales by debtors at the end of a period.

Debtor Turnover Ratio Calculation
Debtor turnover ratio (debtors as % sales) = Debtors ÷ Sales

A rising debtor turnover ratio suggests that the business is taking too long to collect its revenues, which can impose problems on the firm's liquidity as discussed above. By contrast, lower debtor ratios are preferred as they indicate the efficiency with which the business can recover its receivables.

11.4.3.2 Debtor Collection Period Analysis

The time it takes for a small business to collect its receivables from debtors should be monitored carefully using a debtors' matrix, but this ratio is useful to provide a measure of the annualised collection period for the number of days to collect debts. It is a good idea to keep the debtor collection period as short as possible. A period of up to 30 days is generally acceptable for most small businesses, but many firms can have debtor payments pushing out to 60 days or even beyond 120 days. Every business is different and the owner-manager may have good reasons for slow repayment of invoices by customers.

Debtor Collection Period Calculation
Debtor collection period = (365 × debtors) ÷ Sales

However, customers can be trained to pay within a given time period. It is up to the owner-manager to set down clear ground rules and state up front what their business's policy on the payment of accounts is. Chasing unpaid debts is usually a stressful and uncomfortable activity so remember that prevention is much better than the cure. It is much better not to wait until the debtors are pushing out beyond acceptable limits before taking action to remind them to pay up.

11.4.3.3 Creditor Turnover Ratio Analysis

While it is important for a small business to receive payments from its customers in a timely manner, the firm's suppliers also need to be paid. It is important to monitor how long it is taking to pay suppliers (creditors) because if the business gets a reputation for being a slow payer or a bad debtor, they might cut off future supply, withdraw credit, or at least place a penalty on the firm (e.g. charging interest). If the small business is dependent on key suppliers for its trading, it is most important to ensure that creditors are being paid promptly. Rising trade creditor ratios suggest that the firm is experiencing creditor strain as it may lack adequate funds to support its business activity levels.

Creditor Turnover Ratio Calculation
Creditor turnover ratio = Creditors ÷ Sales

11.4.3.4 Creditor Payment Period Analysis

It is also possible to calculate an average payment period for creditors. Ideally the firm's average creditor payment period should be longer than its average debtor collection period. This ensures that cash flows are smoothed out and that sufficient working capital can be retained within the business to allow operations to continue.

Creditor Payment Period Calculation
Creditor payment period = (365 × creditors) ÷ Sales

Where possible the owner-manager should try to shorten the time taken to collect its debtors and lengthen the time taken to pay its creditors. This is not to impose penalties on the firm's suppliers, but if the timing of accounts receivable and accounts payable is not well managed the impact upon cash flow can be adverse and more working capital will be required, thereby potentially forcing the business to increase its debt levels and gearing.

11.4.3.5 Stock Turnover Ratio Analysis

While there is a need to carry stock or inventory in order to do business in the first place, many small firms often carry too much stock. How much stock a business needs to carry will depend on the business cycle and the nature of its industry. It will rise when work is increasing and fall when times are more relaxed. Retailers frequently have to carry a lot of stock in order to satisfy customer demand.

Stock Turnover Ratio Calculation
Stock turnover ratio = Cost of sales ÷ Average stock at cost

High stock turnover levels are good because they demonstrate that the business is efficient with its stock and carries only what is necessary. Locking up too much cash in stock can cause liquidity problems. Low stock turnover is a sign of inefficiency and may require that the business sell it off at a discount, which is never good for the bottom line.

11.4.3.6 Average Holding Period Analysis

The level of a firm's stock turnover can be further examined using an average holding period calculation. This examines the relationship between the average stock held within the business at cost, and the cost of sales. As noted above, each industry is likely to be different in terms of the average period of time an item of stock is held in inventory. It is important to determine benchmarks that are considered typical within the industry into which the firm operates. These benchmarks can be used to gauge whether or not the business is operating more or less efficiently than its peers. Where a business has multiple stores or sites, this analysis can be used to benchmark locations.

Average Holding Period Calculation
Average holding period = (365 × Average stock at cost) ÷ Cost of sales

11.4.4 Profitability Measures in the Small Business

How profitable a small business is ultimately determining how well it serves its owners as a valuable investment for their time and effort. A business that is not profitable is unlikely to grow and unlikely to be much fun to own. There are a number of profitability measures that can be used to keep an eye on the firm's performance in this regard.

11.4.4.1 Gross Profit Margin Analysis

The gross profit margin is probably one of the most important figures a small business owner can monitor. It is a measure of the amount of money generated from sales after variable costs or the costs of goods sold are deducted. By converting the gross profit figure to a ratio, it is possible to examine the performance of the business in a more dynamic manner. Overall gross profitability can be determined for the business, as can the profitability of individual product lines or business units. Accountants often refer to the gross profit ratios as the contribution ratio or margin (De Coster, Schafer & Burrows, 1989). This is because it can be used to measure the contribution that each product makes to the firm's overall profitability.

Gross Profit Margin Calculation
Gross profit margin = (Gross profit × 100) ÷ Sales

A business that has a low gross profit margin (or an individual product) is going to struggle to survive. Low gross profitability means that the business will not have sufficient cash flow to cover overheads and therefore break even. Even if it does break even, it may be unlikely to see much profit or earnings before interest and tax (EBIT) from the business and this will make it harder to build up the equity in the business and thereby take on debt and growth.

11.4.4.2 Net Profit Margin Analysis

The net profit of the business is what is left after the allocation of fixed costs and any interest payments to the gross profit. It is a measure of the firm's overall profitability and determines how much the owners can expect to either retain for future growth in the business, or pay to shareholders. Gross profit is a more useful measure of the dynamics of the business, but net profit is a measure of the firm's value.

> **Net Profit Margin Calculation**
> Net profit margin = (EBIT × 100) ÷ Sales

If the firm's net profit margin is rising it suggests that the owner-manager is demonstrating good control of fixed costs (overheads). However, a falling net profit ratio suggests that the business is experiencing too many overheads that might be caused by rising salary and wages, rising costs of rent or too many long-term borrowings to service. Making changes to the firm's fixed costs to improve the net profit can be substantially more difficult than adjusting variable costs to improve gross profit. Reducing overhead costs is likely to involve termination of employees or the sale of fixed assets. When a firm is forced to cut overheads, the situation is usually serious.

11.4.4.3 Return on Capital Employed Analysis

Finally, a small business owner may wish to monitor their return on capital employed (ROCE) figure in order to determine whether or not the business is a good investment. An owner of a small business should view himself or herself as an investor. The return they are getting from the capital employed in the business tells them how well their business venture is as an investment.

Many small business owners view their venture as a place of work rather than as an investment of their time and money. By monitoring their ROCE, the owner-manager can treat their business more as if it were an investment. It should help them to determine how efficiently they are employing the capital assets within the business.

> **Return on Capital Employed Calculation**
> Return on capital = (EBIT × 100) ÷ Total capital employed

11.5 Dynamic Accounting Principles

For many small business owners, the main role to which they employ their accountant is in the financial accounting and tax compliance area. Although this is highly complex and specialised work, the managerial accounting functions of the accountancy profession are often ignored (Baxendale, 2001). The distinction between financial and managerial accounting is best described in terms of financial accounting being associated with external reporting requirements, while management accounting is focused on internal reporting and decision-making (De Coster, Schafer & Burrows, 1989). Financial accounting is focused on reporting the financial position of the business to external parties, which is typically the Taxation Office or banks in the case of small firms. The main tools required for this are the profit and loss statement and the balance sheet, with the occasional requirement for a cash flow forecast. By comparison, management accounting is concerned with the process of giving managers within the business a timely indication of how the business is trading. Here, the traditional end of year financial reports is less useful than a series of financial KPIs such as those outlined earlier.

The concept of dynamic accounting has emerged through the pioneering work of Brian Warnes (1980), who identified that many businesses, both large and small, found they were in financial difficulties even though they had excellent products and financial accounting systems. A principle of dynamic accounting is that a single number in isolation is of little value to the manager seeking to understand their business. Numbers are only of real value when placed into time series or in relationship to others. The annual financial statement that indicates whether a business has made a profit or a loss is substantially less useful than a continuous set of numbers indicating the trend in business activity over time. It is important in dynamic accounting to identify and use a set of KPIs that can be regularly monitored and displayed in a graphical form.

11.5.1 Fixed and Variable Costs

In determining the financial performance of a small business, it is necessary to identify those costs that will have to be paid regardless of whether the firm generates any income, and those that will vary as the level of business activity changes. The following definitions may be useful in determining these types of costs:

Fixed costs – (also referred to as overheads) may be defined as any costs that do not vary with the level of output because they are linked to a time base rather than to a level of activity.

Variable costs – (also referred to as cost of goods sold), are any costs that tend to vary directly with the level of output or activity that takes place within the business.

The difference between these two costs appears clear cut, but can frequently be more difficult to determine in practice. For example, labour costs might be fixed if they relate to salaries paid to directors or managers, but variable if they apply to wages paid to casual staff. Fixed costs are important, as they must be found regardless of how much income is being generated by the business. As will be discussed below, they impact directly on the ability of the firm to reach a point of break-even, or where its income is sufficient to cover both its fixed and variable costs.

Total Variable Costs

Variable costs have a direct impact on the gross profit or contribution margin of the business. An important measure is that of **total variable costs**, which can be defined as follows:

Total variable costs = Quantity sold × Unit variable costs

In the short term, a firm can be forced out of business if it cannot generate sufficient sales revenues to cover its total variable costs. However, if it can produce sufficient income to cover its variable costs and make a contribution to paying its fixed costs, the business might trade over the short term even if it is making a loss (Snaith & Walker, 2001).

11.5.2 Is it Better to Have Fixed or Variable Costs?

While most businesses have both fixed and variable costs to consider, the treatment of these two types of costs from a financial management perspective can be important. Consider the following example outlined in Table 11.5.

As can be from the example shown in Table 11.5, both companies A and B generate the same sales revenues and make the same net profit. However, although Company A has lower variable costs giving it a higher gross profit, its fixed costs are higher. By contrast, Company B has lower fixed but higher variable costs. The gross profit margin (gross profit ÷ sales × 100) for Company A is 60% while that of Company B is 40%.

The impact of an increase or decrease in sales revenues upon these two companies is interesting. As shown in the example, a sales increase provides Company A with a superior net profit position because its gross profit margin is higher, despite its fixed costs or overheads being higher. Even though Company B has lower fixed costs its smaller gross profit margin means that it must work harder to generate the same net profit as Company A. By contrast, a reduction in sales has a more negative

Table 11.5 Comparison of fixed and variable costs

	Company A			*Company B*		
Year	**1**	**2**	**3**	**1**	**2**	**3**
Sales	$ 8000	$10,000	$12,000	$ 8000	$ 10,000	$12,000
Variable costs	$ 3200	$ 4000	$ 4800	$ 4800	$ 6000	$ 7200
Gross profit	$ 4800	$ 6000	$ 7200	$ 3200	$ 4000	$ 4800
Fixed costs	$ 6000	$ 6000	$ 6000	$ 4000	$ 4000	$ 4000
Net profit	$ -1200	NIL	$ 1200	$ -800	NIL	$ 800

Source: Snaith & Walker, 1999

impact on the net profit position of Company A than Company B. This is due to the higher fixed costs that Company A has to carry.

From this example it should be seen that both fixed and variable costs have an important impact on a small business. Ideally, the owner-manager will seek to keep fixed and variable costs down. Variable costs influence the firm's gross profit margin and therefore its capacity to generate cash flow and enhanced returns for each unit sold. Fixed costs influence the firm's break-even. Different industries typically have various fixed and variable costs that apply to the majority of firms within them.

11.5.2.1 Dynamic and Static Costs

Another way to consider variable and fixed costs is to examine their capacity to be either dynamic or static in terms of how they behave. Snaith and Walker (2001) highlight the importance of distinguishing between *dynamic* and *static* costs:

Dynamic costs - vary with the activity of the business, for example, the time spent on a project, or the materials used in production.

Static costs - are regular costs that occur even if there is no activity, for example, rent and rates on your premises, or salaries. Static costs are often lumpy in that they change in big steps rather than in direct relation to activity, for example, recruiting one person will increase your static costs in one step (p. 8).

As with the earlier discussion around fixed and variable costs – which is essentially the same thing as dynamic and static costs – the ability to recognise how each type of cost influences the way the business works is important in getting a complete understanding of how the company is performing. Dynamic accounting also requires that these figures are presented in such way as to allow the owner-manager to view trends and patterns.

As Warnes (1980) explains, the financial reporting undertaken at the end of each year or trading period is static in nature and also historical, showing the owner-manager what the business has done in the past. However, the day to day or month to month trading of the business is where the dynamic indicators become important. These measure the firm's profitability, break-even and general operational efficiency. For this reason, gross profit margin is a more useful measure than net profit. Also important is the ability to examine the break-even point in a dynamic way.

11.6 Profitability and Break-Even

The small business does not have to be profitable to generate sufficient cash flow to break even. However, over the long term the less profitable an operation is, the more likely it will struggle. The owner-manager who wishes to ensure that they understand and can monitor their profitability will need to calculate their break-even point. This is the point at which total income equals the total costs (e.g. both variable and fixed costs). At this point there will be no profit or loss generated by the business.

Statics Versus Dynamics
There are two quite distinct aspects of your family car:

Its height, length, width, general shape, colour, size, style, comfort, interior layout and so on, all of which are static features. They can be measured and evaluated when the car is stationary.

Its acceleration, road-holding, stopping power. These are dynamic features, to do with the motion of the vehicle. They cannot be measured in any such way. Indeed, how *do* you measure them?

Source: Warnes, 1980, p. 5.

11.6.1 Break-Even Analysis

A break-even analysis involves an interaction between at least three elements that have an important impact on the overall financial performance of the business. The first of these is the variable costs or cost of goods sold. These will increase or decrease along with the level of business activity, and will determine the general dynamics of the firm's financial performance.

The second is the firm's gross profit margin, or the gross profit to be derived from each of its products or services. These provide the business with its capacity to either break-even quickly or continue suffering financial loss. The third element influencing break-even is the overhead or fixed costs. For many firms their inability to reach break-even even after a long period of trading is the high fixed costs that might be created by large capital investments or excessive salaries to directors.

Break-Even Calculations
Break-even in \$ = Fixed costs \$ ÷ Gross margin %

The break-even point is the volume of sales required to cover both fixed and variable costs. Break-even can be calculated by dividing fixed costs by the gross profit margin. It can be used to plot a graph to show how many sales will be required over a given period to generate the profits required to operate the business. The higher a business can operate above break-even the greater its margin of safety will be. It is for this reason that gross profit margins are so important to understanding the financial performance of the business. A small business with a low gross profit margin will have a lower margin of safety than one that has a higher gross profit margin.

As shown in Fig. 11.6 the business that has a break-even of \$80,000 and generates \$216,000 in sales will make a satisfactory profit. However, if the same business only generates \$70,000 in sales it will make a loss.

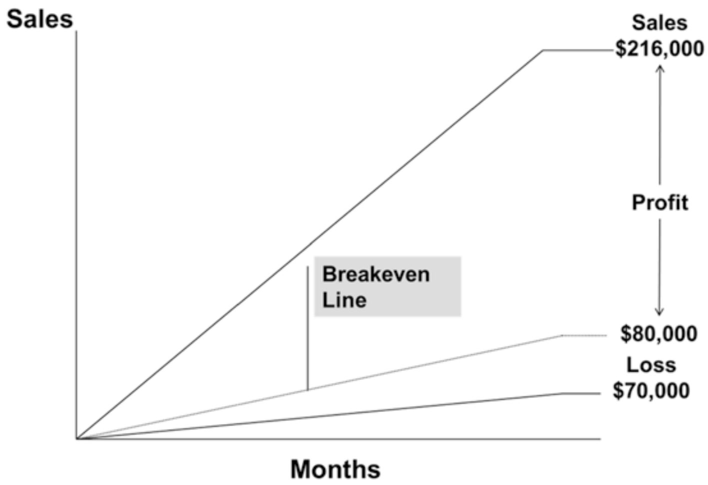

Fig. 11.6 Break-even graph

11.6.1.1 Calculating Break-Even

A small business has fixed costs of $30,000 and a gross profit margin of 30%. Its break-even point will be $100,000.

$$Break-even\ point = Fixed\ costs \div Gross\ margin\%$$

$$\$100,000 = \$30,000 \div 30\%$$

If this business has sales of $70,000 its break-even position will be as follows:

Sales	$ 70,000 @ 30%	=	$21,000 (Gross profit)
Less break-even	$100,000 @ 30%	=	$30,000 (Fixed costs)
Short fall	$ (30,000)	=	$ (9000)

This business finds itself with a loss and must either find another $30,000 in sales or trim $9000 from its overheads. If the business was to reduce its fixed costs by $6000, thereby reducing its overheads to $24,000 and boost its gross margin to 40% through price increases or better variable cost control the break-even point will fall:

Sales	$70,000 @ 40%	=	$28,000 (Gross profit)
Less break-even	$60,000 @ 30%	=	$24,000 (Fixed costs)
Excess over B/E	$10,000	=	$ 4000

The business is now profitable and $4000 in profits will be made on sales of $10,000 over break-even.

11.6.1.2 Margin of Safety

It is important for the owner-manager to know what their break-even point is so that they can determine whether or not they are making a profit. As noted previously, the small business can use its break-even analysis to determine its margin of safety.

It can also be useful to calculate the margin of safety percentage, which provides a key performance indicator for owner-managers seeking to monitor their business activity in a more dynamic way. The calculation of break-even is illustrated below, where it can be seen that the owner-manager of the business can use this calculation to determine the minimum sales turnover required each month to achieve break-even. This information can be used in conjunction with the sales platform analysis outlined in Chap. 5 to assist the small business owner to ensure that their business is profitable.

Margin of Safety Calculations
Margin of safety in $ = Actual sales – Break-even sales
or
Margin of safety % = (Actual sales – Break-even sales) ÷ Actual sales × 100

Knowing the firm's break-even point and determining how many sales are required per month, week or even day, can significantly empower the small business owner to gain control over their company. It is too late waiting until the end of the financial year to sit down with the accountant and work out whether the business has or has not made a profit. Monitoring the firm's break-even point, calculating the number of sales required to achieve break-even, and carefully watching cash flow are all essential to the successful financial management of a small firm. The owner-manager must employ a set of key financial indicators to allow them to effectively assess the financial performance of their business. We can now turn to some of these financial performance measures.

11.7 The Power of Gross Margins

The gross profit margin of a small business can be highly important to its financial performance. Many small business owner-managers, when faced with a slacking in sales or increasing competition, are tempted to lower their prices. While a reduction in price can help lift sales turnover the impact of a price cut needs to be carefully considered in relation to the firm's gross margin. For example, in Chart A of Fig. 11.7 the impact of a price cut for a business with a gross margin of 25% can be calculated. A price discount of 10% would require the business to generate 67% more sales to compensate for the price fall. This is a substantial increase in sales and the business would need to be operating in a highly price-elastic market to achieve such sales. Should it not increase sales to this level, it may not achieve break-even.

Chart A	Existing % gross margin								
	5	10	15	20	25	30	35	40	50
% price reduction	% volume increase for same gross profit								
2.0	67	25	15	11	9	7	6	5	4
3.0	150	43	25	18	14	11	9	8	6
4.0	400	67	36	25	19	15	13	11	9
5.0		100	50	33	25	20	17	14	11
7.5		300	100	60	43	33	27	23	18
10.0			200	100	67	50	40	33	25
15.0				300	150	100	75	60	43

Fig. 11.7 Gross margin impact of a price reduction. (Source: DUBS, 1995a, b)

Chart B	Existing % gross margin								
	5	10	15	20	25	30	35	40	50
%price increase	% volume decrease for same gross profit								
2.0	29	17	12	9	7	6	5	5	4
3.0	37	23	17	13	11	9	8	7	6
4.0	44	29	21	17	14	12	10	9	7
5.0	50	33	25	20	17	14	12	11	9
7.5	60	43	33	27	23	20	18	16	13
10.0	67	50	40	33	29	25	22	20	17
15.0	75	60	50	43	37	33	30	27	23

Fig. 11.8 Gross margin impact of a price increase. (Source: DUBS, 1995a, b)

By comparison, with a gross margin of 50%, the same firm would be able to lower its price by 10% and achieve break-even with only a 25% increase in sales. Thus, the firm with the larger gross margin is more likely to survive a price war. During difficult periods in the business cycle when customers are scarce, a firm with a price cut may attract new business but may cut its own throat in the process.

If the small business has a healthy gross margin, it can also benefit from price increases. For example, Chart B of Fig. 11.8 shows the effect of a price increase at different levels of gross margin. A business with a gross margin of 25% that puts its prices up by 10% can afford to lose 29% of sales without a negative impact on its break-even. If its price went up by 15%, the sales volume it could afford to lose would rise to 37%. By comparison, a business with a larger margin of 50% would experience a less dramatic variation in sales loss potential as its prices rose.

Before an owner-manager decides to reduce prices, they should consider their gross margin and the impact a price reduction will have on their break-even. They might also consider a price rise instead if they can make the same profit margin with fewer sales.

11.7.1 The Moving Break-Even

A problem with a traditional break-even analysis is that it views the business activity at a single point in time. To overcome this weakness, dynamic accounting uses a moving break-even that permits analysis of profitability in a more effective way. It allows the owner-manager to identify not only when they are profitable, but also what might be their point of maximum profitability (Snaith & Walker, 1999, 2001).

Traditional break-even analysis requires several assumptions. The first of these is the concept of relevant range. This relates to the theoretical limits of production within the firm. For example, if a production exceeds the design limits for machinery then breakdowns or stoppages would increase costs disproportionately.

It is also assuming either:

- a constant sales product mix or a single product line;
- that fixed and variable costs can be clearly identified; and
- that profits are calculated on a variable (marginal) costing basis (Warnes 1980; Snaith & Walker, 1999).

To understand the moving break-even the owner-manager needs to examine the following: break-even sales analysis, the break-even gap, and graphing the moving break-even.

11.7.1.1 Break-Even Sales Analysis

Break-even sales, refers to the level of sales for a specific period at which a business makes neither a profit nor a loss. It is calculated as follows:

Break-Even Sales Calculation
Break-even sales = (Fixed costs ÷ Gross profit margin) × 100

This calculation provides the starting point for future analysis. Any sales below this level will result in the business making a loss while any sales over this level will lead to a profit. Raising prices or lowering variable or fixed costs can influence its level.

11.7.1.2 The Break-Even Gap

The break-even gap is the difference between actual sales and break-even sales. This indicator provides the owner-manager with a measure of how many sales they require to reach break-even. This can be particularly useful when monitoring the firm's performance after start-up, or when planning new products and business development opportunities. By converting the break-even gap into a ratio (break-even gap %), the small business owner can produce a useful KPI and plot this trend over time.

Break-Even Gap Calculation
Break-even gap = Sales – Break-even sales
Break-even gap % = (Break-even gap ÷ Sales) × 100

As a general rule the small business owner should aim to keep their break-even down and continue to work toward reducing their break-even gap. A business with a capacity to reach break-even quickly is more likely to be sustainable, and will most likely generate better financial returns to the owners than one that takes much longer to break-even.

11.7.1.3 Graphing the Moving Break-Even

Once the break-even point has been found and data collected on its trend over time a series of graphs can be developed that provide the owner-manager with a useful picture of how their business is performing, or is likely to perform in the future. In Fig. 11.8 the break-even position of four different small firms is illustrated. This shows the weekly or monthly break-even sales figures (line B) against the weekly or monthly actual sales figure (line S). The pictures that emerge from these four companies are illustrative of the importance of tracking the break-even trends or moving break-even within a small business. They indicate four key types of manager: the busy fool; the excellent manager; the bad manager, and the good manager.

11.7.1.4 The Busy Fool

Company A shows a pattern that can be described as that of the 'busy fool'. This is because although sales revenues are rising sharply, the break-even sales level also continues to rise. This means that the owner-manager is making no more profit despite his or her increasing turnover. Such a business is likely to be experiencing rising costs (both fixed and variable) that erode profits. Unless something is done to correct this situation, the company will go broke.

11.7.1.5 The Excellent Manager

Company B is an example of the excellent manager. Here the firm's sales revenues are rising steadily while its break-even sales fall or remain steady. Under these circumstances the business will secure rising profits and retain sufficient working capital to allow for future growth if required. The owner-manager of this business is keeping his or her costs under control even though overall business activity is increasing strongly.

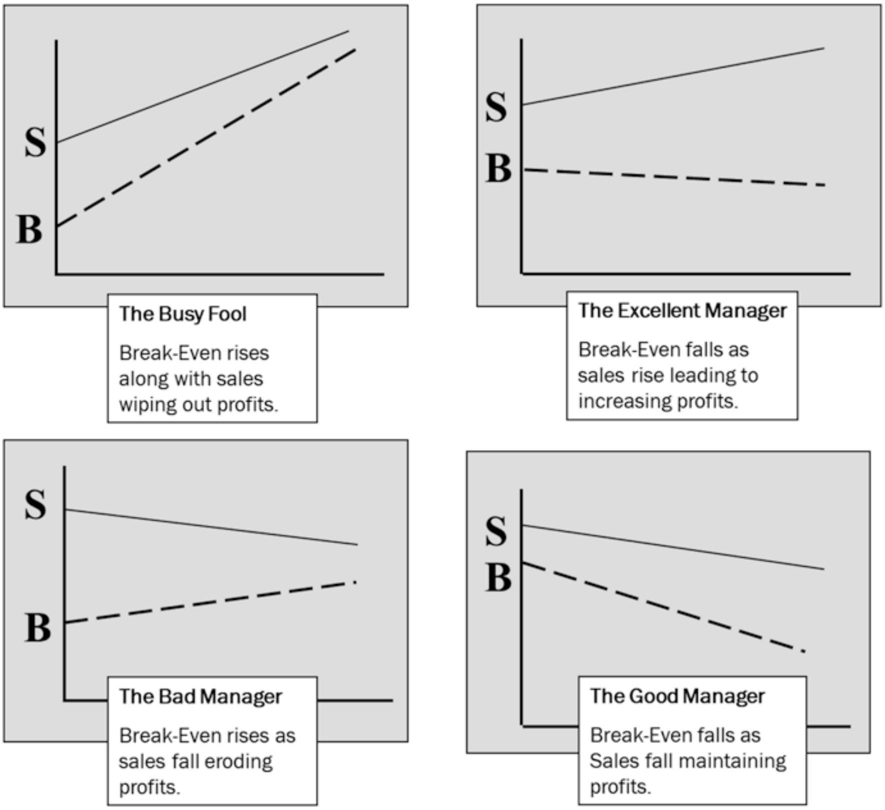

Fig. 11.9 The moving break-even in action. (Source: Snaith & Walker, 1999)

11.7.1.6 The Bad Manager

Company C illustrates the case of the bad manager. As can be seen the company's sales figures are falling sharply but the break-even sales are rising equally sharply. This owner-manager is allowing costs to rise even though revenues are in decline. There is only one outcome likely for this business, a financial loss, perhaps even bankruptcy.

11.7.1.7 The Good Manager

Company D is the example of the good manager. This owner-manager is good because while their sales revenues experience a steady decline, they are taking steps to keep their costs down allowing their break-even sales to fall along with the falling revenues. This manager is likely to survive whatever downward trend their industry is experiencing. Further, if they are able to keep this level of cost control in place when sales revenues return to a positive trend, they will be an excellent manager (Fig. 11.9).

11.8 Financial Control and Funding Requirements

The owner-manager seeking to ensure adequate financial control and to prepare for future funding requirements must develop effective bookkeeping systems. These systems are now available in computer packages with a variety of capabilities and costs. Well-managed small firms use such systems to monitor their cash flows on a regular basis (e.g. daily or weekly). Their owner-managers understand such systems and know what key performance indicators they need to monitor in order to keep their fingers on the pulse.

Owner-managers who can monitor the break-even point and work to keeping it down relative to sales will ensure that their business operates profitably and in a sustainable manner. To keep break-even down the owner must focus on building up the gross profit margin, which in turn is influenced by pricing policies and the management of variable costs. To this end the owner-manager should monitor the contribution margin generated by each product or service line or by customer or market segment. The marketing KPI outlined in Chap. 5 should be collected and used in conjunction with financial KPI to provide a clear picture of the true operating position of the firm.

The need to keep the break-even point down suggests that small firms should avoid competing on price. Following a cost leadership strategy is usually problematic for the small business, as they are often unable to secure adequate economies of scale and simply end up with thin profit margins, break-even problems and customers that only value their cheap prices. Discounting is another trap that many small business owners get into. By offering generous credit terms or discounts, the owner-manager can frequently boost sales, win new business or retain existing customers. However, while there is nothing intrinsically wrong with offering discounts, they need to be given careful consideration to ensure that the end result is not to inflict financial problems on the business.

Principles of Financial Control

For the owner-manager seeking to achieve financial control over their business the following key principles should be followed:

- Measure break-even weekly, monthly and annually, as appropriate;
- Focus on getting break-even down relative to sales and keep it below sales;
- Reduce break-even relative to sales by improving gross contribution or reducing fixed costs;
- Improve gross contribution by: (i) raising prices; (ii) reducing variable costs; (ii) better mix of sales (more high contribution products).
- Avoid trying to increase sales by reducing prices as this usually increases break-even more quickly - busy fool.

Source: Snaith & Walker, 1999, 2001.

11.8.1 Determining Funding Requirements

How well the owner-manager is able to determine their funding requirements can be crucial to the future sustainability and growth of the firm. To assess the external funding need the firm may have, the owner-manager should consider undertaking a calculation of their net fixed assets and true working assets (e.g. stock and debtors, less creditors) minus any equity.

From this, the owner-manager can determine how much capital they could raise from external sources pledged against their net assets less any owners' equity. Through this process, the owner-manager can determine the overall strength of their firm's funding base. They can also assess how future retained profits might contribute to this funding base. The stronger the firm's funding base, the greater its potential for growth. Attempting to grow a business from a weak funding base is risky (DUBS 1995a, b).

External Funding Requirement Calculation

External funding need = Net fixed assets + True working assets – Equity

Where:

- Net fixed assets = Fixed assets less depreciation (e.g. net book value)
- True working assets = Stock + Debtors – Creditors + Creditor strain
- Equity = Share capital + Retained profits

Source: DUBS (1995a, b).

To determine the external funding requirements for XYZ Company, we must first determine the firm's working capital requirement. The key elements are:

Net working assets – the non-cash assets needed to run a business consisting of stock plus debtors minus trade creditors minus preferential creditors;

Debtors and prepayments – customers who owe the business money for goods and services bought on credit, and prepaid items such as insurance premiums;

Stocks – raw materials, work in progress and finished goods usually known as inventories; and

Creditors and provisions – suppliers the business owes money to, usually for goods and services received (trade creditors) and people and organisations to whom the business owes money and who may have a preferential claim ahead of trade creditors – e.g. PAYE, GST.

In analysing a small firm's balance sheet, the working capital requirement is assessed by first listing all debtors and any prepayments, plus stock on hand, and then deducting any creditors and provisions (e.g. taxation liabilities). This will then determine the amount of working capital required within the business.

Table 11.6 Working capital and external funding

Working capital requirement XYZ Company	
Debtors and repayments	\$700,000
Stock (inventory)	\$10,000
Less creditors and provisions	(\$600.000)
Net working capital required	\$110,000
External funding needed XYZ company	
True working assets	\$110,000
Net fixed assets	\$30,000
Less equity and retained profits	(\$300,000)
External funding need	(\$160,000)

Source: Tarantino (2001)

As shown in Table 11.6, the working capital required for XYZ Company is a minimum of \$110,000. The company has \$700,000 in debtors (accounts receivable = \$580,000) and prepayments (prepaid expenses = \$120,000). Its stock (inventory) is \$10,000 and it has creditors (accounts payable = \$350,000) and provisions (accrued expenses = \$190,000; income tax payable = \$10,000; short-term notes = \$50,000) totalling \$600,000. It can be seen from the balance sheet (see Table 11.2) that XYZ Company has \$260,000 in cash. However, this analysis shows the company's true working assets (e.g. the non-cash assets needed to run a business with any creditors and provisions added back in).

If the owner-manager of XYZ Company is seeking to determine their external funding needs, they would undertake a calculation that added true working assets to net fixed assets and then deducted any owner's equity. The difference is the funding needed by the firm. As can be seen, the \$110,000 of true working assets + the \$30,000 of net fixed assets (fixed assets = \$50,000 less depreciation = \$20,000), once deducted from the firm's \$300,000 in equity and retained profits, shows that XYZ Company has a negative external funding requirement of \$160,000.

If XYZ Company had less equity and retained profits, its funding requirement would be different. In effect, the company has to find \$140,000 to fund its working capital requirements and net fixed assets. If XYZ Company were to embark on a growth path, it would need to substantially increase its working capital requirements and potentially its fixed assets. This would then demand sufficient equity and retained profits to fund the gap. If these funds were not available in the firm's net worth, it would need to seek external sources of funding such as additional debt or equity.

As discussed in Chap. 10, banks generally lend on a 1:1 basis, providing \$1 of funding for every \$1 of equity in the balance sheet. Therefore, when seeking to fund a small business, particularly with external borrowing or equity investment the balance sheet is a useful source of information as to the funding requirement.

Table 11.7 Balance sheet – XYZ Company

Current assets		*Current liabilities*	
Cash	$260,000	Accounts payable	$350,000
Accounts receivable	$580,000	Accrued expenses	$190,000
Inventory	$10,000	Income tax payable	$10,000
Pre-paid expenses	$120,000	Short term notes	$50,000
Total current assets	$970,000	Total current liabilities	$600,000
Non-current assets		*Non-current liabilities*	
Equipment, furniture	$50,000	Mortgages	$100,000
Less: Depreciation	($20,000)	Shareholders equity & retained earnings	$300,000
	$30,000		
Total assets	$1,000,000	Total liabilities & equity	$1,000,000

Source: Tarantino (2001)

11.8.2 Financial DOC Analysis

Tarantino (2001) suggests that the firm's financial statements can be analysed using a 'DOC analysis', which involves an examination of the debt, operations and cash position of the business. Let us examine each of these elements with reference to XYZ Company that we saw earlier in this chapter.

11.8.2.1 Debt Analysis

The first phase of the DOC analysis consists of looking at the balance sheet and examining the debt/equity ratio and the current ratio. A key question to ask in relation to the debt/equity ratio is whether the firm has too much debt. The ratio should be less than 1, meaning that there should be more equity than debt. As the current ratio determines if the business can pay its bills when they fall due, this ratio should be greater than 2.

Table 11.7shows the balance sheet of XYZ Company. The key figures that are needed from the balance sheet, as circled, are the total debt (current liabilities plus mortgages) of $700,000, and the equity of $300,000. The debt/equity ratio ($700 K ÷ $300 K) is 2.3. As the ideal debt/equity ratio should be less than 1, the 2.3 ratio of XYZ Company suggests that it is carrying too much debt.

Also, of importance are the current assets figure of $970,000 and the current liabilities figure of $600,000. This allows the current ratio (current assets ÷ current liabilities) to be calculated – which is 1.62. As the ideal current ratio should be greater than 2, it can be concluded that XYZ Company may be experiencing difficulties in covering its current liabilities when they fall due. While a more in-depth investigation of the situation facing XYZ Company will be required to fully

Table 11.8 Profit and loss statement – XYZ Company

Profit & Loss Statement XYZ Company		
Sales revenue		$1,500,000
Less operating expenses (COGS):	Gross Margin ($1,000,000 * 100)	$500,000
Gross profit	÷ $1,500,000 = 66.7%	$1,000,000
Less overhead costs:		
Administration and salaries		$500,000
Depreciation	Net Margin	$20,000
Earnings before interest and tax (EBIT)	($480,000*100) ÷ $1,500,000	$480,000
Interest charges	= 32%	($20,000)
Income tax payable		$110,000
Net income		$350,000

Source: Tarantino (2001)

understand its financial situation, the analysis indicates some problems. Based on the debt/equity and current ratios, XYZ Company may be facing some debt problems.

11.8.2.2 Operations Analysis

The operations analysis is undertaken with data from the P&L statement. Here, the main indicators are the gross profit and net profit margins. The main question to be answered is whether profit has grown along with revenues?

As shown in Table 11.8, XYZ Company has a positive net income of $350,000 and an EBIT of $480,000 for the current period. With a gross profit of $1 million and sales revenue of $1.5 million, XYZ Company has a gross margin of 66.7%. The net profit margin is 32%.

The gross and net margins shown by XYZ Company cannot be fully assessed without additional contextual information. First, XYZ Company management should make a comparison of the gross and net margins for the past three consecutive years to see if there has been any deterioration in the firm's profit margins. Second, if the data is available, the firm's margins should be compared against industry benchmarks. It is important to see if the gross and net margins have grown along with growth in revenues.

11.8.2.3 Cash Analysis

Turning to the cash analysis, the key questions that need to be answered are:

- How much cash is available?
- Is the cash flow positive or negative?
- How has the cash been obtained and used?
- How fast does the cash cycle through the business?

- How much cash reserve does the business have?

The first question is answered with reference to the balance sheet, while the other questions are answered with data from the cash flow statement. XYZ Company has $260,000 cash at bank (see Table 11.7). The cash flow statement (see Table 11.4) shows positive cash inflow of $7000. However, an important question is how long will it take to bring new cash into the business? This requires a calculation of the firm's debtor collection period.

Cash Analysis XYZ Company
Debtor collection period = (365 days × accounts receivable) = sales:

- (365 × $580,000) ÷ $150,000 = 141 days

  Yearly expenses (COGS + Overheads) ÷ 12 months:

- $1,000,000 ÷ 12 = $83,333 per month
- $83,333 × 3.5 = $291,665 cash required

  Source: Tarantino, 2001.

From this analysis it can be seen that it is taking XYZ Company around 141 days, which is approximately 3.5 months, to collect its accounts receivables from its debtors. This may be too long if the business lacks sufficient working capital. In an ideal situation, the firm's cash reserves would equal around 3–4 months. It can be seen from the analysis that XYZ Company has year expenses of $1 million comprising $500,000 in COGS and $500,000 in administrative and salary costs. This means that the firm will require around $83,333 per month to meet its operating requirements. To hold a cash reserve of 3.5 months to cover the shortfall in debtor collection will require $291,665. As shown in the balance sheet, the company has $260,000 in cash, but this may not be sufficient cash.

11.9 A Dynamic Balance Sheet

Although the balance sheet shown in Table 11.7 is useful it does not offer a clear picture of the funding need of XYZ Company. When a small business is seeking to grow or is emerging from its initial start-up period, it is important for the owner-manager to have a clear understanding of the funding need of the business, and where these funds are to come from. As noted earlier, the owner-manager must closely monitor cash flow and the working capital cycle.

Cash within a business can only be found in two places (Snaith & Walker, 1999): in the hands of shareholders; or tied up in the balance sheet. Figure 11.10 illustrates a revised 'dynamic' balance sheet that seeks to display the assets and liabilities of the business in a manner that assists the owner-manager to more clearly understand

	Assets **Funding Need**	**Liabilities** **Funding Available**
F **I** **X** **E** **D**	**Net Fixed Assets** (Cost less Accumulated Depreciation) Property Plant Equipment	**Net Equity** Share Capital Reserves Directors Loans (Intangibles)
V **A** **R** **I** **A** **B** **L** **E**	**Net Working Assets** Stock plus Debtors minus Creditors (trade and others)	**Borrowings** Creditor Strain Overdraft Term loan Mortgage Hire Purchase (Cash) i.e. negative borrowings

Total Asset Need = Funding

Fig. 11.10 The dynamic balance sheet. (Source: Snaith & Walker, 1999)

the funding needs of their business and where such funds may be found. The dynamic balance sheet is divided into four parts. The columns provide the separation into assets and liabilities, but these are classified as: assets = funding needed, and liabilities = funding available. The rows are separated into fixed and variable costs that broadly equate to the current and non-current assets and liabilities of the conventional balance sheet.

The balance sheet for XYZ Company can also be displayed in the dynamic form as shown in Fig. 11.10. This divides the company's balance sheet into where its funding is coming from (liabilities), and where these funds will be employed (assets). Once again, these two elements of the balance sheet are equal or 'balance'. However, it can be seen that the assets (funding needed) and liabilities (funding available) are only \$140,000 rather than the \$1 million shown on the conventional balance sheet.

You will recall from the earlier discussion of the firm's external funding needs that its true working assets are \$110,000 and its net fixed assets are \$30,000. XYZ Company needs \$140,000 to fund its operations.

A key element in the dynamic balance sheet format is its recognition of the relationship between the firm's total asset need and available funding. As shown in Fig. 11.11, XYZ Company has a funding need of \$140,000 comprising the \$30,000 tied up in securing its fixed assets, and the \$110,000 of its working capital requirements. To fund XYZ Company \$300,000 of share capital and retained profits (net worth) is combined with the \$100,000 of long-term debt less the \$260,000 of cash that the firm holds (to determine net borrowings).

	Assets = Funding Need		Liabilities = Funding Available	
F	Net Fixed Assets:		Net Equity:	
I	Property, Plant & Equipment	$50,000	Share Capital & Retained Profits	$300,000
X	Less Depreciation	-$20,000	Director's Loans (provided by owner)	
E				
D			Intangibles (e.g. patents,	
	Net Fixed Assets	$30,000	goodwill at purchase)	
	Net Working Assets:		Borrowings:	
V	Inventory	$10,000	Creditor Strain (Accounts Payable Overdue)	
A	Accounts Receivable (Debtors)	$580,000		
R	Prepaid Expense	$120,000	Mortgages	$100,000
I	Less Current liabilities:			
A	Accounts Payable (Creditors)	-$350,000	Less Cash	-$260,000
B	Accrued Expenses	-$190,000		
L	Income Tax Payable	-$10,000		
E	Short Term Notes	-$50,000		
	Net Working Assets	$110,000	Net Borrowings	-$160,000
	Assets = Funding Need	$140,000	Liabilities = Funding Available	$140,000

Fig. 11.11 The dynamic balance sheet – XYZ Company. (Source: Data from Tarantino, 2001, concept Snaith & Walker, 1999)

11.9.1 Graphic Displays

Rice (2003) suggests that accounting reports such as balance sheets should be displayed in a graphic format to aid readability and allow managers to gain a quick overview of their firm's position. The dynamic balance sheet of XYZ Company shown in Table 11.7 can be graphed as shown in Fig. 11.12.

This graph can be easily produced in an Excel spreadsheet or similar software tool. Like any balance sheet, the two columns displaying the assets and liabilities + equity must be equal. The advantage of this graphic display is simply to provide the owner-manager with a visual representation of their firm that clearly illustrates its financial structure. In this case, the relative size of its fixed assets and borrowings are shown. The relative proportion of the owner's equity in relation to the size of the firm's borrowings is clearly illustrated, as is the size of the firm's current assets in relation to its current liabilities. This also applies to the fixed assets compared to the mortgages used to fund them. A graph offers a better way for many people to see the structure of the firm's financial position in the balance sheet. As can be seen, XYZ Company is not in terrible shape, but a year by year comparison using this technique can be an effective way of viewing the changing shape of the firm.

11.9.2 The Radar Chart

Snaith and Walker (2001) suggest that the key financial data be graphically illustrated using a radar chart. A radar chart is a graph that displays a set of variables from a central point as a series of spokes radiating from the hub. The radar chart

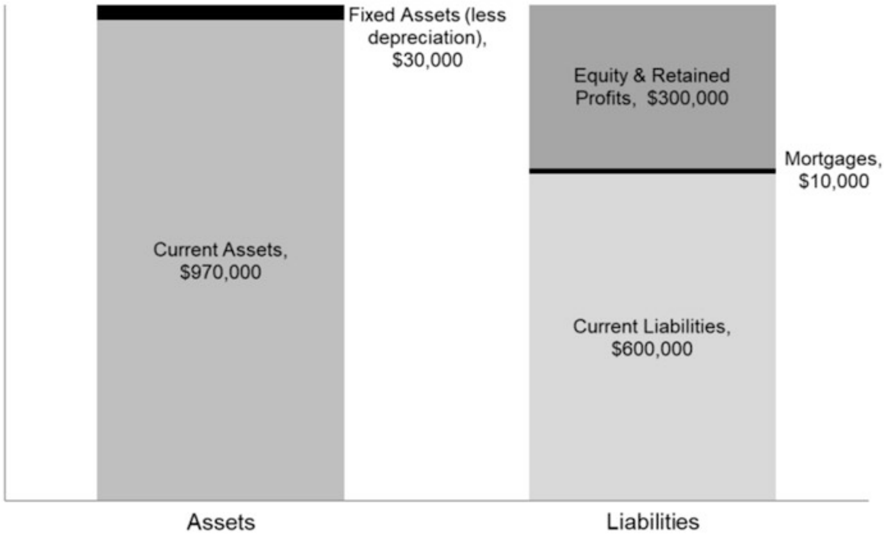

Fig. 11.12 The XYZ Company balance sheet displayed graphically. (Source: Data from Tarantino, 2001, concept Rice, 2003)

offers a picture of the shape of your business and matches its current performance against a target performance. By using the dynamic targets as one line and the actual results (expressed as percentages of income) as the other line, the chart shows a shape of your business at any time and how 'fit' it is (Snaith & Walker 2001, p. 75).

According to Snaith and Walker (2001) there should be at least eight financial KPIs used within the radar chart:

1. Gross contribution % (Gross profit %)
2. Net contribution % (Net profit %)
3. Break-even gap %
4. Stock %
5. Debtors %
6. Trade creditors %
7. Other creditors %
8. Net working assets %

These KPIs are all *dynamic* in nature because all are expressed as a percentage of sales revenues. Therefore, any changes in the level of sales revenues will result in a change in the KPIs which can be readily monitored on the radar chart. Figure 11.13 illustrates the radar chart of XYZ Company.

A radar chart should be mapped using at least eight KPIs, and can show multiple periods in time (e.g. year by year, or month by month) that can illustrate trends in the firm's financial performance. This chart can provide the owner-manager with a graphic view of how their business is performing on these KPIs. By mapping regular intervals, the changes in these measures can be examined. Radar charts can be

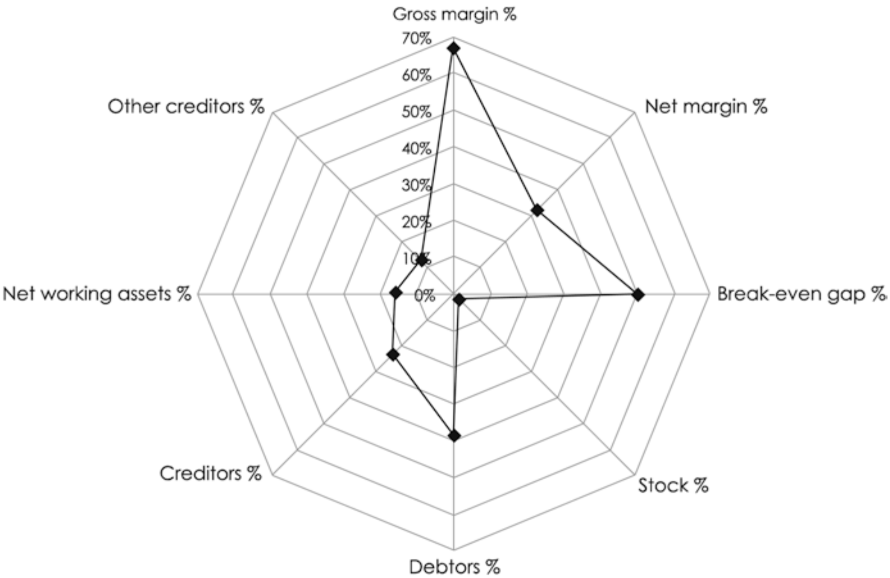

Fig. 11.13 The radar chart of XYZ Company. (Sources: Data from Tarantino, 2001; concept Snaith & Walker, 2001)

constructed relatively easily using the charts option in an Excel spreadsheet or equivalent software product.

11.9.2.1 Reading the KPIs

It will be noted that the data forming these KPIs are drawn from both the balance sheet and the profit and loss account. Further, they are all measured as a percentage of sales to create a common baseline for comparison. In reading the radar chart the following general guidelines are followed:

Gross contribution (gross profit margin) – should be increasing or remaining constant. Remember that the larger the gross profit margin the more easily a business can reach break-even and withstand changes in pricing.

Net contribution (net profit before interest and tax %) – should be larger rather than smaller as this reflects the firm's retained profits and capacity to contribute to its overall equity position or pay dividends.

Break-even gap % – this figure should be increasing rather than decreasing.

Stock % – again this figure should be decreasing not increasing as it is a measure of the efficiency with which the business is turning over its inventories.

Debtors % –lower debtor ratios are preferred as they indicate the efficiency with which the business can recover its receivables. Higher ratios suggest that the business is taking too long to collect its revenues.

Trade creditors % – this figure also needs to be decreasing not increasing. Rising trade creditor ratios suggest that the firm is experiencing creditor strain as it may lack adequate funds to support its business activity levels.

Other creditors % – a similar situation to trade creditors.

Net working assets % – this figure should also be reducing because lower working capital requirements within a business signal enhanced efficiency.

These KPIs and their use in graphic forms such as shown here are designed to assist the owner-manager to more easily monitor the financial pulse of their business. As a general principle the aim of the small business owner-manager should be to maintain good gross profit margins, keep their break-even sales level down, reduce their firm's working capital requirements and increase the level of equity within the balance sheet.

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Franchising and Legal Issues for Small Business

12

12.1 Introduction

> Small businesses often lack the time and knowledge to innovate in managing regulatory obligations and very few have specialist staff to carry out compliance tasks. As a result, compliance with regulation can be a challenge for many small business people, who mostly want to be instructed, clearly and concisely, as to what they need to do to be compliant (Productivity Commission, 2013, p. 67).

Franchising has become a highly popular business system throughout the world with many small business owner-managers joining franchise networks. Although the more famous franchise systems such as KFC, McDonalds and Pizza Hut that came to Australia in the 1970s were established in the US there are now many such as Snap Printing, Jim's Mowing and Eagle Boys Pizza are Australian owned. According to the Franchising Council of Australia (FCA, 2011), 90% of the franchise systems operating in Australia were developed here (FCA, 2016).

The popularity of franchising has been largely due to the perception that a franchise business is 'safer' or less risky than a non-franchise operation. The success of these well-known franchise systems – and claims made by franchise operators – serve to enhance the image of franchising. However, a franchise is not risk free and requires as much managing as any other business. This chapter examines franchising as a model for small business management. It also reviews some of the basic legal issues facing the owner-manager of a small firm, including intellectual property protection.

Franchising is so popular in Europe that this continent is sometimes called "the continent of the franchise". In 2016, Europe counts nearly 14,000 networks, much more than any other continents as North America counts 5000 franchise systems (3800 for the United States and 1200 for Canada), 4000 in China (Asia), 2426 for Brazil (South America) and 1160 in Australia (Oceania). Among the EU members,

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France is the leading country in terms of retailers since it owns over 1900 different systems (Matas, 2016). These numbers are similar to the data revealed during the French November 2015 Franchise Annual Survey, which showed that 77% of entrepreneurs surveyed thought that franchising was a good anti-crisis bulwark, when 89% of franchisors said they were optimistic as to the economic future of the country (Hatchadourian, 2016).

This success has required the setting up of a European Franchise Federation, in order to represent and defend this commercial system with the European authorities. It has been created in 1972 by the French, Italian, Belgian and Dutch federations. It is located in Brussels and is recognized by EU authorities as their main partner when franchising issues are discussed.

12.2 Franchising

> **A franchise is,** … a system of distribution that enables a supplier (the franchisor) to arrange for a dealer (the franchisee) to handle a specific product or service under certain mutually agreed on conditions. (Hodgetts & Kuratko, 2001, p. 126)

A franchise is a contract by which a parent company (the franchisor) gives an individual operator (the franchisee) the right to use a trade name or a business format to sell a particular product or service. The franchisor will usually provide the franchisee with their knowledge, operating and marketing techniques. In other words, a franchise is a pre-packaged business that you can operate under agreement with a franchisor.

It is essentially a means of reducing the risk (both financial and managerial) of the franchisor. In the case of services (such as education) the franchisee usually receives a license for a trading name and the right to use the intellectual property associated with delivering the services. Control over the business or franchise network is limited to the terms of the agreement. The franchisee usually has control over the hiring and firing of staff, operational and budgeting decisions and day-to-day activities. The franchisor usually maintains control over those marketing and service delivery aspects that ensure standardisation of services throughout the network.

> **For example,** … the International Franchise Association defines franchising as a continuing relationship in which the franchisor provides a licensed privilege to do business, plus assistance in organising training, merchandising and management, in return for a consideration from the franchisee. (IFA, 2019)

In essence, franchising is a business model or business system that can be applied to a wide range of industry sectors. It is also worth noting that, while the fast food sector is most commonly associated with franchising, most franchising is in retail, non-food industries. Further, most franchise systems are small with a median number of 20 franchise units (FCA, 2011). The OECD (2003) define a franchise as a type of vertical relationship between two firms.

> **For example,** … Franchising is a special type of vertical relationship between two firms usually referred to as the "franchisor" and "franchisee". The two firms generally establish a contractual relationship where the franchisor sells a proven product, trademark or business method and ancillary services to the individual franchisee in return for a stream of royalties and other payments. (OECD, 2003)

As noted above franchising has become a major business model throughout the world, and has seen a substantial amount of regulatory legislation enacted in order to assist franchisees to deal with the power of franchisors. In 2016 there were an estimated 733,000 franchised businesses operating in the United States. These firms were employing around 7.6 million people and generating an estimated US $404.6 billion to the national economy (PWC, 2016). Franchising is also a significant business activity in in the European Union. For example, in 2014 there were an estimated 517,864 franchised businesses operating across Europe under a total of 13,627 franchised brands (EFF, 2015). This has since increased to 14,000. The European Franchise Federation (EFF) estimates that European franchise businesses employed around 3 million people in 2011 (EFF, 2012).

In France more than 74,000 franchised shops are registered. Owner-managers are mostly male (57% of cases) however the share of women franchisees (43%) is increasing. Franchisees are on average 47 years old and they were 36 years old when they started their franchise. In the majority of cases, the decision to become a franchisee was not the result of a job loss, since more than 70% were employees before embarking on a brand. In terms of education, 53% have reached a Bachelor degree or more. A typical average franchise counts 6.2 employees and in total the franchise represents more than 670,000 direct and indirect jobs and weighs 59.55 billion euros (Matas, 2016).

Franchising has also spread widely through Asia, which in 2014 comprised around 16% of the global revenue generated by franchise businesses. Key growth areas for franchising are China, Hong Kong and Singapore (HKTDC, 2014). Franchising has also spread into the Middle East where major US franchisors such as KFC and Hertz Rent-A-Car began to operate in the 1990s (Martin, 1999). Australia and New Zealand comprise only 4% of the global franchise revenue (HKTDC, 2014). However, business format franchising grew strongly in both countries during the 1970s and 1980s, particularly with the appearance of fast food franchises such as KFC and McDonalds (Weaven & Frazer, 2005).

Over the period 2006–2008 the growth rate of franchising in Australia was 14.6%. In 2010 there were 1025 franchise systems in operation within Australia with 69,900 business format franchise units in operation. These included 7900 company owned units, 8000 fuel retail outlets and 2500 motor vehicle retail outlets. These systems employed an estimated 413,500 persons (FCA, 2011). This was a slight decline from the late 1990s when the sector employed approximately 680,000 people and turned over about $81 billion (The Australian, 1999). By 2016 there were 1120 business format franchisors operating in Australia, with an estimated 79,000 member franchisees. These businesses employed around 470,000 people and generated an estimated A$66.6 billion out of a total A $146 billion within the entire franchising sector. The majority (90%) of these business format franchises originated in Australia (Frazer, Weaven, Grace, & Selvanathan, 2016).

12.3 Types of Franchising Systems

There are two principal types of franchising agreement that can be used to establish a franchise business. The first of these is the product and trademark franchise, while the second is the business format franchise. Each of these has a slightly different legal structure (EFF, 2018; Megginson, Byrd, & Megginson, 2000; Seid, 2018).

12.3.1 Product and Trademark Franchising

Product and trademark franchising occur where the franchisee is granted the right to sell a particular product or brand that has a well-established reputation in the market. Coca-Cola is one of the best-known and oldest franchising systems operating within this model. Motor vehicle dealerships that carry the manufacturers name as part of an exclusive agency relationship is a common use of product and trademark franchising (Seid, 2018). Under such systems, the franchisor is concerned mainly with maintaining the quality or integrity of the product or brand within the market. Such franchisors do not usually become closely involved with the daily operations of the franchisee.

12.3.2 Business Format Franchising

Business format franchising is probably the most commonly known type of franchising model. In this system the franchisee not only gets the rights to market and sell a particular product or service and use its branding, but is provided with a complete business management system. In such systems, the franchisor is closely engaged with their franchisee network, providing substantial guidance. Fast food restaurant chains such as KFC, McDonalds and Pizza Hut have commonly engaged in this type of system. Other systems of this kind have included hotel chains, automotive products and convenience stores.

Under a business format franchising system, the franchisee purchases everything that they need to establish the business. This should include all equipment as well as training in the operation of the business, as well as support in marketing and management systems. Most well-run business format franchises involve well established standards of operation and franchisees are required to attend compulsory training and even probationary periods before being allowed to run the business. McDonald's is one of the most famous franchise systems using a business format model.

Business Format Franchising McDonald's Style

When Ray Kroc set up McDonald's as a franchisor, he controlled the trade name (McDonald's), symbol (golden arches), and operating systems. In turn, he permitted franchisees to use them under controlled conditions – for a fee. Kroc also controlled all aspects of quality that characterised the successful operations of the original drive-in.

Source: Megginson et al. (2000), p. 79.

The business format franchising approach therefore provides the franchisee with a complete business system and requires a legal contract that protects both parties. Most business format franchising systems require the franchisee to pay an up-front fee to secure the rights to use the business concept, and then an on-going royalty fee is paid to allow the franchisor to continue supporting the franchisee. The structure of this royalty fee can vary, but it is designed to fund the continued marketing of the brand, new product development and the training and business systems improvements as well as any financial return to the franchisor (Franchising World, 2006).

12.3.3 Conversion Franchising

In addition to the establishment or expansion of new and existing franchise systems, an emerging trend – particularly in the US – has been the conversion of existing independent businesses into franchisees. This is most common where these existing firms are operating in the same industry (e.g. restaurants) or selling the same products (e.g. computer retailers). Such conversion franchising can be beneficial to small business owner-managers who may be having trouble or who require external financing and cannot attract venture capital. By joining the franchisor network, they can secure access to marketing support, mass purchasing power and enhanced management support. Successful conversion franchising examples include Subway Sandwiches, Best Western Hotels and Century 21 Realty (Hodgetts & Kuratko, 2001).

12.4 Advantages and Disadvantages of Franchising

The major advantages of joining a franchise would appear to be the ability to offer a system that relieves much of the risk and helps the small business owner-manager 'manage' their business well from start-up.

At least four important advantages can be identified (Hodgetts & Kuratko, 2001):

1. *Brand name*. All businesses need a well-known brand name and high levels of brand equity. Buying into a franchise system offers the franchisee access to the use of a brand that would otherwise cost them substantial amounts of money and time to create.
2. *Training and guidance*. Most successful franchise systems provide a package of training for both the franchisee and their staff. McDonald's famous 'Hamburger University' is an example of the apprenticeship that the franchisee is required to undertake before they can be granted full rights to operate the outlet. Because so many small business owner-managers lack business experience and training, franchise systems can compensate for this.
3. *Track record*. As with a successful brand image, a well-established and operated franchise should provide the new franchisee the ability to join a system that substantially enhances their ability to succeed. Even if a franchisor is new it should run a pilot scheme that demonstrates in some considerable detail that the concept is proven or works (Hobson, 1998).

4. *Financial support*. Many large franchise systems will provide franchisees with financial support to get established. It may cost between $500,000 and $1.5 million to establish a major franchise business, but banks are likely to be more willing to lend to a business such as this and some leading franchisors are able to provide financing to franchisees.

In summary, the key advantages of a franchise business are the prospects that if it is well designed and managed with a sound track record and brand image it will be a lower risk than establishing an independent business. The training and systems support provided by the franchisor also allows the small business operator to get established with proven operational and administrative controls in place, which should reduce risk.

Good franchisors will also support their franchise network with brand advertising and ongoing support and new product development. Being part of a network can also enable the small business operator the opportunity to talk with other franchisees and get both new ideas and assistance. Because major franchise systems purchase in bulk the small business operator has the ability to secure lower costs of supply than might be possible if they were independent. For retail franchising businesses, the small business owner can also usually get assistance from the franchisor in the selection and acquisition of suitable sites.

Advantages and Disadvantages of Franchising

Advantages:

- Owning a franchise allows you to go into business for yourself, but not by yourself.
- A franchise allows franchisees a certain level of independence.
- A franchise provides you with access to proven products or services – often with high brand recognition.
- A franchise offers support in site selection, financing, training, marketing and business setup.
- Franchises offer ongoing support such as advertising, training, management assistance, and access to bulk purchasing.

Disadvantages:

- Franchisees are not completely independent.
- Franchisees must pay initial fees plus ongoing royalties and marketing costs.
- Franchisees can suffer from damage to the wider franchise system if the image is harmed by unforeseen problems.
- The franchise agreement can be limited in duration and may be terminated by the franchisor.

Source: (Beshel, 2010).

The major disadvantages of franchising relate to at least three things (Hodgetts & Kuratko, 2001):

1. *Franchising fees*. The cost of being a member of a franchise network can vary from business to business. Fees for large, well-established franchises tend to be higher than for smaller, less well-known ones. Franchisors can require ongoing fees of between 2% and 15% of gross income.
2. *Franchisor control*. As noted earlier the franchisor may wish to exert a high level of influence over the way the franchisee operates the business. Franchisees may find themselves half-way between the independent owner-manager and the large company manager. For those with strong desires to achieve autonomy, a franchise may not be the best kind of business model. However, those with a desire to operate their own business, but who have difficulty accepting independent risk may find the franchise ideal. According to Stanworth (1999) the franchise business lies somewhere between the fully independent owner-manager and the employer-employee. Power and control within a franchise system are not always reflected clearly in the legal contract.
3. *Unfulfilled promises*. Franchisors that fail to deliver on their side of the contract are unfortunately too common. As discussed later in this chapter, the Australian Government has introduced legislation to address this.

Franchising therefore has the disadvantages of high fees and ongoing royalty payments, loss of control and the legal pressures that might be used by a franchisor seeking to enforce their rights against a franchisee that they feel is not fulfilling the agreement. Many franchisee-franchisor disputes arise over these issues, and many franchisors will require franchisee's source all their ingredients or materials from the franchisor, even when these may not be the cheapest. Royalty fees may also be charged as a percentage of sales, or a flat fee, resulting in the franchisee having to pay them even if their business is not profitable. Some franchisors will place sales and growth targets on the franchisee and can use a failure to meet these as cause for severing the agreement. Under some franchise contracts the franchisor may retain the right to remove the franchisee from the location and replace them with another resulting in the loss of the business and any investment made to that point.

12.5 How Risky Is Franchising?

The Small Business Association (SBA) of America has estimated that franchise businesses have a substantially better survival rate than independently owned and managed small firms (Tannenbaum, 1992). According to the International Franchise Association (IFA) the majority of franchise systems in the US are small businesses. For many US franchisees the initial investment in a franchise is less than US$250,000, and some 53% of the systems have 50 or fewer total units that are either company or franchisee owned (Franchising World, 2000) Given that so many franchise businesses are small, some question might be asked over the general level of risk associated with franchising.

Franchising Survival Rates

One piece of empirical data which does exist is the annual British Franchise Association/National Westminster Bank survey estimate of franchisee failure, which suggests franchisee failure and turnover combined amount to about 10% per annum. Of this 'forced changes' (buy-backs, closures and sell offs) typically account for about 7% and 'voluntary changes' (sell-ons) a further 4%. These figures, it should be noted, are based upon uncorroborated, self-reported, low response rate data received from franchisor survivors. The data is nonetheless fairly similar to the figures which Daly (1987) claims typical for conventional small firms between 5 and 10 years of age.

Source: Stanworth, Purdy, Price, and Zafiris (1998).

The IFA also claims that survival rates among small business start-ups that are franchisees are five times more likely to survive their initial years than conventional firms (IFA, 2019). However, despite the success of many leading franchise systems there are some reasons to be cautious about viewing franchising as the safe option to establishing a business. While franchising failure rates in the US have been claimed to be about 5%, as compared to 30% or even 50% among independent start-up businesses; research at Wayne State University in Detroit has suggested that franchising failure rates may be closer to those of conventional firms, and that many franchisees actually make lower profits than independent operators (Daley, 2013).

A further study by Stanworth et al. (1998) examined the survival rates of franchise system firms in the UK and US. They found that accuracy in measuring small firm survival rates was low and that when reliable measures are applied the survival rates of franchised and non-franchised firms are similar. Further, their study suggests that franchise businesses may actually be faced with greater risk in the first 5 years or until *break-even* is achieved. This risk is similar for both the franchisee and the franchisor.

Buchan (2013) has described business format franchising as a "*honey pot in a bear trap*". She makes the point that many franchisees are lured into franchising deals with the promise that they will make money without the usual risks associated with a normal small business start-up. Franchisors will appear to be successful and able to offer the necessary marketing and support to the franchisee. However, there is no guarantee that the franchisor will not fail thereby taking the franchisee down with them.

> **For example,** … Business formal franchising has been described as 'a form of "honey trap" into which inexperienced franchisees are lured by promises of success'. On investigating a franchise, the franchisees and their advisors test the honey, but seldom notice, examine or understand the power of the bear trap that surrounds it. That bear trap is franchisor insolvency. The power to trip this bear trap sits with the franchisor and the franchisor's creditors. Once tripped, all franchisees are caught within its teeth. Most are unable to escape until the franchisor's administrator or liquidator frees them. (Buchan, 2013, p. 283)

Despite this note of caution, as noted earlier, well-established franchise systems are likely to have identified a successful niche and developed a proven product or service mix. Business format franchisors are also likely to provide the franchisee with a complete management package including training, financial and marketing tools, operations and control systems and on-going support.

What Is a Franchise Agreement?

For an agreement to be classified as a franchise agreement it must be written, verbal or implied, under which:

- One party (the franchisor) grants another party (the franchisee) the right to carry on a business supplying services under a specific system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate of the franchisor.
- The business is associated with a particular trademark, advertising or a commercial symbol owned, used, licensed or specified by the franchisor or its associate.
- The franchisee is required to pay, or agree to pay an amount to the franchisor before starting or continuing the business (there are some exceptions).
- Note: A motor vehicle dealership agreement (including a motor boat dealership agreement) is taken to be a franchise agreement even if the definition has not been met.

Source: ACCC (2016).

Business format franchisors will also impose tight controls over how the business is run. This is likely to include performance standards on products or service delivery. For example, McDonald's places strong emphasis on staff training and may require franchisees to allocate large amounts of their budget to this. They have also been known to intervene in determining how much a franchisee pays their managers. Small business owners who prefer to do their own thing may therefore find a franchise system highly restrictive.

Franchising Failures

In the United States, an enterprising young woman and her younger brother put up $2000 as a guaranteed investment for candy machines after the franchisor promised to find good locations for them. These failed to materialise, however, because all the desirable locations were already in use. The franchisor disappeared, and the entrepreneurs lost their $2000.

Source: Megginson et al. (2000), p. 79.

An owner of a tyre and brake retailing business in Australia joined a new franchise system involving the rental of small utility trucks for casual hire.

(continued)

Despite outlays for vehicles and marketing, as well as paying franchise fees, the franchisor failed to deliver adequate marketing, advertising and management support to the network. Complaints from other franchisees eventually led to a franchisee revolt and buyout of the franchisor. The system is now run as a cooperative and the franchisor lost substantial sums of money.

Source: Personal account from a small business owner.

Even if it is assumed that franchising offers the potential for enhanced success, the franchisee must still be prepared to run the business and take financial risk. Most successful franchise systems require a substantial outlay of capital to buy into the network. The franchisor will also require the franchisee to provide regular payments (usually a percentage of gross revenues) in return for use of the name and for marketing.

12.6 Purchasing a Franchise Versus Going Solo

As discussed in the previous section the franchise model has many advantages and several disadvantages for small business owners. For those deciding whether to start up via the purchase of a franchise or to launch an independent green fields venture, the key issues to consider relate to the owner's background and start-up capital. Where an owner has sufficient experience of an industry or a particular type of business, and can raise sufficient start-up capital to successfully launch their new venture, the independent route may be attractive. For example, the cost of setting up a new franchise (including up-front fees and set-up costs) can range from around $5000 to more than $1 million, with fixed franchise payments from $50 per month or more, and percentage fees costing anywhere from 2% to 15% of the franchisee's annual turnover (FCA, 2019).

Franchise Start-Up Costs

Cost of the average franchise:

- In the US – US$143,260.
- In Australia – AU$100,000 (ranges from AU$2500 to AU$1.23 million)
- In France – €5000 to over €50,000.

Outlays:

- Initial franchise fee
- Equipment and stock
- Premises and fit out
- Legal and accounting fees, plus stamp duty
- Working capital and royalties

(continued)

Costs of establishment (Median):

	Retail	Non-retail
Initial fees	$31,500	$28,000
Inventories	$10,000	
Fit-out costs	$150,000	$4000
Training costs	$5000	$1000
Legal and accounting fees	$3000	$2000
Initial working capital	$2000	$10,000
Other costs		
Total costs	$287,500	$59,000

Sources: Franchise Council of Australia (2008), Frazer et al. (2016) and Colas des Francs (2013).

Many new franchisees are former salaried professionals who are generally well educated and who have accumulated good financial assets (e.g. savings and property), but who lack experience in independent business operations. These people generally make good franchisees. They can learn quickly to manage and operate the systems developed by the franchisor, and typically are happy to follow the script. For people with a more independent and innovative mindset who may value independence, the franchise route is likely to be less attractive. Franchise businesses may also not generate the same level of profit or growth potential as a new independent business. Therefore, the individual who is willing to take the risk to secure the superior return may be better to follow the independent business option.

When choosing whether to purchase a franchise or established business, the main issues will relate to the price paid for the benefits secured. A well run and established going-concern business is likely to offer a viable alternative to buying into a franchise system. Assuming the established independent business has good systems, a competent team of employees and a good customer base with sound goodwill, the main considerations will be:

- How important is receiving continuous management support?
- Will the franchise business offer superior marketing exposure?
- Does the franchise system offer an opportunity to share costs?
- Is there likely to be significant reduction in risk with the franchise?
- Does the training and business methodology offered by the franchise system outweigh the advantages of doing things yourself?

The answer to these questions will depend upon the nature of the franchise system and also the character of the owner-manager. Each case needs to be made on its merits. The cost of purchasing a well-established franchise is likely to be high. In addition to the initial purchase fee the franchisee may have to pay for equipment, stock, premises, legal and accounting expenses, stamp duty, working capital and ongoing royalties.

12.6.1 Selecting a Franchise

It is important that any purchase of a franchise business be undertaken after a well-considered process of due diligence has been completed. Although the franchisor will be required to supply a good deal of information, it is still a good idea to undertake separate research. Some key considerations should be:

- Is this type of business really what you are seeking?
- Does it offer the kind of income, lifestyle and intellectual challenge you are going to be happy with over the long term?
- Are there alternative franchise systems that you might look at?
- What are the cost and benefits of going solo?

The FCA recommends that any purchaser of a franchise evaluate at least one or two other systems prior to selecting a particular business model. They provide a franchise directory (see www.franchise.org.au) that contains an online listing of about franchise systems across Australia. This directory is cross-referenced and has an alphabetical index. It also lists professional advisory service providers with expertise in franchising. It is a valuable first point of contact for anyone seeking to purchase a franchise in Australia (FCA, 2019).

It is important to talk to other franchisees within the system and visit their stores before finalising the deal. The total cost of purchasing the franchise need to be assessed. This includes not only the up-front purchase price, but also the on-going royalty fees and any other costs (FCA, 2019).

Finally, it must be realised that the franchisor-franchisee relationship is not one of employer-employee, but a commercial partnership with obligations and rights on both sides. The role of a good franchisor is to create and maintain a well-designed business system that allows the franchisee to make a success of their business, and to maintain steady profits with less stress and risk than might be the case were they independent.

The franchisor must continue to add value to the franchise relationship and ensure that they continuously strengthen the brand reputation of the business, innovate in the development of its products or services, and keep administration and operating systems up to date. In return the franchisee should ensure that they follow the business system and comply with the guidelines outlined in their franchise agreement. A healthy franchise system is one that is built on a sound business case, good products, and mutual respect and understanding between franchisor and franchisee.

When considering whether to buy a franchise the small business owner-manager should investigate the franchisor with the same scrutiny they would with any other established business. Of importance would be such things as:

1. *The territory assigned*. An initial consideration would be how large is the territory being offered within the franchise network? During the early development of a franchise system, it can be possible to secure large sections of territory. Some fran-

Table 12.1 Criteria for selecting a franchise

Criteria	Key questions
Costs	How much will this franchise cost before it becomes profitable? Can you afford to buy this franchise? Can you make enough money to make the investment worth your time and energy?
Your abilities	Do you have the technical skills or experience to manage the franchise? Do you have the business skills to manage the franchise?
Demand	Is there enough demand in your area for the franchisor's products or services? Is the demand year-round or seasonal? Will the demand grow and is there repeat trade?
Competition	How much competition will there be and are competitors well established? Is there a specialty or niche you can capture?
Brand name	How well known is the franchise name and does it have a reputation for quality?
Training & support	What kind of training and support does the franchisor offer and is this adequate?
Franchisor's experience	Has the franchisor been in business long enough to have established the type of business strength you are seeking?
Expansion plans	Is the franchisor planning to grow at a rate that is sustainable?

Source: (Beshel, 2010)

chisors have 'over sold' territory setting up potential competition from within the network. Further, location can be essential in some types of business and the same price probably should not be paid for a poor location as a better one.

2. *Success of other franchisors*. If the franchise network has been operating for a while the potential buyer should contact existing franchisees and seek their candid views over the performance of the franchise.
3. *Terms of the franchise contract*. While it is not in the interests of the franchisor to offer contracts that disadvantage the franchisee, it is essential that careful scrutiny of the contract be undertaken. Of particular importance might be such issues as how much is to be paid for equipment, training, manuals and inventory. The contract should deliver benefits to both parties.
4. *Level of on-going support*. For a franchise to offer genuine advantage, it should offer effective on-going support for the franchisee that justifies the 'royalties' or 'franchise fees' that need to be paid.
5. *Quality of management systems*. If the franchise is a business format system it will be important to determine in advance the effectiveness of the management systems offered. Training in these systems for the franchisee and their staff may also be important issues.
6. *Contract termination*. The prospective purchaser should seek clarification over how the contract may be terminated. They will be investing substantial funds and time into the business. Upon sale – usually back to the franchisor – will this investment and *goodwill* be adequately recognised and compensated? (Table 12.1).

12.6.2 What Makes a Successful Franchise?

Floyd and Fenwick (1999) have proposed a four-stage model for successful franchise system development. Using a case study methodology of ten heterogeneous franchisors they identified four distinct stages in the franchise growth process:

1. *Hatchling: concept development*. Here the franchise system or concept is in its early stages. The initial founder or entrepreneur sets up the franchise and seeks to attract initial participants. As with any start-up firm the owner-founder is usually engaged in 'hands-on' management, ad-hoc planning and simple or informal business and control systems. Successful transition from this stage will depend on the founder's ability to develop a marketable concept, efficient management systems and attract funding.
2. *Nestling: business development*. This stage usually sees the franchisor developing and testing a business system that can be configured for expansion. It should offer franchisees profitability and expansion. The 'track record' of the franchise system is substantially developed here.
3. *Fledgling: initial franchisees*. As soon as a franchisee commences trading the franchise system has entered this stage of development. The system must offer a fully developed support infrastructure for management, marketing and financial support to franchisees. Company-owned outlets may be sold to franchisees at this stage. Securing new sites for franchise outlets may be another important issue at this stage.
4. *Adult stage: franchise expansion*. The mature franchise can expand during this stage. It will require the franchise to have developed a well-structured Head Office, full procedural manuals and a succession plan for franchisees. Important issues for the franchise during this expansion stage will be handling franchisor-franchisee relationships, particularly as the franchisees mature and seek growth.

Many franchise businesses have engaged in this process and development cycle. According to Floyd and Fenwick (1999), the next stage after the Adult stage may be internationalisation. They note that franchisors who fail to give sufficient attention to getting each stage right are likely to experience problems. Moving too quickly through each stage may be a cause of franchise failure.

Fenwick and Strombom (1998) conducted an empirical study of 42 franchisees in New Zealand. They concluded that franchisee performance was likely to be linked to the level of entrepreneurial capacity of the franchisee, as well as their management experience or training. Franchisees with strong entrepreneurial tendencies and past management experience were found to be poor performers. They felt that franchisees without management training or background might be better suited to franchising. This appears to be related to them being less likely to question the franchisor and dispute the system. Further, and not surprisingly, the study emphasised location. Success appeared dependent on both the size of the market and the location of the franchise outlet (particularly in retailing).

Other research has explored the influence of more intangible or even psychological aspects on the performance of franchise. For example, Brand, Croonen, and

Leenders (2018) explored the effects of franchisee networking with peers within a franchise system on franchisee unit performance. Their results suggest that the performance benefits that franchisees draw from networking with their peers vary between low, medium and high performing franchisees.

In another interesting exploration, Mignonac, Vandenberghe, Perrigot, El Akremi, and Herrbach (2015) have analysed emotional attachment of franchisees to their franchise organization and explored the relationship between franchisee's affective commitment and franchisee outcomes. They found that affective commitment to the franchise organization was positively related to franchisee objective performance and intent to acquire additional units, and negatively related to franchisee opportunism and intent to leave the franchise organization.

In their study of 1570 Australian franchisees from 35 different franchise networks, Parker, Cutts, Nathan, and Zacher (2018) note that franchisee proactivity, optimism, family support, and perceived organizational support were positively associated with financial performance of the business.

12.7 Regulation of Franchising Systems

Not all franchises are sure bets and those with a lower purchase cost are likely to be a greater risk than the big names. In Europe is the *European Code of Ethics for Franchising*, initially issued in 1972 and regularly revised since then, has been adapted in the different member states of the EU, e.g. in France with the *Code de déontologie européen de la franchise* (EFF, 2016; FFF, 2017).

> **The EFF code of ethics in franchising is,** … a practical ensemble of essential provisions for the governance of the relations between a franchisor and each of its franchisees, operating together in the framework of the franchise network. The overarching principles of ethics that underline this set of provisions are good faith & fair dealings, which translate as franchisor-franchisee relations based on fairness, transparency and loyalty each of which contribute to founding confidence in the relationship. (EFF, 2016)

In addition to the obligations of the franchisor and the franchisee, it describes the commitment of the two parties. For example, they will:

- Seek to safeguard the image and reputation of the network in the running of their respective businesses;
- Exercise good faith and fairness in their dealings with each other. The parties shall give written notice of any contractual breach and, unless inappropriate, grant reasonable time to the other party to remedy default;
- Respect the confidentiality of information material to the franchise concept provided by the one to the other;
- Resolve complaints, grievances and disputes with good faith and goodwill through fair and reasonable direct communication and negotiation;
- Where appropriate and where parties have failed to resolve a dispute through direct negotiation, seek in good faith mediation before (EFF, 2016, p. 5)

Another example is that of Australia. In 1998, the Australian Government introduced the *Franchising Code of Conduct* to assist with regulation of the industry. This code encompassed all franchises and similar structures. It covered both the franchisors and franchisees. As a legal document the Code was part of the *Trade Practices Act* 1974 and was enforced by the Australian Competition and Consumer Commission (ACCC). Also established was the Franchising Policy Council that assisted with the framing of government policy in the sector. A mediation adviser was established under this Council to assist in the settlement of disputes between franchisors and franchisees (Zeidman, 1998). The Code prohibited unfair conduct (Clayton, 1998).

What the Franchisor Must Provide

Under the Australian *Franchising Code of Conduct* the franchisor must provide a disclosure document to the franchisee at least 14 days prior to the contract being signed or renewed. This document must outline:

- whether the franchise is for an exclusive or non-exclusive territory or limited to a particular state;
- whether the franchisor or its associates may establish other franchises or operate a business in the franchise territory that are substantially the same as the franchise;
- whether you may operate a business that is substantially the same as your franchise outside franchised territory; and
- whether the franchisor may change the territory.

The document should also provide details of the franchisor's experience and track record, and criminal liability, trade practices or other litigation facing them. Disclosure of any fees paid to agents who recruit you into the franchise, as well as details of any existing franchises, plus those terminated or renewed in the past 3 years.

Details of any copyrights, patents, trademarks, registered designs or other intellectual property rights used in the operation of the franchise should be disclosed along with your rights to their use and ownership. All fees charges and ongoing costs need to be disclosed to the purchaser as well as any information relating to site selection and marketing policies.

Source: ACCC (2000).

In 2015 the *Franchising Code of Conduct* was repealed and replaced with a new Code (ACCC, 2016). This continued most of the same general principles of the earlier code and was designed to apply across all franchise agreements entered into, renewed, extended or transferred on or after 1 October 1998, with only a few exceptions. The new Code:

- Obliges both franchisor and franchisees to act in good faith in their dealings with one another.
- Introduces financial penalties and infringement notices for serious breaches of the Code.
- Requires franchisors to provide prospective franchisees with a short information sheet outlining the risks and rewards of franchising.
- Requires franchisors to provide greater transparency in the use of and accounting for money used for marketing and advertising and to set up a separate marketing fund for marketing and advertising fees.
- Requires additional disclosure about the ability of the franchisor and a franchisee to sell online.
- Prohibits franchisors from imposing significant capital expenditure except in limited circumstances.

This level of regulation by governments around the world is a response to the expansion of franchising systems during the 1990s and abusive practice by some unscrupulous or poorly designed franchise systems.

12.8 Franchising for International Expansion

Franchising has also become a popular, and successful, method of internationalisation for many firms (Portmann, 2000) Research in international franchising has begun to identify two distinct set of capabilities needed to franchise internationally (Justis & Judd, 1989). The first set is critical for the management of the international franchise relationship and is most closely related to issues such as international management capabilities and cultural adaptability. The second group of capabilities concerns the ability of the international franchisor to operate in a foreign context and directly relates to skills in host country policy evaluations and exchange risk management.

One of the most critical decisions faced by franchisors seeking to pursue international opportunities is what mode of entry to use when entering a foreign market. (Chan & Justis, 1990) suggest five major starting strategies for franchising in East Asia: master franchisee; joint venture with foreign companies or individuals; licensing; company-owned outlets; and joint venture with the local government.

A franchisor opting to internationalise can select a mode of entry into international markets with alternatives ranging from very little risk and low capital expenditure (e.g. master franchising or direct franchising) to relatively high risk and high capital investment (e.g. wholly-owned subsidiary). Also, two franchisors may perceive the same risk in a country but choose different market entry modes depending on the firm's tolerance of risk (Sharma, 1995). These entry modes range on a continuum in terms of risk and capital investment.

- *Master franchising*. The master franchisee may be an individual, business, or conglomerate corporation that assumes the rights and obligations of the franchisor to establish franchisees throughout a country or region.
- *Joint venture*. The franchisor seeks a form of partnership with a foreign franchisee in establishing franchise units.
- *Direct franchising*. The franchisor establishes each individual franchise and manages the resulting network in the foreign market directly – i.e. without the use of any intervening organisation.
- *Wholly owned subsidiary*. The franchisor invests in company-owned stores or subsidiaries in foreign markets. This means that the franchisor provides all the capital and resources necessary for starting up the foreign outlet.

Identifying the appropriate foreign market entry strategy is therefore a critical determinant of the likely success of a franchisor within international markets (Woodcock, Beamish, & Shige, 1994). Wei and Perry (1995) have attempted to consolidate the influence of these four critical variables upon each of the various market entry modes and their findings are presented in Fig. 12.1. According to this analysis franchising offers a reasonable balance between the issues of cost, risk, return and control. It is perhaps for this reason that research has found greater success among franchise systems entering international markets (Mazzarol, Choo, & Ramaseshan, 1997).

Choo and Mazzarol (2001) have proposed a conceptual model of the factors likely to influence the performance of small- to medium-sized franchisors seeking to enter overseas markets. This model is illustrated in Fig. 12.2. As can be seen, the performance of the franchisor is likely to be mediated by their choice of market entry strategy. However, the major factors likely to have an impact on their choice of this entry strategy are:

- *Ownership advantages*. If the franchisor is sufficiently large, has sufficient experience of international operations, or is able to develop and offer unique products or services, it can command significant power within the market entry channel. These ownership advantages are generally available to such international franchise giants as KFC, McDonalds or Starbucks, but not to smaller franchisors. In this case the franchisor will be required to seek local partners.
- *Location advantages*. The characteristics of the international market into which the franchisor is seeking to enter also play a role in their choice of market entry strategy. Markets which have high levels of existing businesses of the kind envisioned by the franchisor, and are therefore becoming saturated, will offer different advantages to greener field markets. The risk associated with the market will also be assessed in terms of both the financial investment, and the psychic distance (Johanson & Vahlne, 1977). The psychic distance relates to how culturally similar or dissimilar the new market is compared to the franchisor's country of origin. This can have a major impact on the firm's decision to enter and grow the market (Dow, 2000).
- *Internalisation advantages*. The last element is the level of risk that is associated with contracting the franchise system. A franchise system is only valuable if its concepts, trademarks and other intellectual property rights can be protected. Some countries offer good levels of protection to intellectual property, while oth-

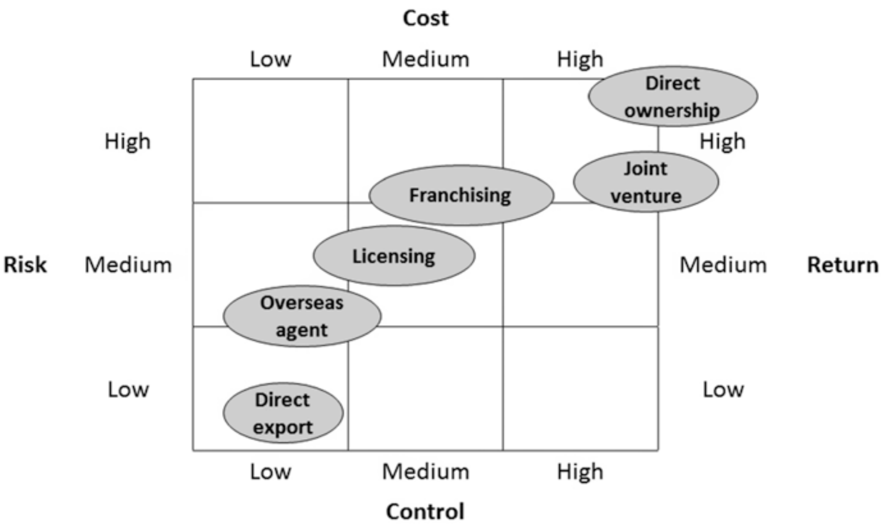

Fig. 12.1 The risk/return and cost/control trade-offs of market entry modes. (Source: Wei and Perry, 1995)

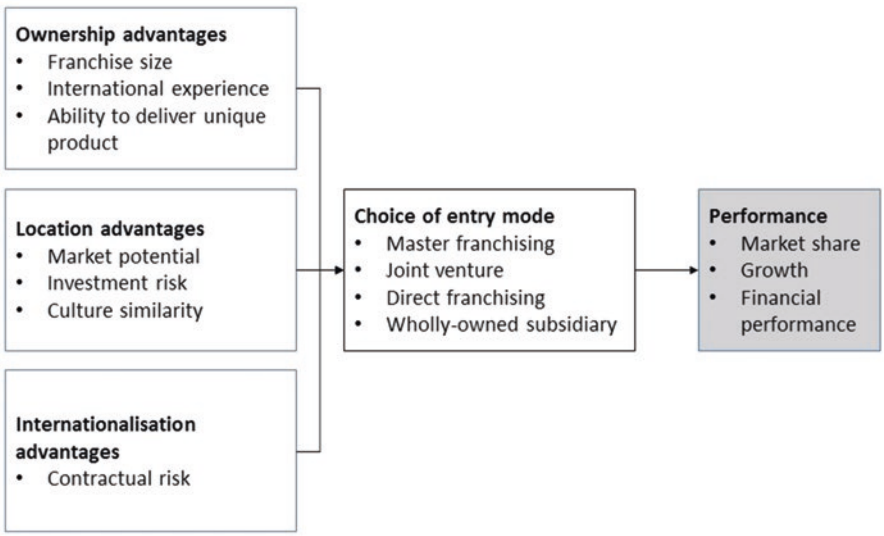

Fig. 12.2 Conceptual model of measuring performance of small to medium international franchisors. (Source: Choo and Mazzarol, 2001)

ers have weak protective regimes. A major consideration for franchisors is how well they can protect their concept once it has been launched in the overseas market. Many franchisors entering Asian markets choose to establish master franchise agreements with major local players to assist in reducing risks of this kind. This was the pattern followed by DOME Coffee in entering the Singapore market, and also that of Pizza Hut in entering the Japanese market.

In summary, the franchising model has proven highly successful for businesses seeking to grow rapidly both at a national and international level. The choice of foreign market entry strategy is likely to be a critical decision by franchisors that will be influenced by their capacity to control the marketing channel. Most small franchisors will be forced to form joint ventures in the form of master franchise entities and share ownership within a selected country with local partners. Nevertheless, the business format franchise system has this growth potential due to its capacity to be replicated at site after site once appropriate systems and training have been put in place. The opportunity to build a successful small business through a turn-key environment has attracted the many thousands of franchisees who have paid to join these systems.

12.9 Selecting Your Legal Structure

An important consideration for the owner-manager seeking to establish or develop their business enterprise is determining the corporate structure that the entity will have. Decisions regarding how the business will be structured are complex and may have profound influence on the future management of the firm. The structure of a business has legal as well as managerial implications and is likely to incur a range of different taxation effects.

Many owner-managers launch their business ventures with little consideration for the most appropriate structure. However, according to Aidun (1997) there are two important benefits for owner's to focus on corporate structure: one is the entrepreneur's ability to do effective tax planning, which is a benefit that can be simple to quantify because you can calculate your savings; the other is more difficult to describe, but you might like to think of it as the benefit of leading a tidy life. If the intention is to grow the business rapidly and potentially use the venture to secure external investment or venture capital an appropriate corporate structure is likely to be necessary (Fraser, 1997).

In most countries the nature of the business structure, how it is operated and its obligations in relation to taxation and employment are regulated by corporate laws. There are three primary business structures found around the world: (i) sole proprietorship; (ii) general partnership; and (iii) corporation. Additional types of business structure include: (i) trusts; (ii) limited liability partnerships (LLP); (iii) various types of corporation (e.g. limited liability companies LLC, S Corporations, public company, not-for-profit limited by guarantee, co-operative and mutual enterprises). Table 12.2 lists some of the most common business legal structures.

Table 12.2 Business legal structures

Business structure	Characteristics
Sole Trader/ Proprietor	Where an individual establishes and operates a business in their own name without any partners or co-workers. They are usually personally and individually liable for any agreements.
General Partnership	A relationship or association between two or more persons with a view to profit. They may be individuals or companies, but are not incorporated. Rights are governed by a partnership agreement and the Partnership Act. A partnership enters into an agreement in the name of its partners. Each is usually jointly liable for any agreements.
Limited Partnership (LP)/ Limited Liability Partnership (LLP)	An LP has one partner who has unlimited liability and other partners with unlimited liability. LLP have limited liability for all partners. In Australia a limited partnership is equivalent to an LP, but may have multiple partners that carry unlimited liability.
Corporation/ Company	A company or corporation is a separate legal entity or person. It can enter into agreements in its own name. If a company breaches an agreement the liability for that breach generally rests with the company itself, rather than with the directors of the company. This is unless there is misconduct by the directors, or offences such as breach of duty, misrepresentation or misleading or deceptive conduct. If a company owes money and there is no dispute over the debt the creditor can serve a statutory demand which must be dealt with immediately. If a company cannot pay its debts it becomes insolvent and the directors may be liable for debts incurred while insolvent.
C & S Corporations	In the United States *C Corporations* are separate entities that pay tax, while *S Corporations* are subject to tax exemptions.
Societas Europea	In the EU companies are referred to as *Societas Europa* (SE) or European Company. It is a commercial company that is recognised as its own legal person and with its ownership distributed amongst shareholders.
Company Limited by Guarantee (CLG)	Under Australian law, a CLG is a not-for-profit public company in which its members liability is limited to the amount of money they contribute to the company upon wind-up. It does not issue dividends or distributions from any profits, and all member shareholders have equal voting rights.
Trust	A relationship or association between two or more persons whereby one party holds property on trust for the other. The first party is vested with property and the holder of the property is called the trustee. The other party (for whom the property is held) is called the beneficiary. Trusts may be made expressly in writing or implied from the circumstances. A company may trade as a trustee of a trust.
Co-operative	A co-operative is a member-owned business structure with at least five members (fewer in some countries), where all members have equal voting rights regardless of their level of investment or involvement in the enterprise. Co-operatives may or may not distribute profits to members, and may enjoy some tax benefits for rebates paid to members for recognition of their patronage. Co-operatives are usually defined by: (i) voluntary and open membership; (ii) democratic member control; (iii) member economic participation; (iv) autonomy as an entity; (v) promotion to members of education, training and education; (vi) co-operative with other co-operatives; and (vii) concern for the community.

(continued)

Table 12.2 (continued)

Business structure	Characteristics
Mutual enterprise	A mutual is a private company whose ownership base is made up of its clients or policyholders. The defining feature of a mutual company is since its customers are also its members, they are entitled to receive profits or income generated by the mutual company. It is owned and run for the benefit of its members. Key features of Mutual enterprises are: (i) absence of shares; (ii) free membership; (iii) solidarity among members; (iii) democratic governance; (iv) autonomy as an entity; (v) limited profit sharing.

Sources: ATO (2019), IRS (2019), SBA (2019), ICA (2019), and Grijpstra, Broek, and Plooij (2011)

12.9.1 Business Structures in Different Countries

Within Australia, just under half (49%) of businesses' legal structures are companies. Partnerships and sole traders comprise a further 33%, and trust make up the remaining 18%. According to the OECD (2017), Australia, Ireland, the United Kingdom and the United States are characterised as having fairly 'dispersed' ownership structures within their business sector. By comparison, the concentration of ownership across companies in many other countries is quite different. In many countries the business landscape is characterised by a few large publicly listed companies that are owned and controlled by a small number of shareholders, and a large number of SMEs, mostly not-incorporated, and in many cases operating within the informal economy. For example, in Israel 75% of all public companies are controlled by a few family or individual interests. In Italy, around 67% of listed companies are controlled by a single shareholder. Within Korea, Indonesia, Mexico, Latvia, Portugal, Sweden, Turkey and Spain, most companies are owned and controlled by a relatively small number of influential families (OECD, 2017).

In France, like in many other countries, it is not ordinarily necessary to establish a separate legal company structure to start and run a business. An entrepreneur would typically have the choice to either operate a business as a sole trader (*Entreprise Individuelle*, EI), or to establish a limited company (EURL or SARL). It is also possible to opt for the legal status of EIRL – *Entreprise individuelle à responsabilité limitée*, a status that grants a strong degree of limited liability, but without the need to establish a company.[1] Most people setting up a business in France do so on a sole trader basis. Whilst it is possible to later migrate to a limited company, there are fees and taxes associated with doing so, particularly if business assets have to be transferred to the new company. The type of legal structure will have implications on the fiscal status of the entrepreneur. Depending on the choice they make, they will either be taxed through the personal income tax system, or through the system of company tax. Another implication will be the type of social security contributions they will pay, either as a salaried employee or as a self-employed person.

[1] https://www.french-property.com/guides/france/working-in-france/starting-a-business/legal-structure

12.9.2 Sole Proprietor

Being a sole trader is the simplest way to set up a business in the EU. Registering is simple and you only need to keep basic financial records. You get to keep all profits – minus any taxes – but you will be personally liable for any debts. Each member state has slightly different legislation, regulations and administration rules for setting up as a sole trader – usually in relation to a country's tax rules. The rules for starting up companies vary between each member state across the EU and you must ensure you are aware of these differences.

The key advantage of being a sole proprietor or sole trader is the simplicity of the legal structure. There are few costs of establishing this system and few ongoing compliance responsibilities in comparison with other systems. Registration of a business name is frequently the main activity required in the establishment of this system and is undertaken via the State Government Corporate Affairs Office. A sole trader is not required to key accounting records and is taxed as an individual at their marginal tax rate for personal income tax.

However, the sole proprietor legal structure suffers from several disadvantages. The first is the legal liability of the owner-manager. From a legal perspective there is no difference between the owner-manager and their business entity. This means that any legal claims against the business will most likely impact directly on the owner's personal assets. From a tax perspective, the sole proprietor is subject to full marginal rates of tax on all business income, meaning that high turnover businesses will incur the top marginal taxation rate of 47% plus the Medicare levy (top rate at time of writing was $54,232 plus 45 cents for each $1 over $180,000) (see www.ato.gov.au).

A final disadvantage of the sole proprietor legal structure is that the lack of legal separation between the owner-manager and their business entity can make the future sale of the business problematic. If a business is to be viewed as more than a job, it must be developed in such a way that it is worth more over time than when it was established. A sole proprietor cannot easily develop the value within their business entity and therefore prepare it for future sale as a valuable asset.

12.9.3 Partnerships

The partnership structure involves two or more individuals engaged in the same business entity. Like the sole trader/proprietor structure, the partnership is reasonably easy to establish, but also suffers from the lack of legal separation between the business entity and the owner-managers. Further, in a partnership the legal liabilities of one partner will usually impact on the others within the firm. Partnerships are not required to maintain legal or accounting records as do companies.

In the formation of a partnership it is advisable for a partnership agreement to be drafted with assistance from a solicitor. If no such agreement is signed the relationship between the partners will be subject to the provisions of the *Partnership Act* that applies in each state or territory (Birch, 1999). Apart from the disadvantages of legal liability between partners, there can be some problems with taxation and the division of profits. As with the sole proprietor, all partners are usually subject to full marginal rates of taxation for income generated by the business. In addition to the tax returns of each partner, the partnership may also have to submit an annual tax return, although it will not pay tax.

Partnership Agreements

A partnership agreement can assist in clarifying the roles of each partner and may be beneficial during periods of strain. Such an agreement can be in written, verbal or implied. It is best to have a written agreement that sets out:

- What will be the partnership shares?
- What are the partnership assets?
- How are profits to be distributed?
- Partnership liability; how liability is to be apportioned between the partners?
- Terminating the partnership/buy back of shares.
- Handling disputes.

Source: DITR (2006).

The *Partnership Act* also assumes that all partners will enjoy equal shares in any profits. This means that if one partner generates more income or has invested more start-up capital in the venture, they will not be able to secure any differential benefits unless they have a specific partnership agreement to secure such rights. Finally, in the event of the bankruptcy, death or permanent disability for any one of the partners, the entire partnership must be dissolved. Each partner has full rights to management control within the partnership unless specified otherwise in any partnership agreement.

12.9.3.1 The Partnership Success Model

The failure of partnerships is frequently due to differences of opinion between the partners that cannot be resolved. Kuratko and Hodgetts (1998) highlight the importance of effective communication strategies between partners. Mechanisms are required to allow disputes to be resolved – or avoided – through communication flow. For example, joint participation enables all parties to better understand the strategic choices facing them. The researchers found that trust, commitment, communication quality, joint planning, and joint problem resolution all serve to better align partners' expectations, goals and objectives. The challenge lies in developing a management philosophy or corporate culture under which independent trading parties can relinquish some control while also engaging in planning and organising that takes into account the needs of all parties (Kuratko & Hodgetts, 1998, p. 387). As shown in Fig. 12.3, the keys to successful partnerships are threefold:

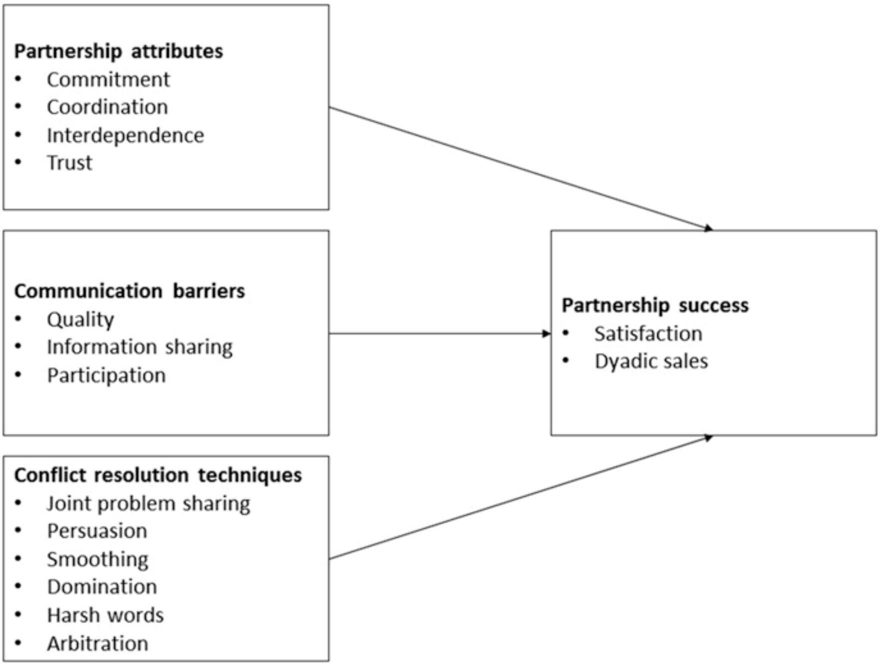

Fig. 12.3 The partnership success model. (Source: Kuratko and Hodgetts, 1998)

1. *Partnership attributes*. Partners need to be committed to the relationship and willing to coordinate their business activities to each other's mutual benefit. Interdependence and trust are important to bind the partners together and avoid conflicts.
2. *Communication barrier*. The quality of communication flow between partners is critical to success. All information needs to be shared, and partners need to be willing to speak their mind and work through problems in a cooperative spirit. All partners need to feel they are equally sharing or participating in the business and any decision-making. Problems frequently arise when one partner feels that the other is not 'pulling their weight'. Issues relating to employee appointments, promotions, discipline and termination must also be discussed equally. The partners also need to share any decisions relating to major financial transactions.
3. *Conflict resolution techniques*. If problems do arise, the partners need mechanisms to resolve conflicts. Using an independent mediator can assist this process.

12.9.4 Companies

The company structure creates a business entity that is legally separate from its owners and managers. There are two broad types of company, the private company and the public company. A private company or proprietary company is the most common within small business and comprises firms in which all share capital is held privately (it can have only one shareholder). By comparison, the public company is listed on the stock exchange and must provide annual, audited financial reports to all shareholders. A company is a separate legal 'person' and as such can own property and enter into legal agreements in its own name. If a company breaches a legal agreement it can be sued, and it can also take legal action for loss or damage. A company is comprised of its shareholders and directors or company officers (e.g. Company Secretary). These office bearers have specific obligations under the Corporations Law. The company also has reporting and accounting responsibilities (DITR, 2011).

The decision to establish a business using a particular structure is frequently driven by taxation considerations in Australia. Private company structures are among the most common form of business followed by sole traders and partnerships. The company structure offers the benefit of lower tax rates and the option of reducing an owner-manager's personal income tax through retention of profits within the company. However, the additional costs of legal compliance associated with a company structure can be a major disadvantage. Company structures may also allow the owner to package motor vehicle leases and superannuation payments via their business with benefits unavailable to the sole trader/partner.

Establishing a proprietary limited company usually involves the drafting of a memorandum of association and articles of association. These two legal documents outline how the entity will be structured. The memorandum of association details: the name of the company; shareholder liability; share capital to be invested; initial subscribers' names (who will be the initial shareholders) and a statement of desire by shareholders to form the company. The articles of association outlines: the rights of transfer in share ownership; the number of shareholders (usually limited to 50); and the extent of public subscription to share ownership (usually restricted in Pty Ltd. firms). There will also be a statement that no invitation is issued to the public to deposit money with the company.

These documents usually need to be signed by all initial shareholders and a copy retained within the company. The Australian Securities & Investments Commission (ASIC) regulates companies and will require the company to complete registration forms for incorporation. These documents indicate who are to be the shareholders and office holders within the company. Companies are also required to lodge annual returns to ASIC that state the details of shareholders, directors, company secretary, registered office and financial details. While companies can be more, expensive to establish they offer many benefits over sole proprietorships and partnerships.

Duties of Company Directors

Directors owe a fiduciary duty to the company. A director's duty essentially requires them to act honestly, with diligence and in the company's best interest. Under the Corporations Law a director is required to fulfil the following duties:

(continued)

- act honestly;
- exercise a reasonable degree of care and diligence;
- not to make improper use of inside information; and
- not to make an improper use of their position.

A company director has other duties not listed here.
Source: DITR (2011).

Key advantages for a company structure are the limited legal liability it offers, thereby protecting the owner-manager's personal assets from claims against the business. Company taxation rates are also a maximum of 28.5%, which is significantly less than the top marginal tax rates for personal income. However, it should be noted that once a Company Director draws an income from the business the personal income taxation rates will apply. Distribution of company profits in the form of shareholder dividends remains another means of generating income from the company. Such dividends can be fully franked (e.g. tax paid by the company), however, the treatment of taxation should be reviewed regularly with a taxation specialist. In addition, the taxation rates are subject to continuous review and you are advised to refer to the Australian Taxation Office (see www.ato.gov.au) for the latest information.

12.9.5 Trusts

A fourth legal entity that can be used by small business owners is a unit trust.

> **In legal terms a trust is,** … a relationship or association between two or more persons whereby one party holds property on trust for the other. The first party is vested with property. The holder of the property is called the trustee. The other party (for whom the property is held) is called the beneficiary. Trusts may be made expressly in writing or implied from the circumstances. A company, for example, may trade as trustee of a trust. (DITR, 2011)

Trusts can be established relatively easily and do not have to be in a written form. A document that establishes a trust is called a trust deed and should set out such details as what property is being held in the trust and who the beneficiaries of the trust are. It may also detail the date at which the trust is to terminate, or the conditions under which such termination will occur. The termination of a trust can also take place automatically once the purpose of the trust is achieved, or the property in the trust is consumed.

Trusts are not separate legal persons as are companies and can only enter into legal agreements via their trustees. However, the trust deed must give permission to the trustee to enter into such legal agreements. As with company directors, a trustee is obliged to act in the best interests of the beneficiaries or beneficiary of the trust. Under Australian legislation trustees have the power to invest the proceeds of a trust, sell, mortgage or lease trust property, purchase insurance cover for the trust, and pay advances to beneficiaries out of trust property. Beneficiaries under a trust have the right to compel a trustee to obey the terms of a trust deed, and to pay them proceeds from a trust.

12.9.6 Contingency Factors in Determining Legal Structure

Rattiner (2000) argues that the entrepreneur's objectives should be carefully considered before deciding on the most appropriate business structure. The issues likely to face the owner-manager and their business should be considered and thought given to what structure is best placed to handle these. Malecki (2000) considers many businesses move through a cycle of structures:

- from sole proprietor to partnership to corporation;
- partnership to a limited liability company;
- partnership to corporation; or
- any combination of the former.

The type of legal entity the small business operator enters into is likely to depend on their specific needs and the general complexity of the venture. Many small business owners start with a sole trader status incorporating once the firm's turnover has grown. Liabilities incurred by the owners during trading must be considered as the business changes its structure. Many insurance firms may refuse to transfer liabilities from sole traders or partners into limited companies. Banks may also wish to have the debts paid out by individual entrepreneurs before re-negotiating loans with companies.

Taxation issues can be a major reason why many companies are selected over partnerships. Regulations for company directors have emerged as a major area of concern for many owner-managers companies. Such regulations do impose greater restrictions on what the owners can do with their business than is often the case with sole traders and partnerships. This appears to be the case in the US where a limited liability company (LLC) is a highly popular business form with taxation benefits (Ripley, 1994).

12.10 Other Legal Issues Facing Small Firms

Within the average small business, a range of legal issues confronts the owner-manager. Franchising and its associated contracts are just one. A comprehensive coverage of the legal issues associated with running a small business is beyond the scope of this book. However, there are a number of guides for small firms that can be found around the world issued by government agencies that provide assistance to small businesses. Table 12.3 provides a list of some of these.

Table 12.3 Small business legal advice websites – various countries

Source	Country	Website link
Small Business Co UK	United Kingdom	https://smallbusiness.co.uk/running/legal-advice/
Small Business Administration	United States	https://www.sba.gov/business-guide/manage-your-business/stay-legally-compliant
Business.gov.au	Australia	https://www.business.gov.au/Guide/Starting/Know-the-laws
Agence France Entrepreneur	France	https://www.afecreation.fr/pid199/questions-frequentes.html
Starting a business in the EU	European Union	https://europa.eu/youreurope/business/running-business/start-ups/starting-business/index_en.htm
Business.govt.nz	New Zealand	https://www.business.govt.nz/getting-started/choosing-the-right-business-structure/business-structure-overview/

12.10.1 Registration of Businesses for Taxation

All businesses in Australia must be registered with an 'Australian business number' (ABN). This is a single 11-digit identifier used to track all dealings that the business entity has with the Australian Taxation Office (ATO) as well as with other government departments and agencies. Application for an ABN can be undertaken online via the ATO website. For sole traders and small businesses that have an annual turnover of $75,000 or more (or $150,000 or more for not-for-profit entities), an ABN is required because these businesses must register for the Goods and Services Tax (GST). Further details on the ABN and GST can be found at the ATO website www.ato.gov.au.

As a comparison, a French business is allocated several identification numbers when it is registered: SIREN, SIRET, registration in the Trade and Companies Register (RCS), registration in the Trade Register (RM), APE code and VAT number. Each company has a unique 9 digits SIREN number that identifies it to the administration and is attributed by the national institute for statistics (INSEE). It must be indicated on invoices and quotations established by the company. It is also found on commercial documents, in the legal notices of the company's websites, … Moreover, it appears on all the tax and social statements issued by the company.

The APE code identifies the main activity carried out by the company. It is assigned by INSEE and consists of 4 digits +1 letter (e.g. the code APE 4399C is for general masonry and structural work). This code determines the convention applicable to the company. The APE code must appear on payrolls of employees and it often mention on the administrative documents of the company (invoices, quotes …).

12.10.2 Taxation Compliance

If a small business is registered in Australia for GST and has an ABN, it will also be required to submit a regular 'business activity statement' (BAS) to the ATO. Once the business is registered, the ATO will automatically send the proprietors of the business a BAS statement for completion by a due date. A BAS statement is used to report and pay a number of taxes, and can be completed on a monthly, quarterly or annual basis. The BAS calculates the amount of tax that must be paid or received by the business across a number of areas including:

- *Goods and Services Tax (GST)*. This is a broad consumption tax at a rate of 10% charged on most goods and services transactions. Businesses pay to the ATO the GST collected on goods and services sold by then, less any GST they have paid on inputs and suppliers.
- *Pay as you go (PAYG) income tax*. This is the tax instalment paid by the business for its trading activity, and the rate paid will depend on the entity's turnover during the trading period.
- *Pay as you go (PAYG) withheld*. This is the income tax on the wages and salaries paid by the business to its employees. It is withheld by the employing organisation prior to payment of the worker's wages and paid to the ATO along with other payroll deductions.
- *Fringe benefits tax (FBT)*. This is a tax levied on the business or employer organisation that covers the majority of non-cash benefits such as meals, cars and housing.
- *Luxury car tax (LCT)*. This is a tax payable by Australian businesses that import or purchase motor vehicles deemed to be luxury cars. At time of writing (during the 2016/2017 financial year), the threshold for the LCT cut in on motor vehicles valued at or over A$64,132. However, fuel efficient motor vehicles (those with a fuel consumption rating of less than seven litres per 100 km) were given a threshold of A$75,526.
- *Wine equalisation tax (WET)*. This is a tax applied to wine consumed in Australia and applies to wholesale, retail and personal use.
- *Fuel tax credits*. This tax applies to businesses such as heavy machinery users, plant operators or transportation companies and related business activities. It does not cover aviation and alternative fuels, or fuels used in light vehicles of under 4.5 tonnes such as motor cars or light trucks (www.ato.gov.au).

Corporate Tax in France (impôt sur les sociétés, Corporate Income Tax/IS, CIT) is the main tax on most types of company. In effect, instead of the business owner declaring its income on his or her personal income tax form, as with the self-employed, the company is charged income tax as an 'impersonal' entity. The tax is levied at two rates: 15% on the first €38,120 of taxable income (i.e. profit) and 33.33% on the remainder.

The last reform implemented by the French government will change the rates. The standard rate of corporate tax will fall in stages from 33.33% to 25% by 2022 in line with the European average, amounting to €11 billion in tax savings. SMEs with annual revenues of up to €7.63 million will continue to enjoy a reduced corporate tax rate of 15% on their first €38,120 of earnings. Starting in 2018, all businesses will be taxed at 28% on their first €500,000 of earnings. From 2019, all businesses will be taxed at 31% above this level, before a rate of 28% on earnings in 2020, 26.5% in 2021 and 25% in 2022 (Business France, 2008).

The tax credit for competitiveness and employment ("CICE") is a tax benefit based on a percentage of a company's payroll (excluding wages exceeding two-and-a-half times the French minimum wage – SMIC), and can be directly offset against the CIT. The Finance Bill for 2018 reduces the rate of the CICE from 7% to 6% from January 2018 and will transform the CICE into a permanent reduction in employer social security contributions in 2019. In addition to the Corporate tax, the Contribution Economique Territoriale (CET) replaced the Taxe Professionnelle. The CET is a local tax implemented by the departmental and regional councils on business to assist in the funding of local services as well as the Chambres de Commerce. However, new companies do not have to pay tax in their first operational year and pay only 50% of the tax rate in their second year.

12.10.3 Competition and Consumer Laws

Australian competition and consumer laws are outlined in both federal and state legislation. On 1 January 2011, the *Trade Practices Act* 1974, which had been supported by complimentary legislation within all Australian states and territories, was renamed the *Competition and Consumer Act* 2010. As with the previous Act, the legislation applies to all businesses throughout Australia. The *Competition and Consumer Act* (CCA) is enforced by the Australian Competition and Consumer Commission (ACCC), with offices in each state and territory and the power of prosecution. There are many issues covered under the CCA, and there is insufficient scope here to address this legislation in detail. However, the ACC offers substantial information on their website (see www.acc.gov.au). They also provide a service for small businesses whereby a compliance review can be undertaken to ensure that the business is not in breach of the CCA.

12.10.3.1 Consumer Guarantees

One area of the CCA that small business owners need to be aware of is in relation to consumer guarantees. The legislation prohibits a business from telling a consumer that a guarantee does not exist, may be excluded or may not have an effect when it actually does. Nor can the business demand a consumer pay for rights that would otherwise be available under a guarantee.

The business cannot put up signs stating *no refunds*, *no refunds on sale items* or *exchange or credit note only for return of sale items*. However, it is lawful for the business to post signs stating n*o refunds will be given if you have simply changed your mind* (see www.acc.gov.au).

Any voluntary or extended warranties that are offered to customers, including verbal statements made by employees about what a good or service may do and how durable it is, must be honoured. This means that, if a consumer has a legitimate complaint over whether a product is in breach of a consumer guarantee – even if the customer does not have a warranty or extended warranty, or if the goods are out of warranty – the business must seek to fix the problem. This also applies to gift certificates where the customer has not actually purchased the goods directly.

The business can require a customer to show proof of purchase, but this is not restricted only to a sales receipt. Credit card statements, lay-by agreements, or stamped and dated warranty cards are also proof. Further, it is not legal for the business to refuse to refund or replace goods just because they are not returned in their original packaging or wrapping.

12.10.3.2 Price Fixing and Anti-competitive Conduct

It is illegal for two or more businesses that would normally compete to collude with each other in order to fix prices. This collusion does not have to be by written agreement and can involve verbal agreements. Some exceptions are given under the CCA to joint ventures, although this can be a complex legal issue. Other anti-competitive conduct covered under the CCA includes (see <www.acc.gov.au>):

- *Cartels*. It is illegal for competitors to collude by forming a cartel via a contract, arrangement or understanding.
- *Anti-competitive agreements*. It is illegal for businesses to enter into agreements or contracts that may substantially lessen competition.
- *Misuse of market power*. The act has provisions to prohibit large firms, or those with significant market power, to abuse this power.
- *Predatory pricing*. It is illegal for a business to set prices at a sufficiently low level so as to damage or force competitors to withdraw from the market.
- *Exclusive dealing*. It is illegal for a business to restrict the freedom of a supplier or customer to trade with others if it serves to significantly reduce the level of competition within the market.
- *Full line forcing*. It is illegal for a supplier to refuse to supply goods or services in order to get a customer to agree not to buy from a competitor, or refuse to resupply to a competitor where it may substantially reduce competition.
- *Third line forcing*. It is illegal for a supplier to demand that goods and services only be supplied on the condition that the customer buys them from a particular third party.
- *Resale price maintenance*. It is illegal for a supplier to demand that a reseller will not advertise, display or sell goods to customers below a specified price. Suppliers can recommend a retail price and set a maximum price for resale, but they cannot refuse to supply or threaten supply as a result of discounting below their preferred prices.

12.10.4 Privacy Laws

Another area of legislation likely to impact on small businesses is privacy legislation. The European Union has very recently changed their rules in terms of personal data protection and this has had consequences in all member states. As of May 2018, with the entry into application of the General Data Protection Regulation, there is one set of data protection rules for all companies operating in the EU, wherever they are based. Stronger rules on data protection mean: people have more control over their personal data and businesses benefit from a level playing field. More information on both aspects can be found on https://ec.europa.eu/commission/priorities/justice-and-fundamental-rights/data-protection/2018-reform-eu-data-protection-rules_en.

An example of how privacy legislation may impact a small firm is that of Australia, where the *Privacy Act* 1988, was originally introduced. It was changed with amendments made to it from 21st December 2001. This affects businesses that trade in personal information (e.g. customer databases) and firms that turn over in excess of $3 million. Of key importance is the collection and handling of customer information.

Most businesses need to collect customer information (e.g. names, addresses, contact telephone numbers) either for marketing purposes or to assist with delivery of products and services. Other information such credit card details, employment and income may also be collected for various reasons. When such information is gathered the business should inform the customer of at least two things:

1. Why the information is being collected.
2. Whether the information is to be passed onto another agency or third party for any reason.

Customer information that has been collected for one purpose should not generally be used for another purpose unless the customer is made aware in advance and gives their permission, or if they would have a reasonable assumption that such a use of the information would take place. Data collected on a customer can be used to further the business relationship with that person, but if the information is provided for a specific purpose it should not be used for any other purpose without the permission of the customer (see www.oaic.gov.au).

Providing customer information to sub-contractors, agents or third-parties that are required to complete the original contract with the customer is permitted under the *Privacy Act*, so long as the information is used for the purpose for which it was originally intended. It is advisable for small businesses to outline the purposes for which they are collecting customer information and to secure permission for any subsequent marketing activities if this is the intention. Privacy statements and consent forms should be included in any websites or forms used in the collection of personal information (see www.oaic.gov.au).

12.10.5 Product Safety and Liability

The Australian *Competition and Consumer Act* 2010 controls what and how a business may trade or promote its products and services. It is similar to laws found in countries around the world. Small business owners must be careful to consider:

1. *Negligence.* How a product or service is delivered to the customer such as false advertising, defects or defective packaging.
2. *Warranties.* Consumers may sue if advertising or information overstates the benefits of a product, or if the product does not perform, as it should.
3. *Liabilities.* Consumers taking legal action may sue because the product or service is defective or not fit for its purpose prior to delivery, or the service is performed in an unsuitable manner (e.g. professional indemnity).
4. *Misrepresentation.* Advertising, labelling or selling can make false or misleading claims over the character or quality of a product or service. Such false or misleading claims may breech the *CCA*.

12.10.6 Insurance Issues

Insurance protection is vital to the overall risk management of the business established by the entrepreneur. Broad groups of insurance include: property (e.g. fire and general) to protect against fire, flood, theft or other risks; casualty and life, to protect against the injury or death of the entrepreneur or their key-people; and worker's compensation (usually required in most Australian state). This provides funds to cover the injuries suffered at work by employees.

12.10.7 Contracts and Negotiations

The small business owner-manager will find himself or herself engaged in a large number of contracts and negotiations. How well these are set up and developed can have a strong impact on the future success of the new venture or its growth. Many owner-managers work on the basis of trust and feel that their word is their bond or that a handshake is enough. However, other parties do not always reciprocate such trust. Lawyers can assist in arranging deals, but are not always essential. Agreements should have four essential elements:

1. All the parties involved should be named and their specific roles in the transaction specified (e.g. buyer, seller, consultant, client, etc.).
2. The transaction should be described in detail (e.g. exact location of land, dates, units, place of delivery, payment for transportation, etc.).
3. The exact value of the transaction should be specified (e.g. instalment payment with finance charges).
4. Obtain signature(s) of the person(s) involved in the deal.

Once an agreement has been reached via a contract both parties are required to live up to the agreement or pay damages. If one party fails to live up to its side of the contract, the second party may also agree to drop the matter and thus not live up to the agreement as well. This is called contract restitution.

Contract Conditions

An offer is made. It can be oral or written but is not binding unless:

- Voluntary acceptance of the offer is given.
- Consideration (something of value) is given by both parties.
- Both parties are competent and/or have the right to negotiate for their firms.
- Contract must be legal. Any illegal activities under a contract are not binding (e.g. gambling or drug dealing).

Source: Hisrich and Peters (1998)

12.11 Protecting Intellectual Property

According to the World Intellectual Property Organisation (WIPO), intellectual property (IP) refers to 'creations of the mind, such as inventions; literary and artistic works; designs; and symbols, names and images used in commerce' (WIPO, 2017). Ownership of IP – or the rights associated with IP – allows individuals or companies to enjoy financial benefits from the sale or licencing of this IP. This is similar to how the ownership of physical property allows it to be sold or leased. In a world that is increasingly yielding value from knowledge-based assets, the role of IP is becoming crucial to future economic success. However, before IP rights can be used for commercial purposes, they must be formally recognised through a process of registration and protection. This is typically the case with many forms of IP, although some IP rights arise automatically as soon as a piece of work is created so long as there is a record of this creation process (Intellectual-Property UK, 2005). IP can be formally listed within the balance sheet of a business and requires a business to develop a formal strategy for its protection in a similar way that physical assets might be protected from loss or damage (SBDC, 2005).

There are several types of IP, some of which must be formally registered before rights can be legally assigned. Intellectual property is divided into two categories: Industrial Property includes patents for inventions, trademarks, industrial designs and geographical indications. Copyright covers literary works (such as novels, poems and plays), films, music, artistic works (e.g., drawings, paintings, photographs and sculptures) and architectural design (WIPO, 2017).

To illustrate the application of IP rights in a product, the example of a toaster can be given. Figure 12.4 illustrates the Black & Decker Fast Toast electric toaster. As shown, even this relatively simple household appliance contains a lot of IP rights. These include patents over the technology behind the sensors for the toaster's browning system, and circuit layout rights for the computer board. The overall design of the toaster is registered, as is the trademark. In addition to these formal IP rights, there is also the copyright for the product booklet and general 'get up' and reputation rights for the device.

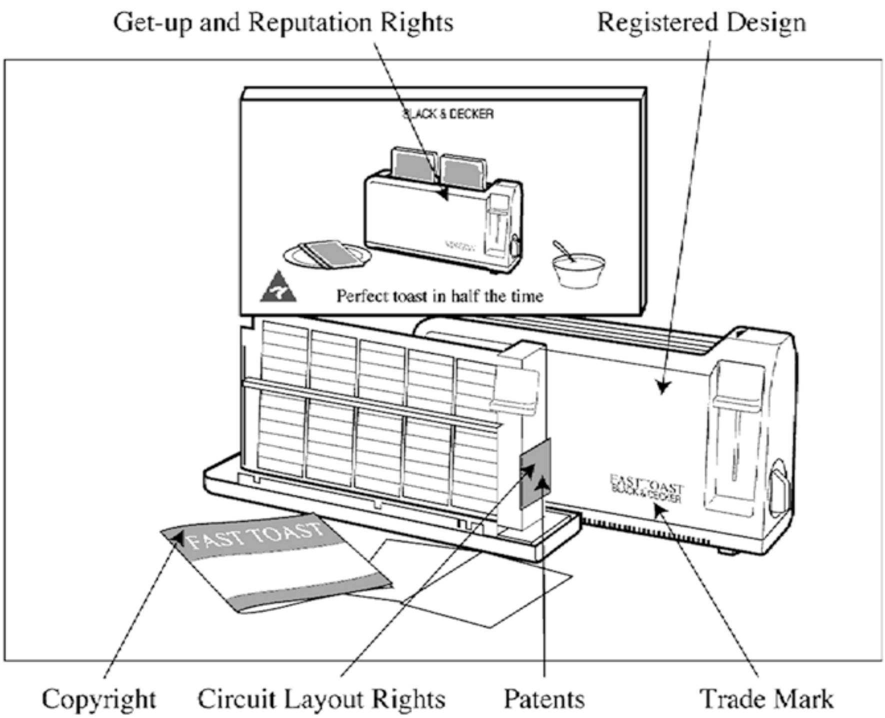

Fig. 12.4 What are intellectual property rights? (The Black & Decker Fast Toast)

Thus, the following types of IP are generally recognised (IP Australia, 2010):

- *Patents* – for new or improved products or processes capable of commercial or industrial application, requiring formal registration;
- *Trademarks* – for words, symbols, pictures, sounds, smells or a combination of these, to distinguish the goods and services of one trader from those of another, and requiring formal registration;
- *Designs* – for the shape or appearance of manufactured goods of the whole or a part of a product resulting from the features of, in particular, the lines, contours, colours, shape, texture or materials of the product itself or its ornamentation, and requiring formal registration;
- *Copyright* – for original material in literary, artistic, dramatic or musical works, films, broadcasts, multimedia and computer programs, and requiring no formal registration;
- *Circuit layout rights* – for the three-dimensional configuration of electronic circuits in integrated circuit products or layout designs, and requiring no formal registration;
- *Plant breeder's rights* – for new plant varieties, and requiring formal registration; and
- *Confidentiality/trade secrets* – including know-how and other confidential or proprietary information, and requiring no formal registration process.

While copyright and circuit layout rights occur automatically upon creation of the original piece of work, patents, plant breeder's rights, trademarks and designs all need formal registration before IP rights can be recognised. Such registration incurs a cost and is generally only able to afford protection within the jurisdiction where it is registered. For example, Registration of a patent in Australia will not automatically guarantee its protection in other countries.

12.12 Formal IP Rights

Formal IP rights are conferred by government authorities in each jurisdiction. These rights require the rights holder to formally register their IP with the appropriate authority and pay a fee. Because these rights are conferred by different governments, it is usual that any business seeking to have its IP rights protected within international markets will need to register its IP in each country or group of countries (e.g. the European Patent Office or the African Intellectual Property Organization), where it seeks to do business. It is common for global patents and cross-border trademarks to be registered with the three major patents office systems of the European Patent Office (EPO), the Japanese Patent Office (JPO) and the US Patent and Trademark Office (USPTO) to protect the same invention. Thus, it can involve quite high costs for the registration and maintenance of such IP rights. The WIPO-administered Patent Cooperation Treaty (PCT) provides for the filing of a single international patent application that has the same effect as national applications filed in the designated countries. An applicant seeking protection may file one application and request protection in as many signatory states as needed (WIPO, 2017).

12.12.1 Patents

> **A patent is,** … an exclusive right granted for an invention – a product or process that provides a new way of doing something, or that offers a new technical solution to a problem. A patent provides patent owners with protection for their inventions. Protection is granted for a limited period, generally 20 years. (WIPO, 2017, p. 5)

This official right is granted to the patent owner by the sovereign state for exclusive title to the use, sale and licencing of a device, substance, method or process. This legally enforceable right provides the patent owner with the exclusive right to commercially exploit the invention for the life of the patent once it has been registered and granted to them. Patents are not automatically granted upon application and must meet the legal requirements for approval. It is not possible to patent artistic works, mathematical models, plans, schemes or other processes of a purely mental nature (IP Australia, 2010).

Kambrook – A Lesson Learned

In 1972, Frank Bannigan, Managing Director of Kambrook, developed the electrical power board. The product was hugely successful and was the basis for Kambrook's growth to become a major producer of electrical appliances. However, the power board was not patented and Kambrook ended up sharing the market with many other manufacturers. According to Mr. Bannigan:

I've probably lost millions of dollars in royalties alone. Whenever I go into a department store and see the wide range of power boards on offer, it always comes back to haunt me.

Today, Kambrook has a number of patents and pending applications for improvements in a range of consumer goods.

Source: IP Australia (2005).

Patents are associated with the functional and technical aspects of a process or product and are generally highly specific about what is being registered. Most patents are incremental in nature and involve evolutionary rather than revolutionary changes to existing technologies or processes. Before a patent can be registered, it must be demonstrated that the invention or process is able to meet three general criteria (Intellectual-Property UK, 2005):

1. *It must be new.* The process or invention must demonstrate that it is genuinely new and does not form part of the 'state of the art', or what was already available to the public prior to the patent application. This means that if the idea has been published, presented at conferences, illustrated in a public display or generally disseminated prior to the patent application, it would not qualify;
2. *It must involve an inventive step.* It should not be 'obvious' from the perspective of a person skilled or knowledgeable in the discipline or area of technology from which the invention is derived;
3. *It must have industrial application.* The invention or process should be able to be made use of in industry in some demonstrable way.

This suggests that the invention or process that is to be described in the patent must be all or part of a product, process or chemical composition that offers something new and innovative for application within industry (SBDC, 2005). It is also important to note that disclosure of the process in the public domain is likely to void the right to a patent. While it is acceptable to discuss patents with employees, business partners and advisors prior to the filing of a patent, this must be undertaken on a confidential basis.

It is advisable to make use of written confidentiality agreements in such discussions to protect patentable IP (IP Australia, 2010). While this can create a good deal of legal red tape, it is often better to be safe than sorry. The case of electrical products, manufacturer Kambrook is illustrative of this. Their power board multi-point electrical product was a highly successful innovation when it was first invented in the early 1970s. However, the company failed to patent the technology, allowing others to quickly copy the design and erode its market share with the loss of millions of dollars of potential revenue (IP Australia, 2010).

Patents do not last forever. A standard patent is generally for a period of 20 years from date of registration. Annual maintenance fees are likely to apply after 5 years. Like all other patents pharmaceutical patents are issued for a period of 20 years from the date of deposit and upon payment of the annuities. However, pharmaceutical products require authorizations in order to be marketed. This authorization can take several years before being given. To compensate for this period when the patent cannot be exploited, a special title has been created for example in France or in the UK, the Supplementary Protection Certificate which extends the rights of the owner of a pharmaceutical patent (Intellectual-Property UK, 2005; INPI, 2017).

12.12.1.1 Innovation Patents

In Australia, it is also possible to lodge an innovation patent that covers incremental developments in products or processes and needs to demonstrate that the new device or technology is 'innovative' rather than 'inventive'. This type of patent can provide protection for up to 8 years and can be applied for online (SBDC, 2005). Innovation patents offer a protection option designed specifically to protect inventions that do not meet the inventive threshold required for standard patents. Introduced into Australia in 2001, they are targeted at small firms and local industries. An innovation patent is a relatively fast way to obtain protection for a new device, substance, method or process.

An Innovation Patent – Boardsling

Boardsling is the brainchild of inventor and surfer Nick Kent who developed the device to make it easier for him to carry his surfboard to the Queensland beaches. With smaller waves in the area near his home, he started riding a long board, but this is heavy piece of equipment to carry. As Nick explained:

"It was a half mile's walk to the surf break, and carrying a big board was awkward and hard on the arms, shoulders and back. People don't like to take their board bags because they can be stolen, or they get full of sand that then mixes with the wax on their board."

"So, I started looking at a way to create a sling-type surfboard carrier that would do the job."

Nick's Boardsling prototype was a 'simple heavy-duty strap that hooks around the surfboard, allowing the carrier to simply sling it over a shoulder'. The device is both simple and ergonomic. It holds the board in place without bouncing, jarring or other injury.

(continued)

Having created the prototype, Nick spoke to a patent attorney who helped him secure two innovation patents to give his device protection from imitation in Australia. It was a new and useful invention, but at the time would not have qualified for the more rigorous tests of a standard patent.

IP Australia examined both patents and certified them to be legally enforceable. It offered Boardsling the necessary protection while the product became established in the market. Later, the patent can be upgraded to a standard patent. According to Nick:

Once this Boardsling wave is finished we want to come up with another invention to get on a new wave, and then we will ride that one, and then the next and then the next.

Source: IP Australia (2010).

However, an innovation patent doesn't allow you to legally stop others from copying your innovation unless you have your innovation patent examined. Examination of an innovation patent will only occur if requested by the patentee, a third party or the commissioner of patents. An innovation patent is only legally enforceable and certified if it has been examined by IP Australia and has met the requirements of the *Patents Act* (IP Australia, 2010).

This is similar in other countries. For example, in France, there are several categories of patents. They are subject to the same legal regime, but the extent of the right of the owner varies according to the nature of the invention, subject of the patent (INPI, 2019):

- The *application patent*, which is a patent covering the new application of a patented product or process. The invention, object of the patent, consists in the use of known means, for a result that can also be known: the novelty does not rely on the means or on the result but on the average-result ratio.

- The *improvement patent*, which relates to an invention which is a technical improvement of another invention, itself protected by a patent. It therefore relates to an invention which consists of an improvement (a new element or a simplification) of at least one claim of another patent of invention.
- The *dominant patent*, which is a patent, also referred to as a *main title*, the claims of which must be reproduced, in whole or in part, for the exploitation of another invention, then referred to as a *dependent invention*.

Patent Example – Orbital Engine

The Orbital engine was a new concept in internal combustion engines designed by Western Australian inventor Ralph Sarich. Having developed several agricultural equipment products, Ralph produced the prototype Orbital engine in the late 1960s.

In 1973 Ralph appeared with his engine on the ABC TV show *The Inventors*. He was then approached by BHP Ltd., with whom he formed a joint venture. The Orbital Engineering Co, now Orbital Technologies, now holds some 540 patents and licencing agreements with a number of major overseas automotive and marine engineering firms.

Sarich Australian Patent No: 467415 lodged 6 July 1970.

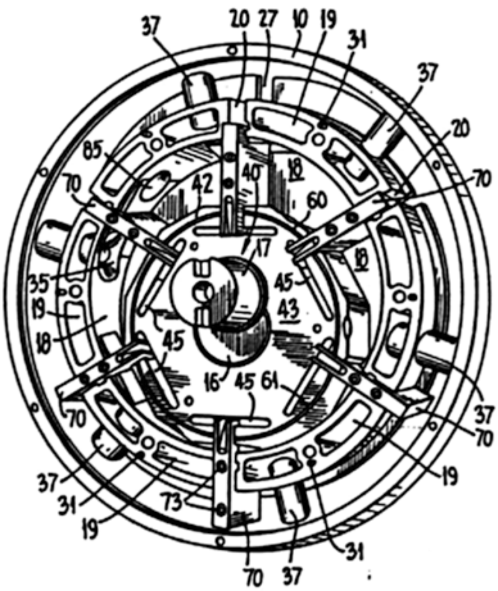

FIG. 2.

(continued)

While the Orbital engine did not become a success from a commercialisation perspective, the company created a number of breakthrough engineering solutions in the area of fuel injection technologies. These were diffused into a range of outboard motor and motor vehicle applications. The original patent for the Orbital engine is 16 pages long with 4 drawings.

Source: IP Australia.

12.12.1.2 Patent Registration

When a patent is registered, the documentation generally must have a clear description of the invention, including drawings that provide sufficient detail for a skilled person in the area of technology to perform the invention themselves. It should also make claims to define the scope of protection that is being sought. These details are then used to determine future claims made for or against the legal protection offered by the patent.

Once registered, the patent documentation is published by the patent office, making it available to the general public. The patent then becomes recognised as part of the 'state of the art' associated with the field of science or technology within which the patent lies. Anyone can then access the patent documentation and comment on it. It is not uncommon for a patent application to involve public comment, and for the application to be modified or amended to meet concerns of other parties before the patent is granted. Once accepted, the patent is re-published in a final form. Subsequently, if new information is made available after the patent is granted that requires the patent to be changed, this will take place and the patent will be republished again (UK Patent Office, 2005).

A Patent Must Be Useful

To qualify for a patent, the invention must be useful for some purpose – however this hurdle is relatively easy to overcome; to be denied a patent under this requirement, the invention has to be totally incapable of achieving any useful result. This does not, however, mean that inventions *always* meet this requirement. A patent application can be denied under the usefulness requirement if the applicant fails to disclose enough information about the patent to make its utility apparent, or if the applicant asserted that the invention could do something that it obviously could not.

Source: Legal Database www.legal-database.com/patent.htm.

12.12.1.3 Patent Costs and Coverage

In Australia, a patent is registered through the IP Australia patents office, which determines if the patent meets the appropriate criteria. In other countries, there are different patent laws and regulations. It is generally advisable to register a patent internationally to fully protect IP rights. Australia is a signatory to a number of international agreements relating to IP rights and patents.

A patent registered in Australia is therefore useful in establishing patent rights in other countries in subsequent years (IP Australia, 2010). According to IP Australia (2010), the cost of registering a standard patent in Australia is $6000 to $10,000 – inclusive of patent attorney fees and registration costs. Over the 20-year life of the patent, there are likely to be additional fees of approximately $8600. Internationally registered patents will cost substantially more than this, and all patents are only a protection if they can be defended legally. Defending an alleged breach of a patent may cost tens of thousands of dollars in legal fees. The Patent Office does not take sides in patent disputes, so there is no automatic legal protection from the authorities. In France, filing a patent with the INPI costs between €3800 and €4600 (filing fees and patent firm fees). Its maintenance over 20 years is on average €4750 (annuities excluding fees). A European patent (EPO) amounts to €2670 – €3800 (taxes and fees) (CNRS, 2019).

There is an international agreement that exists between national patent offices. For example, IP Australia is a receiving office, searching authority and *International Preliminary Examining Authority* (IPEA) for international patents. This allows patents to be searched and initially examined by IP Australia at an international level. This ensures that inventions to be lodged within Australia are not likely to be at risk of breeching those that have already been registered in other countries. However, there are many differences between patent registration systems in each country, and it is advisable to use a professional patent attorney to assist with international patent applications.

12.12.1.4 Patent Rights

While a patent can protect the inventor of a new device or process and allow them to licence or sell the IP rights associated with it, the patents system is also a means of avoiding duplication. It is not widely recognised that the purpose of the patents system is to make public the ‘state of the art’ of the technology or scientific field in which the patent is located. By reviewing the patents register, it is possible for inventors to avoid replicating what has already been developed. Competitors can see what others are doing, or can build on what has already been developed. Once a patent is expired, it is possible to replicate the process or device without risk of legal challenge (UK Patent Office, 2005).

A patent is essentially a negative right in that it is designed to stop someone else from exploiting an invention developed by the patent owner without the owner’s permission. It is no legal defence to claim that you breeched a patent right because you were unaware of the patent. This means that inventors and innovative firms should be checking regularly with the patents register to ensure an idea has not already been registered.

Further, it is not compulsory for a patent to be registered but, once it is, the inventor must accept the risk that the publication of the patent will result in others copying the idea and thereby breeching their patent rights. A patent can also be challenged and revocation ordered by a court or by the patent’s office. Finally, just because an invention is patented does not guarantee that it has commercial value.

What Rights Does a Patent Give Me?

A patent gives you the right to stop others from using your invention. Alternatively, you can choose to let others use it under agreed terms. A patent also brings the right to take legal action against others who might be infringing the invention and to claim damages. The mere existence of a patent may be enough to deter a potential infringer. The Patent Office, however, does not take sides in any dispute.

A patent empowers the owner, or the proprietor, of an invention to take legal action against others to prevent the unlicensed manufacture, use, importation or sale of the patented invention. This right can be used to give the proprietor breathing space to develop a business based on the invention; or, another person or company may be allowed to exploit the invention and pay royalties under a licencing agreement.

Source: UK Patent Office (2005).

12.12.2 Trademarks

> **A trademark,** … is a distinctive sign that identifies certain goods or services produced or provided by an individual or a company. Its origin dates back to ancient times when craftsmen reproduced their signatures, or marks, on their artistic works or products of a functional or practical nature. Over the years, these marks have evolved into today's system of trademark registration and protection. The system helps consumers to identify and purchase a product or service based on whether its specific characteristics and quality – as indicated by its unique trademark – meet their needs. (WIPO, 2017, p 8)

It can be a letter, number, word, phrase, sound, smell, shape, logo, picture, aspect of packaging or any combination of these. It is thus impossible to register *generic* products (e.g. lawnmowers) or services (e.g. dentistry). Geographic place names, surnames and given names are often difficult to register as trademarks, although these can be registered if they have been used in the market place for a long period of time (IP Australia, 2010). In the US, it is possible to register 'service marks' for services with the US Patent and Trademark Office (Williams & Bukowitz, 2001).

While it is not compulsory to register a trademark or trade name prior to using it in the market, it is advisable to do so if you wish to have exclusive rights to its use, or if you wish to licence the rights to using a particular brand name (SBDC, 2005). If a business has used a trademark or brand name in the market for a period of time without formally registering it and then finds that another business has begun to make use of the same trademark, they might still have a legal claim. If the original user of the trademark can prove prior and extended use, they may have legal protection under common law rights. However, this will usually require a court case and a judicial ruling that is likely to be expensive both in time and in monetary terms (IP Australia, 2010).

Registration of a trademark provides the owner exclusive legal rights to use the trademark or to licence or sell it within Australia for the goods and services for which it is registered. It is advisable that trademarks be searched prior to any registration, as a legal claim might be triggered by those seeking to protect their existing trademarks. Costs associated with such registration can vary from a few hundred dollars if registration is done by you to approximately $3000 if legal services are used. A trademark is legally protected for 10 years in Australia, and can then be renewed for periods of up to 10 years at a time for additional fees. However, if a trademark is not used it can be subject to challenge and rights may be revoked (IP Australia, 2010).

12.12.2.1 International Trademarks

To avoid the need to register separate applications with each national or regional office, WIPO administers an international registration system for trademarks. Two treaties enable WIPO to run the system: the Madrid Agreement Concerning the International Registration of Marks and the Madrid Protocol. This international agreement was originally established in Madrid, Spain in 1891. According to WIPO, "persons with a link (be it through nationality, domicile or establishment) to a country party to one or both of these treaties may, on the basis of a registration or application with the trademark office of that country (or related region), obtain an international registration having effect in some or all of the other countries of the Madrid Union" (WIPO, 2017, p. 11). Australia became a signatory to the Madrid Protocol in July 2001.The Madrid Protocol has been amended six times from 1900 to 1967.

Trademark Case – Redheads

The opening of Bryant and May's first Australian match factory was on the 15 December 1909 in Richmond, Victoria. The name 'Redheads' was derived from the red striking head of the 'safety match' and the famous Redheads logo was created in 1946. Soon the woman featured in the logo assumed a personality of her own, and became affectionately known as 'Miss Redhead'. Instantly recognisable as the Redhead's brand, the trademark has only had four major updates since its launch in 1946.

The first change to the trademark was in 1958, which gave 'Miss Redhead' a new hairdo. The next change was in 1975, which saw a red background introduced to the logo to give the product greater visibility on market shelves. This was also the year the word 'Redheads' was first registered as a trademark. Later, in 1980, the image of 'Miss Redheads' was also registered as a trademark. This design, with only minor typestyle and positioning changes, is still used today and can be seen not only on matches but also a huge range of other products including fire-lighters, barbeque accessories, gas matches and fire assist products.

Source: IP Australia (2010).

12.12.3 Designs

An industrial design is "the ornamental or aesthetic aspects of an article. A design may consist of three-dimensional features, such as the shape or surface of an article, or two-dimensional features, such as patterns, lines or colour" (WIPO, 2017, p.12). It often refers to the visual aspects of a logo or product resulting from, in particular, the features of the lines, contours, colours, shape, texture or materials of the product or its ornamentation. The registration of a design grants the owner the exclusive rights to make use of a product design, and to licence the use of this design or to sell it. Design rights are generally viewed as additional rights to any copyright protection that might automatically exist in a design (Intellectual-Property UK, 2005). So, while a patent relates to the *function* of a device or product, a registered design relates to its *form* or appearance (SBDC, 2005).

To be eligible for registration the design must be *new*, meaning that there is no identical design already in public use in Australia, or published in a document either in Australia or overseas. It must also be *distinctive*, in that it is not similar to any existing designs in terms of its overall appearance. If a design has already been published or perhaps posted on the internet prior to the date that it is filed with IP Australia, it may be deemed not to be new (IP Australia, 2010).

Within Australia, a registered design lasts for 5 years from the date of its initial filing, and can be renewed for a further 5 years or up to a maximum of 10 years from date of application. IP Australia offers a reminder for design owners 2 months prior to the expiry date, and allows 6 months after the expiry date before allowing the registration to lapse. In the event of an infringement, IP Australia will provide advice after examining the claim and, if certified as a potential infringement, legal action can be taken.

12.12.4 Geographical Indication

According to WIPO, a geographical indication is "a sign used on goods that have a specific geographical origin and possess qualities or a reputation due to that place of origin". Generally speaking, a geographical indication consists of the name of the place of origin of the goods. It is common for agricultural products which typically have qualities that derive from their place of production or are influenced by specific local geographical conditions (e.g. climate and soil). Geographical indications are used for a wide variety of agricultural products, such as, for example, "Tuscany" for olive oil produced in a specific area of Italy, or "Roquefort" for cheese produced in that region of France (WIPO, 2017, p. 15).

However, the use of geographical indications is not limited to agricultural products. According to WIPO, they may also highlight specific qualities of a product that are due to human factors found in the product's place of origin, such as specific manufacturing skills and traditions: the place of origin may be a village or town, a region or a country. An example of the latter is "Switzerland" or "Swiss", perceived as a geographical indication in many countries for products made in Switzerland and, in particular, for watches (WIPO, 2017: 16).

Design Case – Sebel Metal Frame Chair

Harry Sebel, founder of Sebels (Australia) Ltd was the designer of the stackable Sebel Metal Frame Chair. This chair holds the Australian Registered Design AU-S-35886 which was lodged 16 October 1956 and formally registered in October 1957.

This tubular metal frame chair design that stacks neatly inside another chair has received an international design registration and was a highly successful product for Sebels (Australia) Ltd. The chairs proved particularly popular in schools and large halls where they could be stacked neatly on top of each other to save space when not required.

The first prototype for the chair was produced by Sebel as the ‘Stak-a-bye’ chair of 1953. An example of this chair is now held at the Powerhouse Museum in Sydney.

Source: IP Australia (2010).

12.12.5 Plant Breeders’ Rights

It is also possible within Australia for plant breeders to secure protection over the development of new varieties of plants that they have created. To do so, the plant breeder must be able to demonstrate that they have created an entirely new variety of plant that is distinct, uniform and stable. Through comparative trials, the breeder must be able to show that the new plant variety can be clearly distinguished from other plant varieties already commonly known in the market. This allows them to benefit from the commercial sale of this plant and its reproductive material, or the securing of royalties from the licencing of the plant to other producers as well as the ability to sell these rights to another party. Registration of the plant variety is undertaken with IP Australia, and protection lasts for 25 years for trees or vines and 20 years for other species. However, growers do not have to pay the breeder royalties on crops produced or seeds retained for future production on their land. Protection is also not provided that would restrict other breeders using that variety in future plant breeding (IP Australia, 2010). Some examples of plant breeder rights include:

- *The 'Shalistin'*. A white cabernet sauvignon grape variety bred by Malcolm 'Mac' Cleggett of Cleggett Wines in South Australia.
- *The 'bollgard II' cotton plant.* Developed by Australia's CSIRO, it has a resistance to the helicoverpa or bollworm, which is the primary insect pest for cotton. This species significantly reduces the need for pesticides.
- *The 'Drysdale' drought resistant wheat variety.* Developed by the CSIRO, this species of wheat offers significant drought and disease resistance to conventional varieties. Yields in dry areas are 10% higher than standard wheat species.
- *The 'pink iceberg' rose.* Bred by Tasmanian plant breeder Lilia Weatherley, this rose came from her identifying a pink mutation in her white 'iceberg' roses.

12.13 Automatically Granted IP Rights

In addition to the abovementioned IP rights that need to be formally registered, there a number of IP rights categories that do not require any formal registration. These are copyright, circuit layout rights, trade secrets and confidentiality.

12.13.1 Copyright

Unlike patents, trademarks or registered designs, copyright does not require formal registration. Copyright does not offer protection for creative ideas, only for the original expression or manifestation of these ideas. Once a work of art, music, film, broadcast, literature or computer programming has been created and placed onto media, it is protected under copyright. This prevents its unlawful copying or duplication without the permission of the originator or copyright owner. Australia is a signatory to the Universal Copyright Convention, thereby granting reciprocal protection internationally within those countries that are co-signatories (IP Australia, 2010).

What Is Copyright?

Copyright gives the creators of a wide range of material – such as literature, art, music, sound recordings, films and broadcasts – economic rights enabling them to control the use of their material in a number of ways, such as by making copies, issuing copies to the public, performing in public, broadcasting

(continued)

and using the material online. It also gives the moral right to be identified as the creator of certain kinds of material, and to object to the distortion or mutilation of it. Material protected by copyright is termed a 'work'. However, copyright does not protect ideas *per se*, or things such as names or titles.

Source: Intellectual-Property UK (2005).

Copyright protection is provided under the *Copyright Act* 1968 and gives exclusive rights to licence others in regard to copying the work, performing it in public, broadcasting it, publishing it and making an adaptation of the work. Rights vary according to the nature of the work. Those for artistic works, for instance, are different to those for literary and musical works. Although making copies of copyright material can infringe exclusive rights, a certain amount of copying is permissible under the fair dealing provisions of Australian legislation (IP Australia, 2010).

Creative works such as music, literary or artistic output is a product of a significant investment in human labour and intellectual talent, and is afforded protection under copyright laws to restrict the capacity of others to exploit it without paying royalties to the creators. Without such protection, it would be impossible for creative talent to be rewarded, and there would be little incentive for future new material to be generated. Copyright law does allow some limited reproduction without permission, but in most cases duplication of works without prior consent from the copyright owner is illegal (Intellectual-Property UK, 2005). Unfortunately, the reproduction of music, artworks, software and literary works has become commonplace due to the capacity of modern technology to allow such reproduction.

It is not unknown for two creators to generate identical or similar works independently of each other. Under these circumstances copyright cannot provide protection to the concerned parties. While it is not necessary for copyright to be registered officially, it is advisable that copyright notices be placed on all creative works. This notice should list the copyright owner's name and date of creation and is a means by which copyright can be demonstrated – particularly when seeking to secure copyright overseas. It also serves as a warning to others to avoid any potential infringement (IP Australia, 2010).

Copyright is generally recognised within Australia as lasting for the life of the author plus 70 years for literary and artistic works from the year of the author's death, or from the year of first publication after the author's death. For films and sound recordings, this time limit is 70 years from publication or production (IP Australia, 2010). The Attorney-General's department is responsible in Australia for administering the *Copyright Act 1968*. In the US, the *Copyright Act 1976* provides similar protection and lasts for the duration of the author's life plus 50 years.

12.13.2 Impact of Free Trade Agreements on IP Rights – US-Australian Copyright Law

The copyright laws in the US are administered by the Copyright Office of the Library of Congress (Williams & Bukowitz, 2001). When Australia and the United States entered into a Free Trade Agreement in 2005, it became necessary for amendments to be made the Australian copyright and general IP protection system. In 2004, Australia's Federal Parliament passed the *US Free Trade Agreement Implementation Act*. The main changes that impacted on copyright laws for Australia included the following points (IP Australia, 2005). New rights were introduced for musicians and performers in the area of sound recordings that offer economic and moral benefits. Copyright protection was extended from 50 to 70 years. A scheme for limitation of remedies available against Carriage Service Providers for copyright infringement was implemented. Wider criminal provisions for copyright infringement were introduced, along with broader protections for electronic rights management. There was also a wider range of protection against unauthorised reproductions. This example illustrates both the impact that free trade agreements can have on IP laws, but also the importance that is placed on securing IP rights, given their increasingly valuable role in underpinning the economies of most developed nations.

Using a Copyright Notice

Copyright notices that use the owner's name and date (e.g. ©Mazzarol and Reboud 2019 all rights reserved) are not necessary in some countries such as Australia, but they can make it easier to prove the ownership of the copyright at a later date. Copyright notices are necessary to establish copyright in some countries, however, and may serve as a deterrent to people who might seek to infringe the copyright.

IP Australia note that where a copyright owner applies a 3D artistic work in an industrial application – as might occur with some visual rendering in software programs – it will result in a loss of copyright. In this case the owner will need to register their creation as a design.

Source: IP Australia (2010).

12.13.3 Circuit Layout Rights

The design and layout of integrated circuits and computer chips is critical to the operation of computer equipment and electronic devices, and usually involves a high degree of complex intellectual effort. Where a computer chip or integrated circuit is designed in an original manner, the layout design can be afforded legal protection via circuit layout rights. These are an evolved form of copyright and, like copyright; there is no requirement for formal registration to ensure protection as circuit layout rights are essentially generated automatically as the circuit layout is created (IP Australia, 2010).

The owner of an original circuit layout has exclusive right to copy the layout in a material form, construct integrated circuits from the layout, and commercially exploit the design within Australia for a period of 20 years. Commercial exploitation may occur by importation, sale, hire or distribution of a layout or an integrated circuit made according to the layout (SBDC, 2005). As with copyright, it is the Attorney-General's department that administers circuit layout rights in Australia.

Time Limit for Circuit Layout Rights

The maximum possible protection period is 20 years. Accordingly, rights in an original layout subsist for 10 years from the first commercial exploitation provided this occurs within 10 years from creation of the layout or 10 years from the year in which it was made – if not commercially exploited.

Source: IP Australia (2010).

12.13.4 Confidentiality and Trade Secrets

In addition to the methods of IP protection listed above, there is also the option of employing confidentiality and secrecy within the business to secure IP rights. It is generally recommended that such provisions be employed in conjunction with other means of IP protection. The usual approach is for the company to require all employees and third-party actors (e.g. suppliers, sub-contractors) to sign confidentiality or non-disclosure agreements, thereby restricting their right to reveal trade secrets or proprietary knowledge during their employment or association with the business. Although these legal agreements do not by themselves stop a person revealing confidential or secret information, they provide evidence of what that person has agreed to and can form the basis of future legal action against them.

Use of confidentiality or secrecy provisions may be appropriate where IP cannot be easily patented or registered, or where the process associated with the production of the product or process is particularly complex and where reverse engineering is less likely. However, it can be a difficult process to maintain trade secrets over the long term, and the wider the circle of people who become aware of the process the greater the chance of leakage. Secrecy and confidentiality arrangements also will not prevent another company or individual independently developing the same product or process (IP Australia, 2010).

Protecting Trade Secrets

Proving a breach of confidentiality under common law can be complex, and is potentially costlier than defending registered rights.

Ask contractors and employees to provide written undertakings not to compete with your business after they leave – in addition to signing a confidentiality agreement. It is often much easier to prove this than to prove breach of

(continued)

confidentiality. These undertakings, however, are difficult to enforce and need to be prepared by your legal adviser, as you need to be careful that the undertaking does not restrict the contractor's or employee's right to earn a living.

Source: IP Australia (2010).

Where a breach of confidentiality or an infringement of trade secrecy has occurred, the only legal recourse is under common law provisions. This would require the firm who feels that their secrecy has been violated to sue the offender, and it would be useful to have signed agreements over non-disclosure or non-competition to support the case. However, such agreements can be challenged if they are thought to restrict the rights of the other party to meaningfully earn their living.

It is important to recognise that if you or your organisation have not taken appropriate steps to protect IP rights, such as using non-disclosure agreements (NDA) or trade secrecy procedures, it may be very difficult to seek remedy from a court should you feel that a breach of your IP rights has occurred. The court is likely to take a more favourable view of the claim for remedy where there is evidence that some prior attempt was made to protect commercially valuable IP.

12.13.5 What Should an NDA Contract Look Like?

A non-disclosure agreement (NDA) creates a confidential relationship between a person that holds a trade secret or secrets, and the person to whom the secret is disclosed. As a formal agreement, an NDA legally binds the two parties to keep the information a secret. Under common law it is possible to seek damages for a breach of confidentiality, even if there is no formal NDA in place. However, the NDA provides greater evidence and helps clarify the nature of the agreement and the stated obligations of both parties. It is therefore more likely that a successful court action can proceed.

In developing an NDA, you should consider if the agreement is to be mutually binding or one-way. Also, of importance is that the NDA clarifies why the information that is being held in confidence is proprietary, and to adequately define what this information is. The overall purpose of the NDA should therefore be stated so as to avoid any future confusion. Another consideration in the design of an NDA is whether the parties that are entering into the agreement are individuals or legal entities (e.g. businesses). The authority of the person who is signing the NDA also needs to be considered, and all their contact details should be correct.

In some NDAs, there may be details relating to such things as: the action to be taken in the case of inadvertent disclosure; whether information to be transferred is to be marketed as 'confidential' or 'proprietary'; whether there is an indemnification against third party liability: and what the time period or duration of the obligation is to be. Some NDA may also specify whether it is possible for the information to be disclosed to specific people such as other employees within the organisation or sub-contractor organisations. They may also stipulate the need for documents or data to be stored in secure or locked facilities.

12.14 Developing an IP Strategy

Any IP strategy should be integrated into the overall business strategy, and should be included in business and marketing plans. A wide range of different measures is generally preferable to employing only one or two. Patents and other more formal IP protection measures – such as registered designs – should be supported by registered trademarks, copyright on manuals and other documents as well as confidentiality and trade secrecy provisions (IP Australia, 2010). For many companies, the most valuable long-term protection for their products and services is the development of a well-recognised brand name. The end result of a well-considered branding strategy is the generation of substantial 'goodwill' in the market. 'Goodwill' is the intangible asset value inherent in a business after a period of trading. It can be difficult to accurately measure, but is easier to demonstrate with the presence of well-known brand names.

According to Williams and Bukowitz (2001), there are three separate categories of knowledge that can be found within a business organisation. The first kind is that of intellectual capital (IC), essentially all forms of knowledge – whether held in people's minds (tacit knowledge) or within an organisation's culture. It cannot be owned or appropriated by the organisation, but only borrowed or leveraged. The second type of knowledge is intellectual assets (IA), or such knowledge as can be identified as the exclusive right to the creators. This includes material (explicit knowledge) such as software, databases, algorithms, images, documents or manuscripts. Finally, there is intellectual property (IP) that comprises patents, trademarks, copyright and trade secrets as outlined above and that can be afforded exclusive legal rights. As shown in Fig. 12.5,

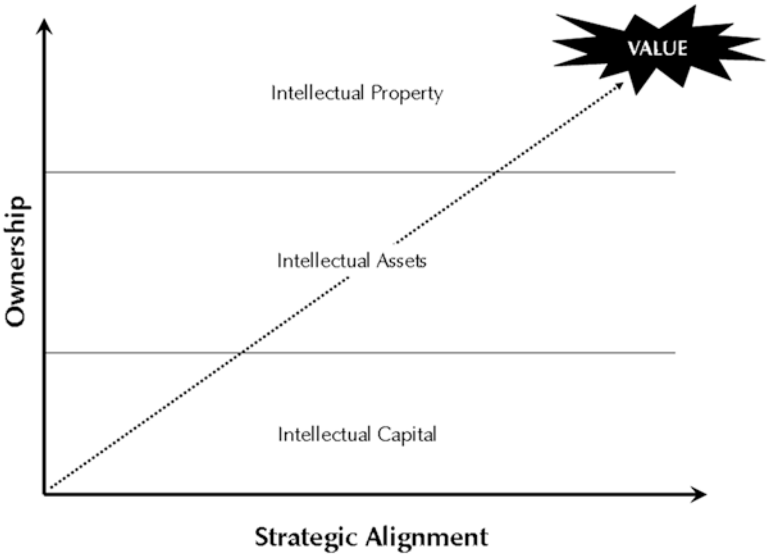

Fig. 12.5 IC, IA, IP degrees of ownership and strategic alignment. (Source: Williams and Bukowitz, 2001)

the value lies with IP that has clearly defined ownership and that is aligned with the strategic directions being followed by the company.

The value of IP within most innovation intensive companies is now recognised as of sufficient importance to justify the development of formal strategies to systematically identify and protect that IP. Recommended strategies for the protection of IP include the avoidance of the public disclosure of sensitive information relating to products or processes until a patent application has been lodged. This is often a challenge for some organisations – and particularly of universities where it is a requirement of academic staff and students to publish findings. It is advisable to always use a non-disclosure agreement when engaging in discussions with potential investors or collaborative alliance partners. A patent attorney or IP lawyer should also be consulted to ensure that all appropriate legal issues have been considered.

All laboratory notes or documentations for processes should be recorded, with each page dated and signed by the person doing the work and countersigned by a witness who is technically competent to understand the work being performed. Any grant applications should be carefully reviewed by IP lawyers to ensure that they don't make any future patent applications a problem. All documentation and related materials should be secured and employees asked to sign confidentiality agreements. If new employees are contracted, they should be asked to sign deeds of confidentiality and non-disclosure and any background IP that they claim to bring with them should be discussed and formally acknowledged. This same process should be followed for collaborative agreements with third party organisations with which the company works in research or development. It is also advisable for due diligence to be undertaken on any IP that is to be licenced into the company or out of the company in order to ascertain its market value and the potential levels of commercial risk (Industry Week, 2003).

It is important not only to protect IP, but to also value it appropriately. Williams (1999) suggests that companies make at least five common mistakes in relation to the valuation of their IP. The first of these is to enter into negotiations with a third party over a joint venture, merger or acquisition without first properly valuing their IP assets. A second mistake is to undervalue the IP assets, looking at what they are worth today rather than what they might be worth in future alignment with the assets of another partner. The third mistake is that of undervaluing corporate brands that have been created over many years and would cost substantial amounts to generate from scratch. For many firms, the fourth mistake is to value IP assets only *after* the deal has been negotiated. Finally, there is the mistake of valuing all IP assets collectively rather than individually. Each asset should be separately valued and this value recorded.

12.14.1 IP Assets Register

The value of IP assets is often greater than the value of physical assets, and it is advisable to have IP assets formally valued and their value recorded within the firm's assets register and balance sheet. An IP assets register can list a wide range of 'items', including: trademarks, brand names, patents, databases, registered designs and copyright materials (IP Australia, 2010).

An IP assets register can take a variety of forms. It is essentially a database that lists all the IP assets and can be developed in a spreadsheet program or other document containing the following information for each asset:

- Description. This is a description or ID number for each item.
- The nature of the IP asset. This is a description of the nature of the IP asset, e.g. patent, registered design, copyright, etc.
- Filing date. This is the date that the asset was filed or lodged with IP Australia or the appropriate authority if applicable.
- Publication date. For copyright, this can include the date the document was published (e.g. either formally via a publisher, or onto the firm's website).
- The creators. The creator is the person or persons responsible for the creation of the asset. This can be the author(s) of the document or the creators of the design.
- The owner. Where the creators and the owners of the IP asset are not the same, this should be recorded. In some cases, an employee can be the creator but their IP rights are automatically assigned to the company or employer who becomes the owner.
- Can it be formally registered? Here you should note if the asset is a patent, trademark or design that can be registered, or if it is something that requires NDA and trade secrecy.
- It is registered? If it can be formally registered, here you record whether it has already been registered already, or what the outcomes were of any application for registration.
- Applicable countries. In this section, you record whether the asset has been formally registered in one or more countries. This can be important when seeking to develop a new technology or product for use in international markets.
- Is it in use? Another important point to note is whether asset is already in use, or if it is still in development.
- How is it used? If the asset is already in use you should note in the register how it is being used.
- Rights to use third party assets. If you don't own the IP rights but wish to use them, you will need to indicate in the register how you can prove that you have permission to use the asset.
- Do contracts exist? If NDA contracts or licence agreements have been signed, these should be noted. This can include contracts signed with employees and sub-contractors.
- Has the IP been valued? It is important to try to place a value on the asset. This may be difficult but some attempt should be made. Where an asset has been purchased or formally valued, the value should be recorded. If no valuation has been made, you should seek to estimate the value using a separate valuation process. This might include the cost of R&D to date, plus a forecast for future sales or profits. Valuations can be complex and are discussed below.
- Term of protection. Here the life of the IP rights protection should be noted. For example, if it is a design and needs to be renewed every 5 years, its anniversary should be recorded.

- Summary of costs. Any costs associated with the registration and renewal of the IP rights protection should be recorded.
- Next date for payment. Here the expiry date for any formal IP rights should be recorded.
- Is it in the business plan? If you are seeking to write a business plan to secure venture capital financing, you may wish to note these assets in the plan. A formal venture financing agreement will usually involve a due diligence process in which the IP assets will be examined and valued. Your IP assets register will prove a very important document at that time.

12.14.2 Checklist for Protecting IP Assets

According to IP Australia (2010), the following is a useful checklist for firms seeking to protect their IP assets:

1. Identify all IP associated with your business and itemise them in your business plan.
2. Check that you really do own all IP used in your business or that you have the right to use it.
3. List registered IP and place a dollar value on identified assets.
4. List unregistered IP and give it a dollar value.
5. List other valuable assets such as client lists and corporate knowledge.
6. Identify key staff involved in developing, maintaining and protecting your IP, and get them to sign agreements relating to confidentiality and competition.
7. Educate staff on the nature of IP, on how to protect it, and on their responsibilities.
8. Consider ways you can use the IP system in your overall business strategy. Decide which markets – including overseas ones – you may wish to pursue before going public.
9. Develop an infringement strategy. Consider insuring your IP against infringement, and against you infringing someone else's IP.
10. Search the patent, trademark and design databases as well as other literature and the internet to ensure that your ideas are new, and to avoid infringing the rights of others. You can also search for new business opportunities as well as keep a tab on what your competitors are doing.
11. Maintain secrecy and be first to market.
12. Make effective trademarks the core of your brand and image building strategy.

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The Owner-Manager and the Troubled Company

13

13.1 Introduction

> Overall, there appears to be a reasonable consensus within the literature that the major causes of business failure are management incompetence and inexperience. (Haswell & Holmes, 1989, p. 73)

Crisis management, turnaround strategies and reengineering are just as important to the small business owner-manager as they are to the managers of large corporations. Unlike their large business counterparts, the small business owner-manager is likely to experience not only loss of profits and shareholder value if things don't go well, but may lose their entire livelihood, personal assets and reputation. Fortunately, the small business is capable of getting itself out of trouble just as quickly as it may get into difficulties. This chapter examines how small business owner-managers can deal with trouble and overcome difficulties by problem solving. It explores the process of crisis management in the small firm and suggests that reengineering and turnaround strategies are not only the preserve of large firms.

13.2 The Nature and Causes of Small Business Failure

In Chap. 1 it was noted that the 1971 Bolton Committee of Inquiry into Small Firms in the UK found most small business owner-managers faced common problems in five generic areas:

1. *financial problems* – particularly raising and using finance, costing, and controlling information;
2. *marketing problems* – specifically identifying and developing new markets and products;

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3. *production problems* – particularly scheduling and purchasing controls;
4. *human resources* – particularly organisation and delegation and personnel management; and
5. *problems with physical resources* – particularly in the management of technological change and the implementation and use of information systems (Bolton, 1971; Creedy & Johnson, 1983).

Regardless of the industry within which the firm is located, the owner-manager is likely to face problems in one or more of these five areas that can plunge the business into crisis. For owner-managers of small firms the cost of business failure can be personally catastrophic, resulting in not only financial hardship, but also psychological damage leading to clinical depression and even suicide (Drummond & Chell, 1994). Bankruptcy, despite legal reforms, remains a stigma for owner-managers and can make it difficult for them to secure future financial capital or even business support from suppliers and customers.

13.2.1 The Many Deaths of Small Firms

It has become a well-accepted view that the majority of small business start-ups fail. The statistics that are quoted argue that for every ten firms launched, five fail, four will struggle and one will be a success (Haswell & Holmes, 1989). Most of these businesses don't fall into bankruptcy; their owners simply decide to close the business because they found it too difficult to manage or not what they wanted to do. Research into small business failure has identified that there is a lack of adequate definitions relating to what constitutes *failure* (Watson & Everett, 1996, 1999). According to Cochran (1981) one way of defining failure is simply not being able to *make a go of it*. Everett and Watson (1998) suggest that business failure may be defined in at least four ways: bankruptcy; discontinuance of the business; discontinuance of ownership; and failing to make a go of it. Small firms experience a variety of different deaths as shown in Fig. 13.1. These can include bankruptcy, termination with or without losses to creditors, and failure as an opportunity cost while the owner seeks better investment prospects. Each of these forms of death has its own dynamics and causes.

13.2.1.1 Bankruptcy – Formal Failure

Formal failure is the most spectacular of small business death and is where the firm is forced into closure due to bankruptcy or liquidation due to financial or legal crisis. A variety of situations can lead to this. Banks may force a small firm into liquidation if the owner-manager defaults on a loan, or even if the firm is considered too great a risk. Creditors may also force such failure and legal action by regulators, competitors or customers can also result in formal failure.

In Australia to bankrupt someone they must owe at least $5000 and a sequestration order is granted by a court appointing a trustee to administer that individual's affairs. The administrator is then able to sell the assets of the firm to pay

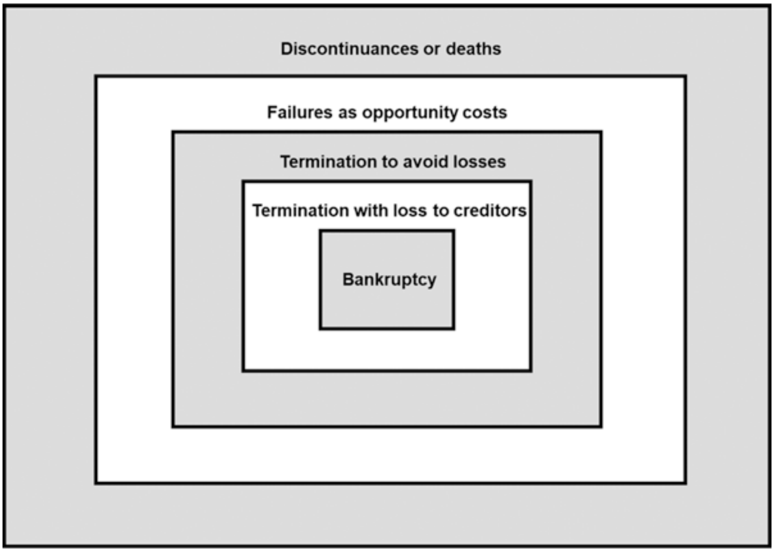

Fig. 13.1 Definitions of business failure. (Source: Cochran, 1981)

creditors, who are both secured and unsecured. A secured creditor is one that has priority claims over the assets. This is typically a bank or financial services organisation that has a mortgage title to the assets and will get paid first. Unsecured creditors are those without security and will be paid if there are any assets left once the secured creditors have been paid. Once a person is declared bankrupt, they remain so until discharged, which takes place either by law after 3 years, or earlier by court order (ITSA, 2011).

13.2.1.2 Failure

Failure generally occurs when the firm is unable to continue trading usually due to the owner-manager being unable to successfully run the business. The firm may not be facing bankruptcy, although it may face financial difficulties caused by internal or external factors. This can involve termination with loss to creditors, a definition commonly used by Dunn and Bradstreet which is a major source of data on business failure (Cochran, 1981). It might also include termination to avoid losses and to cease trading due to insolvency.

Under Corporations Law a company that is in financial trouble will have a registered liquidator or administrator appointed. The company can choose to appoint this individual on a voluntary basis, the liquidator may appoint them, or they may be appointed by a secured creditor (e.g. the bank). The administrator will take control of the firm's books and records and seek to collect debts and pay creditors. They may choose to liquidate the business, or they may try to restructure it (ASIC, 2011). At least three outcomes can occur in the case of a company becoming insolvent: voluntary administration; liquidation; and receivership (ASIC, 2011).

1. *Voluntary administration*. Under voluntary administration, the firm's directors can appoint an independent and suitably qualified person (voluntary administrator) who will take control over the company and endeavour to take steps to either save the business or put it into liquidation. In Australia, this is a fairly simple and quick process undertaken with the company board passing a resolution to appoint a voluntary administrator on the basis that the firm is either insolvent or about to become so. The person appointed to take on this function will then need to get the written consent of a registered liquidator to allow them to act in this way.
2. *Liquidation*. Where the business cannot continue to trade, it is placed into liquidation. Once again, a suitably qualified and independent person (the liquidator) is appointed to take over control of the company. They then manage its affairs, identify its assets and liabilities, and endeavour to wind up the company in an orderly manner. Of importance to this process is the payment of the creditors from the firm's remaining assets. The liquidator will usually call a meeting of creditors to vote on the winding up of the company and identifying how much each creditor is owed. Liquidation can occur outside the court system or an application can be made to the court for the company to be liquidated.
3. *Receivership*. A company will enter receivership when a secured creditor, such as a bank, who holds a claim over some or all of the firm's assets, appoints a receiver. The main role of the receiver is to take control of the business and identify where its assets and liabilities are located. They will then seek to wind up the business and recover the debts owed to the secured creditor.

An examination of business bankruptcies across 12 countries over the period from 2011 to 2017 found a significant decline in bankruptcy with a general trend in declining bankruptcy identified in most countries (OECD, 2018). Figure 13.2 illustrates these findings where it can be seen that the number of bankruptcies over the 6-year period declined at an annual average rate of 6%, despite rising and falling on a year-by-year basis. According to the OECD (2009), SMEs face greater challenges than most large firms when impacted by severe economic downturns such as the Global Financial Crisis (2007–2009). They are potentially more vulnerable in times of crisis due to such factors as:

- It is more difficult for them to downsize;
- They are usually less diversified in their activities and often dependent on limited products and markets;
- They have limited financial reserves and are often dependent on cash flow financing;
- They have lower credit ratings and often dependent on credit; and
- They have fewer financing options.

The OECD (2009) also notes that SMEs, which are connected to large firms via global supply chain networks, are at potentially greater risks as they may be impacted by any significant problems facing their larger customers.

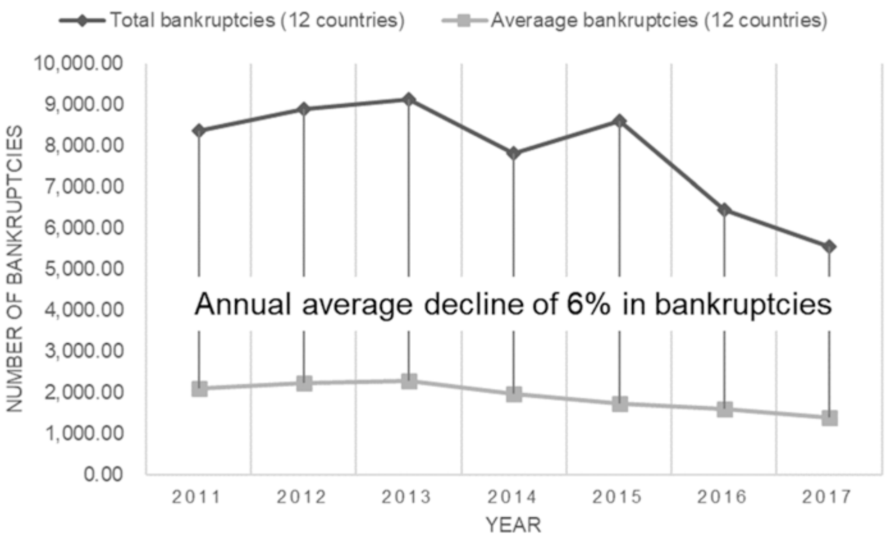

Fig. 13.2 Business bankruptcies 12 countries 2011–2017. (Source: OECD, 2019)

13.2.1.3 Discontinuances

The most common 'death' of a small business is where the owner-manager simply decides to terminate the firm and cease trading. Discontinuance of the business may not result in financial failure and all creditors may be paid. There may be nothing fundamentally wrong with the business and the owner-manager may have the skills and ability to keep it operating. Many small firms die when their owners no longer wish to trade, have little opportunity to sell them for a reasonable return and cannot arrange a succession strategy. Everett and Watson's (1998) longitudinal analysis of small business terminations over a 15-year time period found that discontinuances were the most common form of failure, substantially exceeding bankruptcies or insolvencies.

For example, these results suggest that many businesses are sold, or cease, voluntarily and their proprietors are able to time their exits to best take advantage of prevailing economic conditions. Thus, depending on the definition of failure adopted, a positive economic outlook may be associated with an increase in the rate of small business failure (Everett & Watson, 1998, p. 388).

Figure 13.3 illustrates the trend in the average deaths and births as a percentage of all firms across 27 countries around the world. As can be seen, the birth rate has generally exceeded the death rate, with the exception of 2009 when the Global Financial Crisis (GFC) was at its peak. What these figures show is that the 'deaths', or at least the discontinuances of businesses have been declining since the GFC, while 'births', or start-ups, have remained fairly steady.

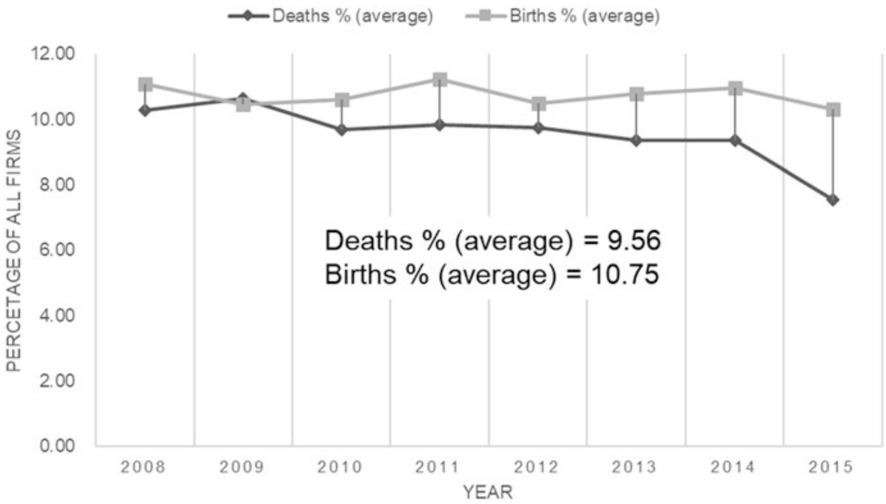

Fig. 13.3 Deaths and births of businesses – average %, 27 countries 2008–2015. (Source: OECD, 2019)

13.2.1.4 Personal Failure

A less public form of small business death is personal failure or simply failing to *make a go of it*. The owner-manager is faced with burn out caused by long hours, high stress and the inability to find a way out of a workaholic tread mill. This is common among many owners who are operating quite sound firms with growth potential. As the business intensity increases, they find themselves unable to cope with the workload. They may give up the fight.

13.2.2 Common Causes of Failure in Small Firms

Some of the more common causes of failure in small business are due more to the ineptness of the owner-manager than the hostility of competitors, government policy shifts or disloyal customers. The following are typical.

13.2.2.1 Too Much Left to Chance

The owner-manager is weak at strategic thinking and planning and commits to action without thinking through the pros and cons of a decision. They trust to their good fortune and leave too much to chance. If their luck holds, they will survive, but if the situation turns against them, they will experience hardship. A small firm that launches into a new market without undertaking adequate market research and preparing a contingency plan should sales not reach the targeted levels is an example.

13.2.2.2 Too Many Decisions Were Based on a Hunch or Intuition

Many entrepreneurs operate on instinct and seize an opportunity when it feels right. For many small business owners with entrepreneurial tendencies, this ability to judge the market can be essential to their success. More cautious or ponderous decision-makers that require extensive research and analysis before making decisions can find themselves missing out or playing catch up. However, operating on intuition is a high-risk strategy and if the investment required is likely to place the business under threat should the project not achieve its goals, the consequences can be serious.

13.2.2.3 Crucial Obstacles Went Unnoticed for Too Long

The desire to achieve specific goals among owner-managers can be so strong as to blind them to the reality of a situation. When facing problems entrepreneurs frequently persist and look for creative strategies to overcome them. Such persistence is an admirable quality, but it can also lead owner-managers to ignore or dismiss crucial obstacles for too long. For example, a firm that takes on too much business when it lacks sufficient resources to comfortably service it all can quickly find itself overtrading with potential loss of quality and subsequent customer goodwill. Also, a small firm that seeks to diversify into new product/market niches when it lacks the expertise or capacity to perform well in these segments is choosing to ignore crucial obstacles.

13.2.2.4 The Amount of Time and/or Physical Effort Demanded

Ambitious small business owners are commonly engaged in biting off more than they can chew. They launch into a new strategic direction without considering the amount of time and effort that the new activity will demand of either them or their staff. A small firm that is already working to capacity to service its existing customers is likely to find itself stretched to breaking point if the owner suddenly commits it to a substantial new contract without planning the impact on staff resources and physical plant and equipment.

13.2.2.5 The Amount of Capital Needed Was Either not Estimated or Grossly Underestimated

Most small firms are undercapitalised and owner-managers frequently fail to estimate the level of capital required to allow them to fully implement the strategies they plan. This is usually due to a lack of planning skills within the firm and an unwillingness to seek external advice.

Lessons From a Crisis: The Pretzel Logic Story

Pretzel Logic was a new media development agency based in Perth, Western Australia, offering a full range of internet, intranet, extranet and e-business solutions. It had specialist skills in enterprise portals, content management systems and business process management. The company was founded in 1992 by Steve Pretzel who had prior experience in the advertising and newspaper industries and saw an opportunity to build a business in the emerging growth in website and internet technologies. At the time of its establishment, Steve ran the business from the backroom of his house.

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A year later, the business had grown to the point where his wife Valerie was able to join him. She also had a background in the newspaper industry. The business grew until, with 45 clients and five employees, it became necessary to move out of the home and into business premises. At this time, Pretzel Logic secured its first government client – the State Government was investing in the creation of e-business solutions and websites. Steve and Valerie had to learn how to ‘play the Government game’, but quickly expanded the business as use of the internet grew, picking up large corporate clients.

By the 4th quarter of 2000, the company was earning 55% of its sales from government contracts, employed 61 staff, and had a monthly turnover of more than $500,000. The year 1999 had been a hectic one for Pretzel Logic. Fears over the Y2K, or millennium, bug led large corporations and government agencies to seek compliance and computer systems upgrades to avoid the anticipated crash as clocks reached 01 January 2000. Business activity grew strongly as a result.

Faced with this growth, the company outgrew its premises and relocated into a larger, more expensive new office building by the end of the year. The move into the new building was a major event and incurred significant additional overhead costs. Rent increased from $5600 per month to over $20,000 per month, and $250,000 had been spent on the fitting out of the office.

Lesson 1: Don’t get complacent – never think it couldn’t happen to me

Although the Y2K crisis proved to be a false alarm, as the year 2000 unfolded the company began to experience problems. Three unforeseen challenges emerged that were to shake the business to its foundations.

The first of these was the election of a new State Government that immediately cancelled marketing and website development spending. The second challenge was the collapse of the ‘dot.com’ new media revolution that had seen many internet-based firms growing rapidly during the 1990s.

Although the dot.com crash didn’t affect Pretzel Logic directly, as the company had been careful to avoid the speculative projects that typified this period, the impact that it had on many of Pretzel Logic’s competitors saw desperate pricing tactics emerge as companies sought to replace evaporated contracts to keep their production facilities occupied. A third crisis was the downturn in the global economy that saw expenditure by large corporate groups within the West Australian mining sector dramatically reduced.

This sudden downturn caught the firm by surprise despite, the fact that it was well managed and had excellent accounting and reporting systems. Pretzel Logic had been in listed in the *BRW Fast 100* companies list 2 years in a row, and had received many awards for small business success. The company had a solid management team and Steve Pretzel monitored his cash flows and break-even carefully.

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Despite the quality of the management within Pretzel Logic, the collapse of both its government and corporate client base meant that it was no longer able to generate sufficient work to break even. Steve and Valerie had the lease for the new offices secured against their personal home and assets, and so they were facing both a personal and business risk.

Lesson 2: Make sure you have emergency facilities in place before you need them

At first the collapse of their government business was viewed as a temporary, short-term problem. The business was confident that its services would still be required and cash flow would get back to normal once the new government settled in. Unfortunately, the new government took much longer to resume its spending as it commenced a major restructure of the public sector agencies.

As 2000 rolled into 2001, the cash flow situation for Pretzel Logic had grown steadily worse. Overhead costs were too high and the company was committed to a 5-year lease over their new building. A process of serious cost cutting was required. Steve was forced to commence negotiations over the early termination of the lease and to put in place a factoring arrangement to help ease the firm's cash flow crisis.

Lesson 3: Loyalty is great but if you don't cut soon you will hurt everyone

The need to commence the retrenchment of staff soon became dire, but at first Steve Pretzel resisted this. Many of the managers counselled Steve to terminate their contracts and let them take pay cuts. Although he was well aware of the financial crisis facing the firm, he continued to hope that the business would turn around. His management team was excellent, and 'had helped the company on the way up', so he felt it was only fair to try to stick with them in the tough times and did 'not want to lose them on the way down'.

However, the company simply could not afford to carry so many fixed costs. As Steve explained: 'You cannot take this attitude if you own a business and have your house on the line'. In his view is it better to 'cut back and restructure early' when faced with a cash flow crisis of this magnitude.

In a bid to retain the key staff and keep the business in a position to capitalise when the market returned, the decision was made to cut all staff salaries by 10%. While the staff reluctantly agreed to this, the mood was gloomy. This was then made worse by several unavoidable rounds of redundancies.

By March 2003, Pretzel Logic was forced into voluntary administration and was 'right-sized' with the loss of many staff. Fortunately for Steve and Valerie, the company was taken over by a 'white knight' in the form of PIVoD Technologies, which found the firm a 'good fit' with its own business model.

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Once the overhead costs were taken away from the business, Pretzel Logic 'bounced back' into profit.

In retrospect, Steve believes a far better strategy would have been to cut staff early and cut deep. That way the business would immediately have started growing again, which would have had a much better impact on morale and the energy of the company. Instead, the progressive shedding of staff led to low staff morale and a feeling that the company was spiralling downwards.

Lesson 4: If things get really bad, put the bullet in early to save the company

He recalls how in the middle of the financial crisis his chief financial officer 'walked out', and the company had a taxation liability payment due that was worth around $40,000. They had secured a large contract in Saudi Arabia, but once they did the math it was apparent that the costs of servicing the work, and the lack of working capital in the business, meant that they could not really afford to undertake the work.

The acquisition of Pretzel Logic by PIVoD Technologies saved Steve and Valerie from personal financial ruin, but also lost them ownership of the firm. Fortunately, the new ownership saw that Pretzel Logic was basically a sound, well-managed business, and they retained Steve as the General Manager. According to Steve, he always goes into business now with the view that: 'I've only just arrived now. What needs to be fixed?'

Lesson 5: Get customer and staff loyalty early

Despite the crisis facing Pretzel Logic, Steve feels that the firm's good track record in servicing its clients meant that, when times became tough, they found customer and employees remained loyal. At the height of the crisis, Pretzel Logic lost only one accountant from the payroll and one programmer. The company had built a sound reputation for honesty, integrity and quality. This ethical behaviour meant that its clients remained loyal – and even its competitors were willing to 'help out'. According to Steve, the key message for others in business is: 'Never lose your humility or your respect for others on your way up. You never know whose support you may need on the way down.'

Lesson 6: It's never as bad as it looks

As the financial crisis facing Pretzel Logic grew worse, Steve and Valerie considered their options. At one point they fully expected to lose their house and be forced into bankruptcy. They joked about taking a 'sea change' and spending time sitting on the beach and living frugally. Despite this impending

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doom, Steve kept his customers and suppliers fully informed of his situation with regular weekly emails.

Eventually, the State Government came back to the market, allowing Pretzel Logic to secure several long-term contracts with government agencies. Although Steve and Valerie no longer owned the company, their personal assets were not at risk and the stress was gone. As Steve noted: 'You can always grow back'.

The final outcome

Steve and Valerie Pretzel nurtured Pretzel Logic back to health under the ownership of PIVoD Technologies. Unfortunately, in 2005 the parent group found itself in financial difficulties and Pretzel Logic was forced to prop up the parent, starving the company of the cash needed to expand.

Steve and Valerie resigned in January 2007, and on the 15th of January, 15 years to the day after they started Pretzel Logic, PX2 was formed. They now work together, from the home that they nearly lost, and have a range of business interests that leverage their consulting skills and personal aspirations.

Source: An interview with Steve Pretzel 2010.

13.3 Good Management Is the Key to Avoiding Trouble

It has been estimated that the majority of small business failures are caused by poor management, which suggests that the owner-manager is inexperienced or incompetent (Haswell & Holmes, 1989). A study by Bradley and Cowdery (2004) into the causes of bankruptcy among small firms pointed to a lack of working capital, lack of planning, poor record keeping, failure to use advice, unrealistic expectations by the owners and personal issues.

For example, some of the major causes of bankruptcy are poor planning, lack of financing, lack of business experience and lack of personal discipline. Anyone considering opening their own business should have not only the vision of where the business is going to end up, but a strong business plan. An important part of this business plan should be an exit strategy in case the business runs into problems. No business should start with just enough money to actually open the door. Many entrepreneurs do not realise that it takes 2 or 3 years for most businesses to turn a profit (Bradley & Cowdery, 2004).

Poor financial record keeping, a lack of financial management knowledge and not seeking external professional advice were all major causes of small business failure found among a review of 18 research studies (Haswell & Holmes, 1989). This pattern of findings suggests that the key to success or failure in the small business is the competencies of the owner-manager. It is important therefore that the small business owner be in a position to identify future causes of potential trouble and take corrective action.

Signs a Company May Be at Risk of Insolvency

- Ongoing losses and poor cash flows.
- The absence of a business plan.
- Incomplete financial records or disorganised internal accounting procedures.
- Lack of cash flow forecasts and other budgets.
- Increasing debt (liabilities greater than assets).
- Problems selling stock or collecting debts.
- Creditors unpaid outside usual terms (creditor strain).
- Solicitors, letters, demands, summonses, judgements or warrants issued against the company.
- Suppliers placing the company on cash-on-delivery (COD) terms.
- Issuing post-dated cheques or dishonouring cheques.
- Special arrangements with selected creditors.
- Payments to creditors of rounded sums that are not reconciled to specific invoices.
- Overdraft limit reached or defaults on loan or interest payments.
- Problems obtaining finance, changing banks or increased interest by banks and financiers.
- Inability to raise funds from shareholders.
- Overdue taxes and superannuation liabilities.
- Board disputes and director resignations, or loss of management personnel.
- Increased level of complaints or queries raised with suppliers.
- An expectation that the ‘next big job/sale/contract’ will save the company.

Source: ASIC (2008).

13.3.1 Duties of a Company Director

The Australian Securities & Investments Commission (ASIC) is the agency responsible for overseeing and regulating company activity. They outline the duties of a company director in the following terms (ASIC, 2008), as specified by the *Corporations Act* 2001:

- *It is important that the directors of a company exercise care and diligence in their duties* – as would any reasonable person. This includes making sure that they are well aware of the financial position of the company to ensure that the business does not trade while insolvent.

- *Directors should carry out their duties in good faith,* and in the best interests of the company and for a proper purpose. This means that they should not use their position to gain an advantage for themselves or another person or persons in such a way that would be detrimental to the company. Information that they may obtain from their position should not be used to gain such an advantage or to cause detriment.
- *It is the responsibility of the company directors to keep adequate financial records,* and be able to correctly record and explain transactions and the firm's financial position and performance. This also requires that they do not allow the business to trade while insolvent. The company should be able to pay its debts when they fall due. For example, a company is insolvent if it is unable to pay all its debts when they are due. This means that, before you incur a new debt, you must consider whether you have reasonable grounds to suspect that the company is insolvent or will become insolvent as a result of incurring the debt (ASIC, 2008).

13.3.2 Consequences of Trading While Insolvent

It is an offence under the Australian *Corporations Act* 2001 for directors to allow their business to trade while insolvent. To do so can incur civil and criminal penalties. Insolvent trading can lead to civil penalties of up to $200,000. In a situation where dishonesty has been involved in the insolvent trading, a company director can be subject to criminal charges. Fines of up to $220,000 or imprisonment for up to 5 years, or both, can be imposed on company directors found guilty of dishonesty leading to insolvent trading. Such directors will also be disqualified from holding such positions. ASIC can pursue company directors for insolvent trading and impose personal liabilities on them for company debts.

13.4 Causes and Danger Signals of Impending Trouble

Some of the principal causes and danger signals of impending trouble within a small business have been grouped together into three broad categories: strategic issues; management issues and financial issues. Each of these is worthy of consideration in more detail.

13.4.1 Strategic Issues Likely to Cause Trouble

Timmons (1998) identifies at least six strategic issues commonly identified within small firms that might lead the business into trouble and can be viewed as danger signals for owner-managers or their advisors.

13.4.1.1 Misunderstanding a Market Niche

A common problem for small firms is to enter a market niche without undertaking adequate market research and analysis of its potential for growth. Many small firms enter markets only to find that the growth potential they thought was there was overestimated and they are caught with too much stock, or large investments in capital assets or equipment and sales forecasts that are unattainable. However, sometimes the market growth is strong and sales turnover rises substantially but without the profit margins needed to allow sustainable expansion. Under these conditions the owner-managers may find themselves caught in the 'busy-fool' syndrome with low gross margins and rising break-even points. Such owner-managers are frequently caught in such difficulties because they focus too much on sales turnover growth rather than profitability.

13.4.1.2 Mismanagement of Supplier and Customer Relationships

For many small firms their suppliers and customers are critical for survival. While customers provide the income needed to keep the business operating, the suppliers are often essential to the firm's ability to deliver products and services to the customers. Owner-managers that abuse their supplier relationships through slow payment, unethical dealing or misrepresentation risk losing the support of key suppliers at critical times. Effective partnering with suppliers and customers requires high standards of ethical and moral behaviour, as well as the development of empathy, understanding and trust.

13.4.1.3 Diversification into an Unrelated Business Area

Diversification into products or markets that are new to the firm is a common expansion strategy for large corporations. While many large firms can successfully deal with diversification strategies, it is frequently highly risky for small firms to do so. The main reason for the added risk to small firms is that diversification into new business areas outside the experience of the owner-manager is that they lack knowledge and benchmarks as to how they should behave in such environments. Further, the more diverse the new business activities become, the less synergy that is likely to exist between the firm's activities. This lack of synergy is likely to impose costs (in time and money) on the firm and its owner-manager. As shown in the Market-product development model of Ansoff (1965) (see Chap. 6), shifting into completely new markets with completely new products is high risk and should be recognised as such.

13.4.1.4 Mousetrap Myopia

The challenge facing many small business owner-managers is their propensity to dream up what they feel is a great idea and then convince themselves that it will sell well in the market. Everyone wants to invent a better mousetrap and make a million dollars, however, just because the idea seems good to the inventor does not mean the market will want it. Small firms should market test all new product or market ideas before launching them or investing significantly into them.

13.4.1.5 The Big Project

Another common issue for small firms is the tendency for owner-managers to become excited by a big opportunity and over invest in it based on overly optimistic or poorly researched expectations. If sales forecast or profits are less than expected, or cash flow is slow, the firm's heavy investment in the big project can become a rapid trip into insolvency.

13.4.1.6 Lack of Contingency Planning

Long range planning is uncommon in small firms and may be almost impossible to achieve due to the highly dynamic environment such businesses are usually engaged in. However, even a small firm can engage in contingency planning, particularly when investing or engaging in risky new ventures or facing uncertain times. Owner-managers should consider the 'what ifs' and seek to develop strategies to follow in the event that things don't go as anticipated.

13.4.2 Management Issues Likely to Cause Trouble

Poor management or lack of management experience is a common cause of small business failure (Perry & Pendleton, 1990). A study of the causes associated with failure in small business identified four key factors: inadequate management skills; weak financial controls; external pressures; and problems arising from growth and over expansion (Gaskill, van Auken, & Manning, 1993). Poor management skills, particularly cash flow management and the ability to effectively manage human resources within the business are likely to be significant causes of future problems.

13.4.2.1 Lack of Management Skills, Experience and Know-How

For many small business owner-managers the problem is simply that they don't know what they don't know. Their lack of understanding or experience of managing within certain types of environment can lead them into trouble (Haswell & Holmes, 1989). As the business grows, enters new markets or seeks to trial new systems the owner-manager will most likely find him or herself out of their comfort zone. If they don't seek expert advice or undertake training and education to provide them with needed skills, they are likely to risk making mistakes, which could prove costly. Further, as the firm grows and takes on greater scale and scope, the owner-manager must learn how to shift from tactical manager to strategic leader.

13.4.2.2 Weak Finance Function

The most common management deficiency among small business owner-managers is a lack of financial or accounting skills. It is frequently the case that the owner is dependent on their accountant or bookkeeper to keep them informed of how well their business is travelling financially. Accountants are typically used for taxation advice and offer once-a-year historical reviews of the firm and its liabilities to the taxation office. This is usually too infrequent to allow the owner-manager to deal with dynamic market environments or rapid growth.

Inadequate financial control and reporting systems are also a cause of small business problems. Ideally the small firm should have systems that allow it to produce reliable estimates of profitability, cash flow, break even and future sales forecasting that permit the owner-manager to make strategic decisions with greater certainty (Howorth & Westhead, 2003).

13.4.2.3 Turnover in Key Management Personnel

Many small firms have difficulty finding and retaining all the staff they need, particularly when experiencing periods of growth or change. The loss of key staff with managerial functions is damaging even to large firms, but can be devastating to small firms. Professional service businesses such as consultancies or those dependent on key staff are likely to suffer additional problems when such employee turnover occurs. This highlights the importance within small firms to design the business around systems rather than people so that the loss of any particular individual will not be as damaging.

13.4.2.4 Inadequate Focus on Cash Flows

Within large firms the tendency is to focus on accrual-based accounting rather than cash flow. This is often beneficial to large firms and may permit significant adjustments across time periods to be managed and interpreted in a more effective way. However, for many small firms the need to have real cash to pay real bills is frequently of greater importance than keeping financial reports to impress shareholders and analysts (Mamis, 1993). The small business owner needs to heed the call 'turnover is for vanity, profit is for sanity and cash is a reality'.

13.4.3 Financial Issues Likely to Cause Trouble

In conjunction with poor management skills there are several financial issues likely to lead the small business into trouble.

13.4.3.1 Poor pricing, Over Extension of Credit Terms and Excessive Leverage

The tendency of small firms to under-price is a key cause of financial problems. Low prices may attract increased sales, but they also commonly result in low gross profit margins. A lack of profitability is likely to reduce the level of retained earnings in the business and starve the firm of working capital. In addition to under-pricing, small firms are also prone to offering credit terms that are too generous, or failing to effectively manage debtors.

The owner-manager should prepare a debtor matrix that tracks the customers on one axis and the day's receivable on the other. Debtors that consistently run out beyond 90 to 120 days should be addressed with strategies to increase the pace of their payments. On the other side, the small firm that is slow to pay its creditors can suffer creditor strain, leading to the firm becoming over extended in current liabilities (Business Credit, 2006).

13.4.3.2 Lack of Cash Budgets and Projections

Effective cash flow management requires the small business owner-manager to set realistic sales projections and budgets, and to monitor their break-even carefully with an eye on variances from budget forecasts. Failure to undertake such monitoring is likely to result in cash flow problems. According to Corner (1998) some of the financial reporting and control measures that the small firm should have in place and monitor on a monthly basis are:

- *bank reconciliation statements* – showing the position of the cash balance after all cheques have been paid out and income banked;
- *cash flow forecasts* – of expected cash inflows and outflows for the forthcoming month (if possible, this should be projected over the next 3 or 6 months to provide an early warning of future cash short falls);
- *a debtor matrix* – listing the debtors and aged each debt has become (this can serve as a warning for future bad or doubtful debts and should also prompt the owner-manager to follow up the customers slipping behind in payment); and
- *a creditor matrix* – listing the aged creditors and allowing the firm to compare the rate of payment to suppliers with that of receipts from customers.

13.4.3.3 Poor Management Reporting

In addition to establishing realistic budgets and sale forecasts, the owner-manager should also establish a set of financial reporting systems to generate regular Key Performance Indicators (KPIs). Each small firm is likely to need to determine its own set of KPIs and how best to generate them. Commonly used ones are break-even, gross profit margin, stock turnover, space utilisation, billed hours, wastage levels and sales. Linking financial and non-financial information together is often critical to providing a complete picture of where the firm is placed at any given time.

13.4.3.4 Lack of Standard Costing

For most small firms, there is a lack of understanding of the true cost of operations and this frequently translates into under-pricing. Owner-managers should determine the average cost per hour operating within their business and use this to assist with job costing.

13.4.3.5 Poorly Understood Cost Behaviour

Cost control within small firms is often crude and substantial leakage and slippage can take place due to a lack of understanding over the differences between variable and fixed costs. The allocation of costs against specific operational activities to determine the true contribution made to the firm by any particular product or market segment needs consideration. All too frequently small firms bundle all costs together and look only at the overall profit or loss generated by the business. This frequently hides the poorly performing or under achieving areas of the firm that only serve to drain profits and resources.

KPIs for Plant World

Paul Soros, the owner of Plant World, a small business providing indoor plants to commercial customers, was facing a crisis. His family business had run successfully for over 15 years with little or no systems and only a vague sense of what the firm's vision should be other than to turn a profit. For the first time he had ended the financial year with a loss. Although it was only a 'paper loss' the financial result was unsettling for Paul and created a sense of crisis.

Faced with this problem Paul decided to critically examine his firm's operations and talked the matter over with his accountant and a business management consultant. What Paul felt he needed was an 'aircraft instrument panel' to allow him a means of monitoring his firm's performance on a regular basis, a set of Key Performance Indicators (KPIs).

Following several months of analysis and discussion it was agreed that the most important measures for Plant World were related to the efficiency with which the company could service any particular customer. For example, a customer located in the northern part of the city who was to be serviced on the same day as another customer in the southern area would incur substantial transport costs. Further, the longer a plant servicing visit (e.g. watering and feeding individual plants) took, the greater the cost to the firm.

Faced with this realisation Paul developed two KPIs that he felt were critical to Plant World. The first was the number of kilometres taken by company staff when servicing each client. The second was the minutes taken per units (plants) during each client visit. By monitoring each client against these two KPIs, Paul was able to determine how efficiently his firm was operating.

Source: Paul Soros (2002).

13.5 Features of Successful and Unsuccessful Firms

An analysis of the differences between successful and unsuccessful firms suggests that the more successful are adaptable and display both a capacity and willingness to change their organisational structure to meet the changing strategic directions they undertake (Applebaum, St-Pierre, & Glavas, 1998). A change in strategic direction or mission requires the business to adjust its structure, which in turn requires flexibility among employees and management. Successful firms are also likely to be more innovative and entrepreneurial in their management and are willing to take decisive action when required. Such firms are also well focused and understand their core competencies. They are less inclined to engage in strategies that take them away into directions where their capabilities are poor matched to the market needs. In doing so the successful firm is able to clearly articulate a single common value proposition (unique selling proposition) that makes them more competitive than the others in their industry. Finally, such firms seek to gain consensus with employees to build mutual trust and encourage innovation in the workplace.

In contrast to the successful firm, the unsuccessful firm is found to suffer from external shocks frequently resulting from the emergence of new technologies or similar changes that allow competitors to seize the initiative. Firms that become too reliant on a key supplier, or key customer or market segment are also vulnerable to changes in the market. This unbalanced 'supplier-buyer' power relationship has also been noted by industrial organisational economics. Failure has also been attributed to poor monitoring and control systems that make financial reporting, budgetary or cost controls ineffective. Such firms also possess weak leadership that cannot take decisive action. Such management is usually unable to make structural or cultural changes required to improve performance.

13.6 Key Considerations with Business Survival

Whatever industry a small business operates in there are several key issues that should be considered by the owner-manager that might impact on its survival. These can be broadly divided into the things that can be foreseen or predicted, the things that cannot be foreseen and the need for basic consolidation of systems.

13.6.1 The Foreseeable

Things that can be predicted with small businesses relate to the basic business model. Whether the business is a start-up or has been in operation for several years the following issues should be considered.

13.6.1.1 Ideas

How viable is the basic business model or idea behind its concept and products? Many small firms are founded on inadequate market research or analysis and seek to enter markets that are already saturated or with products that are unviable.

13.6.1.2 Resources

As noted in earlier topics, a common problem for many small firms is a lack of working capital, insufficient equity and a lack of human resources. These problems are due to inadequate planning and assessment of the firm's needs in advance.

13.6.1.3 Finance

Lack of sufficient cash flow is one of the main factors that lead to problems for small firms. As discussed in earlier topics, this can be foreseen by looking at the firm's gross profit margins, break-even point and general cost structure. Too many firms enter markets with low prices and fail to adequately assess their financial model.

13.6.1.4 Management

Finally, the issues of management such as the level of skills that the owner-manager has in the management of the firm, or family and partner problems that can impact on the business are important. These things are so common to most small businesses that they can be largely foreseen.

13.6.1.5 The Unforeseen

While many things can be foreseen there are many others that cannot. Among these are economic downturns, sudden changes in key personnel caused by death, injury or resignation, and illness or changes in family circumstances (e.g. pregnancy). Other unforeseen circumstances are the failure of a lead customer or key supplier, or changes to government regulations or legislation. Most of these things are either unforeseen or beyond the control of the owner-manager. There is little that can be done except to prepare the firm for dealing with such a crisis.

13.6.1.6 Basic Systems Consolidation

Whether the issue is foreseeable or unforeseeable the owner-manager can alleviate many of the worst aspects of a crisis through the development of essential systems within the firm that enhance its capacity for survival (Peacock & Palmieri, 1988). Good financial management systems are the starting point for any small firm. These include cash flow management and cash flow forecasting and budgeting systems, regular monitoring of KPI with a view to controlling the firm's costs and trimming waste.

On the market side, the small business can develop systems to monitor sales performance and trends, including customer feedback, in order to enhance future sales forecasting. Market research can assist the owner-manager to make better predictions as to future market behaviour, particularly with respect to the launch of new product or market entry strategies. Finally, the small business owner should seek assistance from professional advisors to help design and implement such systems (Leslie, Magdulski, & Champion, 1985).

13.7 When a Crisis Takes Hold

The difficulties facing small firms may emerge suddenly when external forces impact without warning. However, such exogenous shocks are less common than the slower decline caused by internally generated problems. For most small firms' business-related difficulties are the result of problems that build up over time, frequently periods of 2–5 years. Symptoms begin to manifest themselves in various ways perhaps via such things as falling quality, strategic drift, excessive debt levels, falling sales or profits. Employees and outside stakeholders such as banks, accountants or even suppliers and customers may notice and either disengage from the firm or seek to advise the management of the need for change. Owner-managers that are willing to listen and take corrective action have the chance to survive, while those that ignore such warnings may not. Timmons (1999) outlines the process through which small firms are likely to move as a crisis takes hold.

13.7.1 The Paradox of Optimism

It is common for small business owner-managers to resist acknowledging that they may be facing difficulties. This is particularly the case if they have had a successful track record until that time. The naturally strong ego drive and optimism of many entrepreneurs makes them less inclined listen to bad news. They therefore fall into the 'paradox of optimism 'syndrome (Timmons, 1999). In this situation the early warning signs of trouble within the firm go unnoticed or treated as typical 'teething problems' when a business changes direction, launches new products or enters new markets. External partners such as suppliers, bankers, accountants and customers may notice and seek to advise the owner or just quietly disengage. Eventually, should the owner-manager continue to resist addressing the problem, the firm's overall management credibility erodes. External stakeholders cease to have confidence in the firm and their support weakens.

Net Liquid Balance to Total Assets Ratio

The importance of liquidity within the small firm should not be underestimated. Running out of cash is a frequent cause of small business failure or crisis because it means that the owner-manager cannot pay staff wages, purchase from suppliers and may be forced to liquidate assets at below cost.

One measure of the overall vulnerability of the business is the net liquid balance to total assets ratio. The firm's net liquid balance (NLB) is determined as:

$$\text{NLB} = \left(\text{cash} + \text{marketable securities}\right) - \left(\text{notes payable} + \text{contractual obligations}\right)$$

The NLB is a measure of the firm's available liquid assets and its relationship to its total assets (e.g. the NLB to Total Assets Ratio) is a useful overall measure of how liquid the business is. When the firm is overtrading it begins to strain its supplier's credit terms and pressure is placed on its liquidity. Creditor strain is therefore a key element to be monitored.

For example, a business that has $45,000 in cash and marketable securities less $40,000 in notes payable and contractual obligations will have an NLB of $5000. If it also has total assets of $200,000 its NLB to Total Assets Ratio will be ($5000/$150,000 = 2.5%). Such a ratio is very small and may indicate that the firm will face problems in covering its short-term liabilities. Continuous monitoring of the NLB to Total Assets Ratio will serve as an early warning signal to the owner-manager as to whether they are likely to experience cash flow problems.

Source: Timmons (1999).

If the erosion of support from customers, suppliers or perhaps the bank becomes too noticeable the owner-manager is forced to acknowledge that they have a problem. A management crisis is brought on that may involve staff layoffs, the withdrawal from markets or the shedding of assets. It is common for owner-managers to resist such cut backs for as long as possible and hope to trade out of trouble.

Depending on the extent of the problem the firm can find itself plunging into a spiral of trouble with mounting stress on both the owner-manager and their staff. As the crisis builds the small business manager can be paralysed with indecision and may even go into psychological denial, seeking to simply avoid facing the reality of collapse or ruin. It is also common in such situations for the owner-manager to try to project their frustrations and management failings onto others, blaming their accountant, banker, competitors, employees or the government for causing the problem. Owners facing financial or business collapse may even resort to deceit and dishonesty when seeking to secure resources. They may promise suppliers, customers and employee’s things that they cannot deliver and once such deceit becomes entrenched the reputation of the owner-manager is destined for ruin (Timmons, 1999).

13.7.2 Employees Notice First

Due to their close association with the business it is common for employees – particularly those with supervisory or managerial responsibilities – to be among the first to notice the business is facing problems. If they seek to bring these matters to the attention of the owner-manager without satisfaction, their morale is likely to suffer. Increasing staff turnover by key employees is frequently a sign of a business in trouble.

13.7.3 Non-quantitative Signals

In addition to keeping an eye on the cash flow, the owner-manager or their advisors can also monitor several non-quantitative signals that might indicate trouble. According to Timmons (1999) for those observing the small firm the following signals are important:

13.7.3.1 Changes in Management or Key Network Support

When a small business loses key managerial staff or decides to change their bank or accountants, attention should be given to whether these developments reflect reasonable shifts in business activity, or something more sinister. As noted above it is common for owner-managers to become caught in the ‘paradox of optimism’ leading to the disengagement of key supporters.

13.7.3.2 Inability to Produce Financial Statements on Time

The well-run small firm is usually able to produce its financial statements on demand and with a good level of accuracy. Delays in producing financial reports (e.g. bank requested financials or even Taxation Office Business Activity Statements) are often a signal of poor managerial control.

13.7.3.3 Accountant's Opinion Is Qualified Not Certified

Where a small firm has its financial statements audited by professional accountants the most telling sign of trouble is when the auditor producers a qualified opinion.

13.7.3.4 Owner-Manager's Behaviour Changes

The behaviour of the owner-manager is also important. Erratic or uncharacteristic behaviour is usually a sign of the owner being under stress, which may signal a problem. Because the performance of a small business is usually closely tied to the performance and behaviour of the owner-manager, any major negative shifts in behaviour should be noted.

13.7.3.5 New Competition, New Markets or New 'Big' Products

Although the growth of small firms is dependent on it entering new markets, launching new products and taking on new competition in the process, each change of this kind will increase the overall risk level faced by the firm. The entry into a small firm's market niche of a new and aggressive competitor is a sure sign of trouble. However, if the small firm is seeking to launch aggressively into new markets, or launch ambitious new 'big' products requiring significant resources, attention should be given to the ability of the firm to implement such strategy.

Cutting costs, selling assets, increasing creditor strain – the small firm that begins engaging in cost cutting, asset liquidations or seeking extended credit terms from suppliers is signalling signs of stress. These are frequently the manifestation of underlying problems that have built up within the firm over a longer time period.

13.8 Principles of Reengineering

Hammer (1990) suggests that managers seeking to 'reengineer' their firms should not be timid and should implement significant changes if required. Improvement targets should be ambitious and encourage cross-functional exchange and innovation. A series of 'reengineering principles' are suggested.

The first principle is to organise around outcomes not tasks, suggesting that managers should ensure structure is focused on the broader outcomes desired as a result of the change process rather than specific functions or tasks. This may lead to individual job specifications becoming much wider than might otherwise be the case. Second, that those who use the output of the process perform the process, meaning that firms should avoid too much bureaucracy *and* seek to create more multi-skilled, multi-function teams. A third principle is for the firm to subsume information-processing work into the real work that produces the information, this suggests that the firm should allow teams to both gather and process their own data. The benefit here is greater ownership of the process and potentially more efficiency, made increasingly possible due to modern IT systems.

A fourth principle is for the firm to treat geographically dispersed resources as though they were centralised. Here the emphasis is upon use of information and communications technologies (ICT) to shrink distance and overcome barriers to effective management caused by a lack of geographic proximity. A fifth principle is to link parallel activities instead of integrating their results. This is a call for concurrent action among co-dependent teams operating in the firm, but ensuring that such concurrent action is suitably integrated to ensure there is maximum synergy between the activities performed by the teams. The sixth principle is to delegate responsibility for tasks downwards by putting the decision point where the work is performed and build control into the process. Finally, the firm should seek to capture information once and at source using ICT's and associated data storage/management systems.

These principles were designed for the large firm however they can be applied to small businesses with modification. For example, owner-managers must keep both themselves and their staff focused on achieving the objectives required to ensure the business is restructured, a process that may involve changing work behaviour.

While bureaucracy is generally absent from small firms, all employees within the firm should be brought to an understanding of how their specific work impacts on other parts of the firm. For example, getting employees who don't generally deal with customers to participate in customer visits can be beneficial to enhancing quality and market responsiveness.

According to Snyder (1999) the general principles that small business owner-managers should consider when undertaking a reengineering program are:

- Be open with all employees regarding the process;
- Solicit input from all employees;
- Involve everyone in the implementation of the new systems; and
- Understand the systems yourself because this understanding is more important than bringing in consultants and helps to ensure that costs are kept under control.

13.9 Principles of Turnaround Strategy

Connors and Smith (1999) suggest a process for implementing turnaround strategies within the firm. This focuses strongly on the use of the firm's culture to achieve the desired outcome. It commences with the manager setting clear objectives as to the type of changes that are required in the firm's existing culture and practices, and identification of the beliefs that need to be held to shift the culture. Once these are set the next step is to ensure that all managers, key employees or leaders of teams are united together in the common cause. These team leaders are then empowered to engage with their staff and create new experiences for them. Further, these experiences should be of the right kind. This may involve changing their own behaviours to role model the new practices. For example, the senior management team all taking a pay cut to demonstrate commitment to cost cutting.

Because significant behavioural change is difficult the management team leaders need to constantly seek feedback from their teams to ensure that they are taking everyone with them. Setting the example through modelling behaviour is also critical to this process. The manager should ensure that there is an integrated process taking place. The 'McKinsey 7-S 'model is an example of an integrated approach to achieving change. A top down approach is unlikely to achieve the 'buy-in' required for successful change management. As such a further goal is to get everyone enrolled in the change process.

Once the entire firm is 'enrolled' in the change process, the manager should seek to create accountability for change. Delegation of tasks with responsibility is critical to this process. Because the change process is not likely to run smoothly with all parties satisfied, the manager needs to troubleshoot the turnaround. This means paying attention to staff or groups unwilling or unable to make the changes. Finally, the firm needs to 're-freeze' the change by ensuring formal systems alignment. Here the firm's formal systems are re-adjusted to bring them into alignment with the new strategic direction and reinforce the changes that have been implemented.

While the Connors and Smith (1999) strategy is designed for the large firm, there are still many lessons for the small business. It is critical for the owner-manager to set a clear vision to guide their staff towards a positive future. Role modelling the changed behaviour required to bring about the new strategy should be a key feature for the owner.

13.9.1 Turnaround Strategies for Small Firms

The small business owner-manager facing a crisis is likely to need urgent attention to be given to financial controls and the acquisition of cash inflows or cost reductions. The following strategies can be useful under such conditions: quick cash; negotiating with lenders and trade creditors; workforce reductions; longer term remedial action; and better defining the size of the problem from the outset.

13.9.1.1 Quick Cash

One of the most crucial issues for small firms in trouble is to secure sufficient working capital to keep the firm operating. Working capital is comprised of debtors and prepayments (accounts receivable), plus stock or inventory, less creditors and provisions. For example, working capital is the most important element in managing the financial side of a business. Proper management of working capital requires ongoing attention to the granting of credit to customers, subsequent debt collection and efficient stock control, while at the same time obtaining favourable payment terms from suppliers. It is the under-funding of initial working capital requirement that is the cause of many failures for new business starting up (Jamieson, 1999).

Turnaround Strategy at Archer Personnel

Linda Archer owns and manages a small personnel placement firm employing nine staff. Having established the business as a new start-up 12 years ago she developed it into a successful and profitable operation. However, 1 year ago she found herself facing a crisis. In her own opinion she had 'lost focus' and saw her business drifting. As an owner-manager she was losing her sense of purpose and as she withdrew strategically from the business her staff went into what Linda described as 'cruise mode', becoming complacent.

Shaken by this apparent decline in her business Linda sought help from business consultants and enrolled in a management development program at her local university. She found the course and advice enabled her to rethink where both her and her business were headed. She spent a year thinking strategically, monitoring her firm's market performance and reshaping the marketing strategies.

As she began to work 'on' rather than 'in' the business, Linda found that many things within the firm needed to be changed or reviewed. With advice from her consultants and using the lessons from her training program Linda undertook a change program within the firm. This included increasing prices and launching new marketing strategies.

One of the first outcomes from these changes was the resignation of her bookkeeper. This woman had worked for Linda almost from the establishment of the business and had been viewed as a 'friend'. The departure was a personal blow to Linda and was followed by the departure of several other staff during the same year. Many of the staff left because they were unwilling to adjust to the changes being asked of them by Linda in the new business strategy.

After a year of implementing a range of changes and recruiting new staff, Linda feels Archer Personnel is now stronger and better focused. The firm's sales are up despite a slowing of general business activity. The new staff recruited to replace those that left have proven much better team members and have accepted the new strategies without question. Linda is now working on enhancing the image of her business and views herself as a 'team leader'. Her focus is now on upgrading her strategic management skills and spending more time planning rather than engaged in the daily business tasks.

Source: Linda Archer (2002).

Managing working capital in the firm requires the owner-manager to closely monitor the granting of credit to customers, debt collection and stock management or control. The owner-manager in trouble might seek extended trade credit from suppliers, while seeking advanced payments from customers. If the firm's accounts receivables are large, the owner may consider factoring as a means to raise cash.

The business should also look closely at its gross profit margins, with modest price increases or reduced costs of production serving to enhance the firm's profitability. For firms in serious crisis the liquidation of stock or asset sales may be necessary and are usually essential if the business cannot secure funds elsewhere. Such stock or asset liquidation is likely to signal the firm's distress to the market, and is not a first option that should be sought.

13.9.1.2 Negotiating with Lenders and Trade Creditors

When seeking to secure additional financing from banks or other lenders, or to secure longer repayment terms from trade creditors, the owner-manager should prepare a clear strategy. Think carefully about how to approach these organisations and have a clear plan that outlines how the loans will be repaid. Honesty is essential when seeking lending under stress or increasing creditor strain. Ideally, the owner-manager will have developed a good working relationship with their bank or suppliers (Business Credit, 2006).

13.9.1.3 Workforce Reductions

If the business finds itself under substantial duress it may be necessary for the owner-manager to retrench staff. While such downsizing is common within large firms, it is highly traumatic for many small business owners who are usually quite close to their employees. If the small firm must restructure by laying off staff it is advisable for the owner-manager to announce a 'one-time' reduction and do all layoffs together to minimise the impact on the firm. A quick retrenchment cycle is desirable because it will be highly unsettling for remaining staff and any delays will only cause greater disruption. It is also suggested that the owner should cut more deeply into the firm's staffing levels than may seem necessary.

13.9.1.4 Longer Term Remedial Action

Once the owner-manager has taken the steps described above and stabilised the firm's financial situation, it is important that strategies are put in place to consolidate the position and ensure future stability. Attention should be given to the firm's systems and procedures to ensure that they are benchmarked against best practice and can deliver the quality and efficiencies required. The firm's capital requirements should also be fully reviewed with consideration given to the financial restructuring of the business. Some firms have sold and leased back capital items to free up liquidity. Creative solutions involving out sourcing non-essential production activities or the introduction of stock control just-in-time measures are examples of how a small firm might develop longer-term action plans.

How well the owner-manager deals with a crisis is likely to be dependent on their problem-solving ability. For advisors seeking to assist the owner-manager facing a crisis the first step is to quickly define the problem and pinpoint its underlying causes. It is important to separate the fact from the supposition and seek to examine what frequently multiple causes are leading to the business problems.

The small business is typically poorly developed in relation to its systems and the managerial skills of its owner-manager. When seeking to develop a turnaround strategy, it is preferable to first draw up a list of probable causes to the firm's problems and then any barriers to addressing them. Once a list of possible solutions has been developed the owner-manager, and their advisor, should identify those things that are most readily tackled or most urgently in need of attention. This allows these activities to be placed in order of priority with mutual agreement reached of what will be undertaken and who will be responsible.

While it is common for small business owner-managers to try to address problems in a reactive, intuitive manner hoping for a quick solution, the research evidence suggests that a more logical, systematic and long-term approach to problem solving is likely to be more effective (Alpander, Carter, & Forsgren, 1990).

13.9.1.5 Defining the Size of the Problem

One of the main problems facing small business turnaround strategies is the need to overcome the perceptions of the owner-manager(s) as to the magnitude and causes of the problems. There is frequently a gap between the perceptions the owner-manager has about the problem and its causes, and the reality of this situation. Further, many small businesses may not be in a position to make the changes needed to achieve the turnaround required.

For many owner-managers their business is their life and its success or failure is a reflection of their personal ability or achievement. Under such circumstances it may be difficult for an owner-manager to view their situation objectively. Advisors or others seeking to assist the small business owner need to be aware of this.

13.9.2 An Integrated Problem-Solving Approach

When seeking to address problem-solving within the business it is important for managers to approach the process in a systematic way. It is common for managers in a crisis situation to seek immediate solutions to the perceived problem without undertaking an adequate diagnosis of its causes. This frequently results in the causes going untreated and the problem failing to improve. An integrated approach to problem-solving involves an eight-step process in which time is devoted to analysis of the causes and identification of the full nature of the problem before proceeding to solutions. These steps are outlined in Fig. 13.4 and discussed in more detail in the following sub-sections.

13.9.2.1 Stage 1: Problem Finding Initial Statement

It is usual for a company in crisis to have many problems, which may or may not be well known to all members of the business. The first stage in the process is to seek the opinions of all employees within the firm as to the problem. All ideas should be listed and considered for future analysis. It can be useful for these ideas to be placed on a whiteboard and cross-matched with each other until a picture emerges as to the extent of any problems.

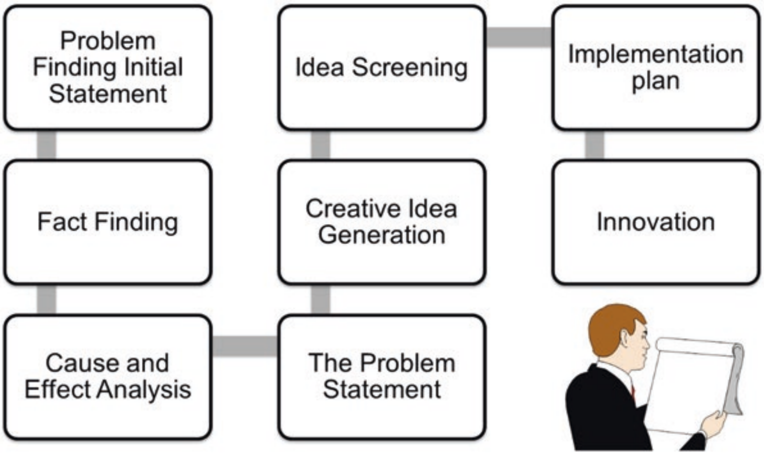

Fig. 13.4 An integrated problem-solving process

13.9.2.2 Stage 2: Fact-Finding

Having produced a list or general picture of the problem(s) facing the business it is important to then evaluate the extent to which each problem or issue is well known or supported by evidence. All data relating to these issues that are known or available should be identified and listed, while information that is unknown or yet to be collected should be listed. This then requires the gathering of additional information prior to the problem-solving process progressing.

13.9.2.3 Stage 3: Cause and Effect Analysis

Once sufficient information is available as to the possible problems and their possible causes, an analysis can be undertaken to identify causal linkages and pinpoint the areas that need attention. Of importance in this stage of the process is to better understand the underlying causes of problems. Once again, a whiteboard or similar planning tool can be used to facilitate the analysis. Techniques such as 'mind mapping', 'fishbone' or 'why-why' diagnostic charts can be used to examine the possible cause-effect relationships within the available data.

Problems in organisations are usually attributed to one of two things: people problems, or systems problems. The former is dealt with via job design, training, supervision and selection/de-selection. Systems problems are addressed by systems engineering or reengineering. As a general rule of thumb: if you have a problem, turn it into a procedure and it ceases to be a problem anymore. The concept of 'fail-safe' emerged in railways during the nineteenth century in an attempt to reduce accidents and make the rail network safer. Systems design and staff training were targeted at ensuring problems did not result in tragedy.

13.9.2.4 Stage 4: The Problem Statement

Once the owner-manager and their team have developed an understanding of the situation and its most likely causes they can proceed to draft a problem statement.

This is a sentence or paragraph that states the problem clearly and succinctly. Even if there were a large number of ‘problems’ identified and listed in Stage 1, it is usual for there to be only one or two key causes underlying the company’s problems. Once drafted, the problem statement should be placed in a conspicuous location where the team seeking to address the firm’s situation is working. This is designed to remind the owner-manager and their staff what the principal problem they are facing is, and to avoid them drifting off target as they seek to solve it.

13.9.2.5 Stage 5: Creative Idea Generation

Having identified the core problem and posted the problem statement where all team members can view it, the next stage of the process is to seek creative ideas for how to solve it. Brainstorming sessions using various techniques such as meta-planning or scenario planning can be useful to trigger ideas. Once again, a large whiteboard can be a useful tool. Meta-planning involves getting all participants to write their ideas down on large post-it notes that are then taken and stuck onto the whiteboard where they can be organised into categories.

13.9.2.6 Stage 6: Idea Screening

The work in Stage 5 should result in a list of potential ideas for addressing the firm’s problem statement. In this next stage these ideas are screened using either qualitative or quantitative evaluation criteria. The aim is to remove as many ideas as possible leaving behind the ‘best’ ideas that can then be evaluated for their feasibility or acceptability depending on the evaluation criteria.

13.9.2.7 Stage 7: Implementation Plan

Ideas that emerge as worthwhile are then developed into implementation plans with clear objectives comprising the performance benchmarks that are to be achieved, the timeframe or deadline for their achievement and the person or persons who will be responsible for ensuring that they are achieved. Such a plan is the basis for a turnaround strategy or re-worked business/operations plan in most small firms.

13.9.2.8 Stage 8: Innovation

Finally, once the process is complete and the implementation plan is underway the owner-manager should not ignore the opportunity to review their firm’s progress and regularly bring together the team to repeat the process with a view to enhanced performance in innovation. Creative problem-solving is the basis for a system of innovation management within the company.

13.10 Risk Management in SMEs

The ability to manage a crisis when it hits is often assisted by the development of a risk management plan within the business. How well and organisation identifies, measures and manages risk, crises and disasters, and its ability to build up its resilience and dynamic capabilities to external shocks, are key areas of risk management

(Smith & Fischbacher, 2009). Since the 1990s, the field of risk management has emerged from a largely operational issue within business, to a strategic one (Arena, Arnaboldi, & Azzone, 2010). At a global level the majority of large companies now have fully implemented and defined risk management plans, with their boards receiving regular risk management reports generated from an *enterprise risk management* (ERM) framework. Most have formal positions of Chief Risk Officer (CRO) or equivalent at senior executive level (Deloitte, 2010). This adoption of formal risk management processes has increased significantly since the GFC (Lam, 2010). Even prior to that major economic crisis, there was mounting pressure on boards from corporate regulators and stock exchanges, for large public companies to implement ERM frameworks (Ng, 2008).

Despite this significant growth in formal risk management activity within businesses, and the examination of risk management within academic and professional circles, relatively little attention has been given to risk management within SMEs (Gao, Sung, & Zhang, 2013). A review of the research literature into risk management in SMEs undertaken by Falkner and Hiebl (2015) identified several types of risk facing SMEs:

- *Interest rate risk:* The high reliance of many SMEs on bank financing for short and long-term debt makes them potentially vulnerable to rising interest rates. This can impact the firm's cost of capital and limit its ability to raise funding for growth. Reducing the firm's reliance on external debt and lowering its working capital requirement (see Chap. 11), are all ways to mitigate this risk.
- *Raw material pricing risk:* As most SMEs are price-takers in relation to negotiations with major suppliers of raw materials, they face higher risks over increasing prices of major inputs. This can take the form of rising fuel costs, electricity, consumables, and materials used in production (e.g. steel, plastics, glass, aluminium, fertilizer, foods, cloth and chemicals).
- *E-business and technological risks:* As discussed previously in Chap. 9, many SMEs view their engagement with e-business and the adoption of technology for e-commerce, as exposing them to potential risks of cyber-crime, dependence on software vendors, and/or entrapment into restrictive supply chain relationships with large customers or suppliers who require them to adopt their proprietary e-business software suites.
- *Supply chain risks:* Many SMEs that become engaged with servicing the supply chains of large firms face the risk of becoming dependent on these customers. Further, when connected to a national or global supply chain, the SMEs may no longer be able to service the needs of local customers, or respond to local market needs. In other cases, SMEs can become restricted to one key supplier, with the risk of having to accept any pricing increases, supply problems or issues over quality.
- *Growth risks:* SMEs that are engaged in robust growth strategies are likely to be placed at the greatest risk. The pursuit of rapid growth not only places pressure on the firm's financial resources, due to the need for greater working capital, but also on its physical and human resources. Expansion into new products and/or

markets will risk placing the owner-manager(s) under pressure as they will need to learn and adapt to new product-market conditions, and devote substantial time to building up both the external networks and internal competencies required to manage this growth.

- *Management and employees:* Another area of potential risk is the firm's knowledge management and HRM capabilities. As discussed in Chap. 9, knowledge management is an important strategic issue within any firm, but needs to be approached in a systematic way. Good management of human resources (see Chap. 7), is also important if the business is to attract and retain the right employees. The loss of a single employee can have significant impact on an SME, not only due to the firm no longer having that person to undertake the work they were doing, but also the loss of their knowledge and experience.

13.10.1 Risk Management Processes in SMEs

The process of risk management within an SME involves at least three stages (Falkner & Hiebl, 2015). The first is *risk identification*, which involves a systematic assessment of all areas likely to suffer from potential risk. This can include assessing potential risks to resources such as: company data (e.g. financial, customer, systems); employees; and physical assets (e.g. plant and equipment). It should also include an assessment of financial risk facing the firm (e.g. due to potential loss of key customers or resources). Finally, there should be an examination, using flow charts such as business process mapping (see Chap. 8), to identify areas of potential risk to operations or activities.

A second step in the risk process management process is *risk analysis*, which involves determining the frequency and probability of any financial losses or loss or resources, likely to impact upon the firm's ability to operate. It is suggested that each potential risk be ranked using a measure of probability (e.g. 1 = highly unlikely; 2 = unlikely; 3 = likely; 4 = highly likely), and also a measure of gravity of impact (e.g. 1 = negligible; 2 = significant; 3 = major; 4 = catastrophic) (Marcelino-Sádaba, Pérez-Ezcurdia, Echeverría Lazcano, & Villanueva, 2014). The third step is that of *selection of techniques*, which involves the firm consideration a range of risk management tools. These can include taking out insurance cover, selecting suppliers, assessing the impact of weather and climate change, scheduling for over capacity, developing networks and collaborative relations (e.g. agreements with subcontractors), and developing emergency plans (e.g. fire, flood, earthquake) (Falkner & Hiebl, 2015).

Figure 13.5 illustrates the basic process of risk assessment within a business. As discussed above, a wide range of tools can be employed to identify, estimate and evaluate risk. It is suggested that the owner-manager of an SME consider this basic process within the context of their business strategy, and the management of their marketing and sales, finances, operations, human resources, technology and legal issues as outlined elsewhere in this book. Factors that might influence how an SME approaches these areas of risk assessment may be the industry in which they are

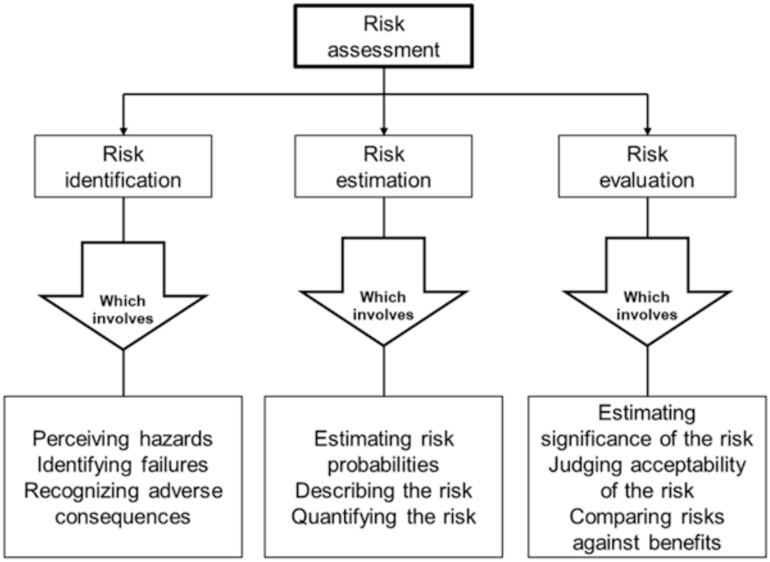

Fig. 13.5 The process of risk assessment. (Source: White, 1995)

operating, the size of the business, and the ownership structure. Also, of importance are the firm's growth aspirations, which might include its plans to expand into new markets, invest in new products and process technologies, and commercialise new products or services (Brustbauer, 2016).

13.10.2 Risk Management Within SMEs During Times of Crisis

As discussed earlier in this chapter, SMEs are often impacted more severely by external shocks such as the GFC or other major disruptions of their business over which they typically have no control. This is because SMEs, already small, cannot easily downsize, lack sufficient cash reserves to trade for extended periods without positive cash flow, may be overly dependent on a small number of key suppliers or leading customers, and may experience difficulties in securing access to credit (OECD, 2009).

An examination of SMEs from Greece and Romania in their management of financial crises highlighted the importance of firms having well developed procedures to manage and control their financial, operational and human resources. The possession of good technology systems to provide timely and accurate information to management was also important, as well as risk management policies and KPIs for assessing the firm's financial position (Mihai Yiannaki, 2012). The possession of reliable and relevant KPIs, supported by ERP and related ICT control and reporting systems, are very important to SME managers faced with financial crises.

A further study of SMEs in the United Kingdom and their management of crises noted that the owner-managers of these firms had a 'multifaceted understanding of the longer-term impacts of a crisis, but these do not necessarily correspond with a high level of formal adoption" (Herbane, 2013, p. 91). Further, the SME managers distinguished between strategic and operational crisis management, viewing the latter as the things that were predicable and of relevance to the day-to-day operation of the business. The study suggested that SME owner-managers should try to focus more strategically in their approach to risk management.

> **For example**, … Having reflected on their experiences of business level crises, SME owner and managers should place attention to their firms' exposure to a wide variety of crisis events in terms of their likely occurrence, the impact of such events in terms of operational interruption and short- and longer-term financial effects, and the ability of the firm to invest in measures that can reduce (or remove) both occurrence and impact. (Herbane, 2013, p. 92)

Gao et al. (2013) suggest that SMEs can address risk management with an investment in *social capital*. This would involve focusing on three core areas: (i) *structural capital* – the configuration of networks the firm has between itself and its suppliers, customers and third-party resource network actors (e.g. banks); (ii) *relational capital* – the existence of trust, norms, obligations and identification within the social network; and (iii) *cognitive capital* – the sense of shared representations and meanings amongst the members of the network, including a common vision, understanding and communications. These findings serve to highlight the importance of having a knowledge management strategy and KMS system within the SME (see Chap. 9). This helps to connect the four elements of knowledge, learning, communication and relationships together in the risk management process.

> **For example**, … The ability to use existing informal networks to access additional resources, knowledge and skills is crucial for SMEs in the effective management of risk. Under the cognitive dimension, communication is needed to access and use social capital through exchanging information, identifying problems and managing conflict. Communication helps employees maintain close bonds and share common goals while clarifying complex tasks and meanings, and improves access to external sources of learning by increasing actor willingness to engage in two-way interaction. (Gao et al., 2013, p. 694)

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14 Buying, Selling and Valuing the Business

14.1 Introduction

> The financial theory based on the public market, as presented in the valuation of the closely held business, is not representative of the "real world"; nor is there any evidence of its usage in actual sales. The only substantiation is the fact that this is the way it was done before. … Perhaps somewhat analogous would be estimating the value of a home by taking the national average of the selling price of homes on a square footage basis and using that figure as a multiple on the square footage of a subject house (Karsh, 2012, p. 158).

This chapter examines the issue of valuation and the related issues of purchasing and selling a small firm. It highlights the fact that valuation is not a precise science, and there is no established formula for determining how much a business should be worth. It also considers consolidation and harvesting of the wealth from the business. The process of buying, selling and valuing a business can be among the biggest challenges facing the small business owner. In particular, valuation of the business is one of the more complex issues facing the small firm. For many owner-managers the value of their business is not something that they measure in an overall sense. The firm is for them a vehicle for personal and professional growth, a source of income and a place of work or lifestyle choice. However, once the owner seeks to sell their business the issues of how much it is worth comes sharply into focus.

14.2 Buying an Established Business vs. Starting from Scratch

An important issue for many small business start-ups is whether to launch the business from scratch or whether to buy an established business. There are advantages and disadvantages for both. For small business start-ups the decision can be critical

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to determining how quickly the owner-manager can achieve certain levels of activity. For many established firms the opportunity to grow through a process of acquisition is frequently attractive. In both cases the principles of evaluating the merits of a green fields or established option are much the same. According to the US Small Business Administration only two out of every five start-up firms survive longer than 6 years, while according to the US Business Brokers Association the survival rate of small firms that have changed ownership is closer to four out of five (Meeks & Rotenier, 1993). However, there are still many challenges for anyone who seeks to purchase an established business.

14.2.1 Advantages of Purchasing an Established Business

There are several advantages to purchasing an established business rather than establishing one from scratch. To begin with the business is already in operation and will be generating cash almost from day one. If the business has had a good trading history it should have a pool of established customers with a degree of loyalty to the business. This loyalty and the general capacity of the business to secure its niche in the market will ensure that it has a degree of goodwill to allow it to generate above average returns to the initial investment. It may also be easier for the owner-manager to secure bank financing as the trading history and established customer base will give greater confidence than a green field site. Another reason for purchasing an established business is that buying out a going concern does not increase the number of competitors in the market. By comparison, to create a completely new business will only further divide an existing competitive market.

According to Megginson, Byrd, and Megginson (2000) some of the advantages of purchasing an established small business are:

- The staff is already employed in the business and have experience and an established record of performance.
- The facilities and equipment of the business are already available and can be immediately employed perhaps at a lower overall cost than purchasing entirely new equipment.
- The business has established products or services that have a market profile and sales track record known within the firm's customer base.
- The physical location of the business may be attractive (this is particularly the case with retail operations).
- Relationships with financial institutions and trade creditors have already been established and can be leveraged to the advantage of the new owners.
- There is established 'goodwill' within the business including a record of revenues and profitability that can be valued.
- The overall time and effort required getting the business up and running is substantially less.
- Given the nature of the purchase, it can be possible to secure a good business at a bargain price.

14.2.2 Disadvantages of Purchasing an Established Business

While the advantages of buying an established business are substantial, there are also many disadvantages. One of the major disadvantages is the cost. A well-managed, established firm is likely to cost a significant amount of money. There may also be problems with the business that may not be easily identified prior to purchase. These may include such things as equipment that is ageing or not as productive as initially hoped. Inventory may also be too old and a good quantity may need to be written off. When taking over a small business the new ownership will need to consider the impact on existing managers and employees who may not respond well to the change in leadership. It may also transpire that the customer base of the business may not be as good as initially thought. There may be worse and doubtful debts than shown in the account receivables.

According to Megginson et al. (2000) some of the disadvantages of purchasing an established small business are:

- The physical facilities, plant and equipment may be old or obsolete.
- Staff already employed by the business may have developed poor work practices or attitudes and the overall culture of the firm may be dysfunctional.
- There may be problems with the firm's accounts receivable ledger, and it may be impossible to recover all the monies owing.
- The firm may have a location that is not as ideal as it might be.
- If the business has had trouble prior to coming on the market (a common problem), its reputation within the financial and trade creditor circles may be poor.
- Its inventory and product range may be poor or tired.

To ensure that the business does not experience too many problems with bad and doubtful debts it may be advisable to not pay for receivables upfront but to agree to pay the vendor any goodwill against performance over time. Alternatively, the deal may be structured to require the vendor to reimburse the buyer for any bad debts.

14.2.3 Finding the Business

When seeking to buy an established business, an important starting point is to know where to look. Many small businesses are sold via Business Brokers, who are professional agents who will act as an intermediary for the vendor and the buyer. They will also offer a valuation on the business, and offer services in a similar manner to real estate agents. In some cases, real estate agencies can be a source of finding businesses for sale, in particular if the deal primarily involves the land or buildings (e.g. retail, commercial, industrial or rural farm businesses). Law firms, accounting practices and even some banks will also assist with business broking. There are also a large number of online business broking services, which includes business franchising opportunities.

14.2.4 Business Brokers

Business brokers are similar to real estate agents in their role as a broker between a vendor seeking to sell a business and the buyer seeking to purchase it. In many jurisdictions, business brokers are regulated by the same legislation that governs the activities of real estate agents. As with real estate agents, business brokers must be licensed, and are usually required to undertake professional accreditation.

Brokers usually represent the seller rather than the buyer, but can be hired to act as a search agent for an up-front fee. It is important to spend time evaluating various brokers and their charges before becoming too involved in the deal. Business brokers usually have the responsibility to assist the buyer and the seller to reach an agreement and manage all aspects of the process. This can include the negotiation of the purchase price, and any terms of final settlement (e.g. payment of goodwill, transfer of clients, customers, suppliers and employees) (Ruback & Yudkoff, 2017).

Business brokers earn commissions on the sale of businesses and their fees can vary quite considerably. As a general rule, the smaller the transaction, the larger the commission. The sale of a small business may incur a commission of about 5–10%, while a multi-million-dollar corporate sale may be about 1–2% (Jones, 1998). As with real estate, the broker's commission is paid by the seller not the buyer. In the United States brokers are quite numerous with around 3000–4000 registered business brokers recorded. Most are members of the International Business Brokers Association (www.ibba.org), others can be found via merger and acquisition advisors, which in the United States includes: the Association for Corporate Growth (www.acg.org); the Alliance of Merger & Acquisition Advisors (www.amaaonline.com); and the Association of Professional Merger & Acquisition Advisors (www.apmaa.com) (Ruback & Yudkoff, 2017).

Anatomy of a Business Sale: By the Numbers

I just closed a deal that in many ways was typical. As such, I thought I'd answer the question I often get: "What exactly do business brokers do?" Let me elaborate.

A seller walked into the offer and mentioned he might want to sell his business. We discussed his situation and I explained what he would need to proceed forward. He returned with his collected data including financials, equipment list, marketing materials, production and operations information, and other important details. Next, a business value was prepared, we agreed on an asking price, and entered into a listing agreement. Once we had the listing, the following happened – by the numbers:

Marketing Effort:

A 14-page marketing brochure was created. Listings were posted on three industry websites, which further populated others. Three industry experts were consulted. An email marketing piece was designed and sent to 23 business brokers, select customer in our database, and other targeted audiences.

(continued)

Two newspaper ads and two press releases were written (confidentiality preserved when required). Twelve key players in the market were contacted. One ad was placed in the company newsletter with a circulation of 6141. A presentation was made to a group of six brokers at an office meeting, and 14 fellow brokers at a commercial marketing session.

Marketing Results:

60 plus inquiries were received. Twenty two prospect confidentiality agreements were obtained. There were eight tours of the business. There were three offers received and negotiated. The Contract for 100% of list price was accepted in 178 days.

Closing the Sale:

A 194-page loan package was prepared. Five banks were approached to determine the best fit. Two banks cooperated with each other to finance the deal. Two government agencies were involved in the transaction. It took 113 days from contract to closing.

Fun Facts:

The office files grew to 4.25 inches. 849 plus prospect follow-up contacts were made by phone or email. Then client meetings were held. Four final buyer meetings were held. There were more than 409 seller communications (this is on the way high side of normal). 153 plus buyer communications took place. 268 plus communications with banks, lawyers and government officials took place.

I didn't include the cups of coffee but that number was also quite high.

Source: Balfour (2017, pp. 63–64).

A broker is also a good source of information on the business that can be given to the buyer prior to purchase, and this can help them make decisions as to whether or not to proceed. For people seeking to buy a business, a business broker can act as a useful source of information and bring opportunities to the potential buyer's attention in much the same manner as a real estate agent does.

For example, … Good brokers are much more than just a listing service of businesses for sale. A great business broker will provide critical information about the seller's commitment to sell and background about the company. Moreover, brokers help manage the seller, organize the sales process, and help resolve disagreements between the buyer and the seller. Brokers also are helpful coaches to first-time sellers, guiding them through each step of the sale. … A good broker might make the difference between a successful acquisition and one that collapses (Ruback & Yudkoff, 2017, p. 103).

In most countries business brokers are usually regulated and licenced by either national (federal) or state (provincial) authorities. Australian business brokers are regulated at the state and territory level and are required to be licenced. The United States follows a similar model, although in some states there is no requirement for licencing. Business brokers are also specialised with some focusing on the sale or leasing of buildings, such as commercial office, retail, warehousing, industrial or rural property, others are focused on the sale of the business as their prime concern. However, in many small towns and rural areas the same broker will handle all matters (Balfour, 2017).

14.2.5 Qualify yourself as a Buyer

Hill (2011) suggests that, prior to embarking on a decision to purchase small business, you first qualify yourself as a buyer. This entails having a critical look at whether you have the required experience and skills to run the business you are seeking to buy. Also, do you have necessary commitment and passion for the challenges that this new venture is going to demand? If this is all positive, you will then need to ensure that you have sufficient financial capacity to make the purchase, cover all additional costs and fees, and put in sufficient working capital to ensure that the business can survive. For example, consider sitting down with a banker before you talk to a seller. Like anything that is done successfully, a lot of preparation is required to make the process go smoothly (Hill, 2011, p. 20).

14.2.6 Define your Parameters

In conducting your search, a useful starting point is to sit down and map out the parameters or guidelines that define the type or types of businesses that you are looking for. This should outline the things that are important in determining whether you will or will not buy the business. Such things may include the products or services it produces, the location of the business, its size, age of equipment, turn over and profitability. Such a plan or vision will not only help to guide your own thinking, but will assist business brokers who may be searching on your behalf. Knowing what you don't want is just as important as knowing what you want. It is important that you feel happy with the business and that it fits your own vision of the type of venture that you will be content to own and manage. For example, if you don't like dealing with the general public, it may be best not to buy a retail business. The business needs to suit your background and general image.

14.2.7 Seek Advice

It is important to seek advice from competent professionals when undertaking a search and evaluation of prospective businesses to buy. At a minimum you will need an accountant, a lawyer and a banker (if financing is required). Select advisors who have some experience in business acquisitions and/or the industry that you are seeking to enter. Good advice can save you a substantial amount of money and grief over the long-term. Such professionals will also be important when due diligence is to be undertaken. If possible, the best source of advice is often another owner-manager with relevant industry experience.

14.2.8 Questions to Ask

Once a potential business purchase opportunity has been identified it is important that the owner-manager asks several questions to ensure that they are making an effective evaluation of the prospect. It is important to learn as much as possible about the business and its current ownership before making a commitment to purchase.

14.2.8.1 Why Is It on the Market?

An important initial question to ask is why the business is being sold in the first place. According to some analysts if a business is successful why would the owners be keen to sell it (Townes, 2001)? Frequently the owners are simply retiring after a long and successful career. Sometimes the owners have experienced a major change in personal circumstances, such as a death of a partner, or a serious illness. Often, they are going overseas, interstate or simply feeling worn out. Care should be taken to assess the accuracy of such claims. In the case of personal matters, it may be difficult to prove such claims, but often such claims are merely a smoke screen for problems.

14.2.8.2 What Is a Typical Day or Week Like for the Existing Owners?

When buying an established business, you are also buying a way of life and taking over a way of working that has been developed over time. The way the present owners have run the business and how they have set up their management philosophy and policies is important. Even though you may be keen to put a new broom through the business and make changes, you should think carefully and try to learn from the past owners. If they have made a success of the business, they must be doing something right. Also, you may upset the employees and customers if you seek to make too many changes too soon. Finally, it is a good idea to find out as much as possible about how the current owners run the business so that you can get a feel for the amount of work that you are potentially going to be taking on.

14.2.8.3 What Will the Owners Do After the Sale?

It is important to get a sense of the current owner's future plans once the sale is over. Will they simply retire or will they be tempted to start up again in competition to the business they have just sold? It is possible for legal contracts to be drawn up that seek to restrict the current owner from setting up in competition within a specified time period after the sale, but such agreements are difficult to secure and enforce (Hodgetts & Kuratko, 2001). It will be beneficial for a prospective buyer to spend time talking and negotiating with the owners and learning as much as possible about the past history of the firm and the future intentions of the current owners.

14.2.8.4 What Is the Outlook for the Market?

The past track record of the business, no matter how good, is only a rough guide to its future performance. Attention should be given to the future market environment facing the firm. For example, is the industry likely to experience changes adverse to the business such as the entry of new competitors, or shifts in consumer preference or technology that will erode its sales growth? Local government planning decisions can also cause the business to suffer problems as road traffic patterns change or land use zoning is altered. A process of independent market research and analysis, and checks with local government authorities or planning agencies is advised.

14.2.8.5 What Is the Current Physical Condition of the Business?

Whether the purchase price represents value for money may be contingent on the condition of the firm's fixed assets. If buildings, plant or equipment are included in the price these should be physically inspected and any costs of replacement or repair taken into consideration in assessing the total purchase price. As with the purchase of a house some negotiation may be possible with the current owners to have certain assets repaired or even replaced as a condition of sale. Fixtures and fittings in buildings should be examined and a clear understanding of what is and what is not to be included in the purchase. If the building is leased rather than owned, there should be discussions with the landlord to ensure that rents will not suddenly rise, or that extensions, repairs and maintenance will be possible.

14.2.8.6 What Is the Condition of the Inventory?

If the business holds stock or work in progress the condition of such inventory should be examined and agreement reached over its value. The book value of inventory is frequently different to the actual value. One small business owner-manager who purchased a ceramic tile company inherited a warehouse containing what represented a book value of $1 million in stock. When a full inventory was undertaken post-purchase the total value of the stock was estimated at closer to $10 million. A legal dispute then ensued between the new owner and the previous owners over the value of the business. Despite the apparent windfall the new owner found that much of the stock was dated and of limited value. The moral of the story is to check first.

14.2.8.7 What Is the State of the Company's Other Assets?

In addition to inventory the business is likely to have a variety of other productive assets (e.g. vehicles, office and production machinery) that need to be inspected and valued. If such assets are important to the firm's future earnings potential and appear to be obsolete or worn out the cost of replacing or upgrading should be factored in. Any capital items that are subject to lease agreements should be considered and the terms of such agreements examined to determine what flexibility exists for future management.

14.2.8.8 How Many Staff Will Remain?

If the business is already employing staff it is likely that the firm's capacity to continue earning and generating profits will be crucially dependent on their skills and experience over the short to medium term. In some companies the staff are the most valuable assets. An important question is whether the existing staff will remain loyal to the business or if they are going to leave with a change of ownership. It is unlikely that employees will be unaffected by a change of ownership within a small business and it may take time before they become comfortable with the ways of the new management. Key personnel such as professional sales staff, skilled engineers or production people and perhaps the bookkeeper may decide to leave the company with a change of owners. If so, the business may experience falling sales and loss of productivity until new staff can be hired and trained.

14.2.8.9 What Type of Competition Does the Business Face?

The market environment assessment described above should also include a detailed evaluation of the nature and potential actions of key competitors following a sale. The size of the firm's market share, and the estimated share held by competitors should be considered. If possible, the prospective owner should draw up a list of the strengths and weaknesses of key competitors and make a judgment as to how they are likely to react once word of the business changing hands becomes public knowledge.

14.2.8.10 What Does the Firm's Financial Picture Look Like?

It is desirable before any purchase that the buyer has the firm's accounts examined by their own or an independent accountant. Of crucial importance is the overall profitability of the business. Remember that there is a lot of information that can be hidden in even the best-kept set of books. In addition to the balance sheet, profit and loss and cash flow statements, the prospective purchaser should also seek the company's bank statements, order book and any letters of contract between suppliers or customers. At least a three-year trend should be examined to determine whether the firm has a story to tell. It is also a good idea if feasible to compare the company to similar firms in the same industry. Key performance indicators are:

- *Gross profit margins*. As recalled from Chap. 11 the higher the gross profit margin percentage the easier it will be to generate profits from the same volume of sales. Determining what the gross profit margin is for the business will tell the future buyer whether the company or its products are offering good potential profitability or a lot of hard work to make the same money.
- *Break-even sales*. The sales volume required to make the business reach break-even will provide the prospective buyer with a good indicator as to the risk associated with the business. Examined in conjunction with the gross profit margin it may suggest areas for cost cutting that could have an important determination on which fixed assets are to be purchased and how many staff can be retained.
- *Net profit before tax as a percentage of sales*. A calculation of the firm's net profit before tax (e.g. sales less, total costs) worked out as a percentage of sales

will provide insights into the capacity of the business to generate wealth for its new owner. Small or declining percentages in this area may suggest that the business is unlikely to generate sufficient net profit to support future dividends or growth plans.

- *Retained profit as a percentage of sales*. Another calculation that may be useful is to examine the trend in retained profit or earnings as a percentage of sales. This may reveal the extent to which the current owners have been re-investing in the business or whether they have been using it to fund lifestyles. A large percentage suggests that the owners have been reinvesting.
- *Stock as a percentage of sales*. For businesses that must keep stock a calculation of their stock as a percentage of sales is likely to reveal the overall efficiency with which the firm has been managing its inventory. High levels of stock turn may reflect a more efficient level of activity than low levels. Given that stock is frequently a sponge for cash within a business, low stock turnover could be a warning sign.
- *Debtors and creditors as a percentage of sales*. One of the most important issues for how well a business operates is the efficiency of its cash flows. By determining the level of debtors (accounts receivable) as a percentage of sales turnover, and then the same calculation for creditors (accounts payable) an indication of the efficiency of the firm's cash flow can be obtained. Rising percentage figures in either of these areas may signal problems within the firm's cash flow.
- *Creditor strain as a percentage of sales*. Creditor strain is the amount of unauthorised extra credit that a business takes from suppliers. If it can be determined, the level of creditor strain as a percentage of sales can reveal the extent to which the business has been trading on other people's money. High creditor strain against rising sales may indicate that the firm's growth has been based on shaky foundations

14.2.8.11 How Much Additional Investment Is Needed?

Even though you are buying an established business it is unlikely that the firm will need no new additions, upgrades or repairs. As noted above, worn or obsolete equipment or plant will eventually incur additional costs. These expenses should be factored into the overall purchase price of the deal. Accurate assessments will be useful as a negotiating point when seeking to finalise price.

14.3 Negotiating the Price

Once the prospective buyer has undertaken their due diligence the negotiation over final price can take place prior to settlement. A key question to ask at this stage is how much are you willing to pay for the business? Determining the price to be paid is likely to depend on how the assets of the business are valued. This process can be assisted by undertaking some calculations focusing on the book, estimated replacement and liquidation value of the business, as well as its past earnings and cash flow (Hodgetts & Kuratko, 2001).

As with the purchase of cars or houses the purchase of a small business is a negotiation process and there is the risk in all cases that the final purchase price will be too high. As discussed above there are several questions that the prospective buyer should consider while undertaking their research of the merits of the business. Fixed assets such as buildings, plant and equipment should be fully valued and any additional costs of replacement or repair taken into consideration. Any depreciation should be deducted from the purchase price and if the items are worn or obsolete the liquidation value should be paid. Prepaid expenses such as insurance premiums should be purchased at face value but only in terms of their pro-rata value remaining. Supplies should generally be purchased at the price paid for by the original owner, and *accounts receivable* should be vetted to ensure that any bad and doubtful debtors are removed or have their value reduced.

According to Hodgetts and Kuratko (2001), there is a seven-step process for determining the purchase price for a business (see Table 14.1):

- *Step 1:* Determine the liquidation or market value of all assets and then subtract the debts or liabilities of the business.
- *Step 2:* Determine how much the buyer could earn in other investments such as stocks or property. If the level of risk associated with the business is low the returns could be approximately 10%, but if the business is considered to be a higher risk the figure could rise to approximately 15%–25%.
- *Step 3:* Add the salary of the owner-manager, which should be based on past average earnings. By adding Steps 2 and 3 together the prospective buyer can determine the returns they might expect from both investing the money elsewhere and working.
- *Step 4:* Determine the average net profit before taxes and the average salary the owner could obtain from the business over the immediate future. This is an important calculation, as it requires the owner to consider how long it will take to recoup the investment.

Table 14.1 Determining the purchase price for a business

Steps for the valuation process		
1. Liquidation or market value of all assets less liabilities		$100,000
2. Earning power at 10%	$10,000	
3. Salary for the owner-manager	$15,000	
	$25,000	
4. Average annual earnings before subtracting Steps 2 & 3	$30,000	
5. Extra earning power of business (Step 4 less Step 3)	$5000	
6. Value of intangibles using five-year profits (5 multiplied by Step 5)		$25,000
7.Final price (Step 1 plus Step 6)		**$125,000**

Source: Hodgetts and Kuratko (2001)

- *Step 5:* Subtract the earning power and the salary (Steps 2 & 3) from the average net earnings figure from Step 4. This calculation identifies the 'extra earning power' the buyer will obtain by owning the business.
- *Step 6:* Determine how long the extra earning power will last by using a multiplier of say 5 years (for an established company) and 3 years (for a newer one), and multiplying this by the product of Step 5. This calculation represents the amount the buyer is willing to pay for the goodwill in the business. The older or better established the business, the more the goodwill figure should rise.
- *Step 7:* Determine the final price by adding Steps 1 and 6. This should provide a figure that is equal to the net market value of the assets plus the value of the intangibles.

Hodgetts and Kuratko (2001) suggest that this formula is a useful way to arrive at a fair price when seeking to value intangible assets or goodwill within the firm. They provide the example above where the business has net tangible assets valued at $100,000, and where the estimated earning power from other similar investments is about 10%. The salary of the prospective buyer is $15,000 resulting in a total outside earning potential of $25,000. The estimated average net profit before tax of the business is $30,000 leaving a net extra earning potential of $5000. When multiplied by five (representing 5 years of goodwill) the total is $25,000, which can be then added to the net tangible assets to suggest a final price of $125,000 for the business. It should be noted that where the extra earning power (Step 5) figure is negative there is no goodwill in the business and nothing should be shown for this.

14.4 Negotiating the Deal

In the final analysis all such calculations are only a rough guide and the final purchase price will be agreed as a result of negotiation or bargaining. It is unlikely that the buyer and seller will reach agreement over the purchase price without some negotiating. Just as with the purchase of a house, the vendor is seeking to get the best price, while the buyer is hoping for a bargain. After undertaking a substantial amount of research and due diligence it is likely that the buyer will be eager to buy and conclude the deal. Don't be rushed. The time taken to get the deal struck is worth taking and could mean the difference between paying many thousands of extra dollars for the same business. Being willing to walk away from a deal even after protracted negotiation and due diligence is something that prospective buyers should be prepared to do.

The prospective buyer should consider carefully their alternatives because the party that has more alternative options is less likely to become pressured into a poor decision. The participation in the negotiation by third parties such as business brokers, lawyers and accountants need to be monitored. Any undue pressure from such third parties should be resisted.

14.5 Can You Manage the Business?

An important question that any prospective buyer of an established business must ask is whether they have the management skills and determination to manage the business they will be buying. Not all businesses are the same and most small firms quickly adopt the personality of their original founders. A well-established business that transfers to a new owner-manager will inevitably experience some problems in shifting its culture from one owner to another. The most important impact will probably be on the staff, which will not always find the new owner-manager and their new ways of doing things to their liking. Customers also may find the new management less amenable to their needs and may choose to shift their business.

In deciding whether or not you have the management capacity to run the business it is prudent to spend time working in the firm – at least for a short period of time – with the original owner serving as a mentor and guide. It is frequently possible to reach an agreement during the sale for the original owner to remain on for a short period of time to assist the new owner to settle in. This hand over period can be crucially important to how well you do in the first few months or even year. Sometimes it may be possible to reach an agreement where you try the business before you finally settle the deal, although this is contingent on how quickly the former owner needs the sale. The most important point to remember is that whatever the former owner-manager did, you must determine your own management style and eventually imprint on the business your own personality. For a period of time you may consider that you should manage the business in the same way as the former owner, but once you have built up confidence, don't be afraid to do your own thing.

14.6 Location, Location, Location

A final word on the buying of a business relates to the importance of selecting the right location for the company premises or outlets. While different types of industry place differing levels of importance on location, many small firms have only a single physical site and owner-managers frequently prefer to own this property rather than lease it. A study of 87 Australian small firms undertaken by Kupke and Pearce (1998) found the two most important industrial location factors for owner-managers were being close to the CBD and having direct access to main roads. This finding appears to be similar to those of large firms. In comparison with small firms, which tend to be locally based, large firms are frequently national or international in scale. As a result of their national and international coverage the larger firms tend to be footloose in relation to industrial or commercial land acquisition.

A firm is considered footloose when … it has relatively few constraints and is not tied to specific resources and would have a relatively wide range of choices from which to select a new location (Decker & Crompton, 1993, p. 85).

Jungthirapanich and Benjamin (1995) conducted an extensive review of the literature relating to locating a manufacturing facility in the US from 1975 to 1990. Their study found a hierarchy of eight location factors, starting with market as the most important to community environment as the least important. This is summarised in Table 14.2. Other research, with medium to large firms, identified six factors influencing location selection. These, in order of importance, were:

1. accessibility to the CBD;
2. cost of land;
3. freeway access;
4. proximity to customers;
5. attractiveness of area; and
6. nearness to suppliers.

In a study of the factors influencing the operating location decisions of small firms, Mazzarol and Choo (2003) examined the behaviour of 450 SME owners and an expert panel of 22 industrial and property specialists. This study found significant differences between micro, small, medium and large firms in relation to three issues:

1. *Proximity to customers*. This factor was found to be of more importance to micro and small firms that to medium and large ones.
2. *Proximity to freight terminals*. This factor was also more important amongst the larger firms than the SMEs.
3. *Proximity to the owner's home*. This factor was more important to the SMEs than to their large counterparts.

Table 14.2 Location factor hierarchy

Factor	Metrics
Market	Proximity to markets; local consumers' purchasing power.
Transportation	Land transportation; water transportation; air transportation.
Labour	Availability of general employees; availability of engineering and science employees; labour unionisation; work stoppages.
Site consideration	Cost of land; cost of plant construction.
Raw materials & services	Availability of raw materials; availability of business services.
Utilities	Energy generating capacity; energy cost; fuel availability; water availability.
Government concerns	Federal aid to local government; Government's debt; taxes; state supported employment training.
Community environment	Housing availability; education; health & medical consideration; human services; security; environmental consideration; cost of living; business climate; physical climate.

Source: Jungthirapanich and Benjamin (1995)

The importance of the industrial site being close to the respondent's home was a prominent difference found in the study between the smaller and larger firms, and highlights the personal nature of the selection process and decision-making for the small business. The desire of many large firms to lease rather than buy the land is frequently in contrast to the small firms whose owner-managers view the land purchase as a personal acquisition. Small business owner-managers will be interested in the long-term capital gain of the site if they choose to purchase it, and may place this above such factors as transport route access and logistics costs.

14.7 Packaging for Sale

In seeking to get the best value for a small business when it is time to sell it is important for the owner-manager to prepare their firm and package it for sale. As with any selling process the target customer or buyer needs to be considered, and an appreciation of who they are and what their needs are likely to be. Is the potential buyer looking for a business that can offer them a rapid expansion base and the potential for high returns albeit with high risk, or are they seeking steady returns, and a lifestyle with low risk? For example, successful sellers have normally ensured their systems and processes are documented: they've got job descriptions for everybody, and employment agreements and purchasing processes. They've normally put some performance measures in place so that the purchaser can see how they rank against industry benchmarks.

The current economic and market environment into which the business is to be sold also needs to be assessed. Will competitors threaten the long-term profits that the business might achieve? Knowing something about the requirements of the buyers, and the context in which the business is being sold, can allow the owner to better package the business and thereby get a better price. Having good data on the future trends within the industry or the potential actions of competitors will enable the owner-manager to answer questions and concerns by potential buyers during the negotiating process.

The capitalisation rates associated with the valuation of the small business will also change over time. Planning the sale of the business some years away from when the business is to be actually placed onto the market will therefore require the owner-manager to continuously monitor the changes taking place within their industry and opportunities for their firm to secure competitive advantage.

Seven Ways to Increase the Value of Your Business

Prior to putting a business on the market, attention needs to be given to getting it ready for sale. Attention should focus on the following seven things:

1. Produce credible financial statements
2. Grow a broad base of customers
3. Build the business into an organisation

(continued)

4. Continue to increase sales and profits
5. Develop unique products
6. Try to supply niche markets
7. Have a clear vision and mission

Source: Le Pla (2011).

The preparation of the business for valuation and sale should involve the owner seeking professional advice (Prince, 2006). Just as with private housing where vendors typically receive a superior price following advice from professional real estate agents, the owner-manager who enlists the advice of professionals is likely to get a better price. Among the professionals who may need to be consulted are:

- *the accountant* – to assist with the preparation of the financials and to develop the case to put a valuation on the business.
- *the lawyer* – to assist with any legal contracts.
- *the business broker* – while a business broker is not essential, they can assist in helping to market the business if a word of mouth sale is not available.
- *the business valuation or appraiser* – a specialist appraiser may not be required if the accountant is sufficiently expert. However, if the business is large and complex a valuation specialist may be required.
- *the taxation specialist* – again most accountants are likely to be able to assist here with any taxation issues associated with the purchase. The established firm is likely to have outstanding tax liabilities and to owe PAYG tax instalments for any employees. These issues need specialist consideration to ensure that the buyer is not carrying unnecessary liabilities.
- *the banker or financier* – the purchasing of an established business is likely to require the buyer to raise money in the form of a mortgage or other debt. A banker or mortgage broker is therefore likely to be required.

Not all these professionals are likely to be required in the purchase of a small business. It is generally possible to get a qualified accountant to deal with most of the taxation, valuation and financial management issues. At least three things need to be considered when seeking to package the business for sale. The first is how best to communicate the benefits of the business. The second is when to time the sale. The third is how to develop the brand image of the business to assist in the enhancement of its goodwill.

Selling a Broker to Sell Your Business

The sale of a business is a specialised area. It is advisable to check the business sales experience of the agent carefully. Some questions to ask business agents as you compare services include:

(continued)

- Are they a member of a relevant industry body chapter like, a real estate business broking chapter or a business brokers association?
- How will they assess the value of your business?
- Do they have any experience in selling your type of business?
- For how many years have they been selling businesses?
- What information about your business will they provide to prospective buyers?
- Can they arrange specialist information as required, such as valuations or government and municipal inspections?
- What are their strategies for introducing prospective buyers?
- How often will they provide reports on buyer interest?
- Are the marketing and advertising fees included in the selling fee? (Remember that fees are negotiated.)
- Will there be any other costs?

Sources: Balfour (2017), Ruback and Yudkoff (2017).

14.8 Using a Business Broker to Sell a Business

Earlier we looked at the use of a business broker to help find and buy a business. When selling a business, the decision to use a business broker should also be considered carefully. As with the sale of property, it can be undertaken by the individual vendor without using a real estate agent. However, there are some reasons why using a business broker may be worthwhile (Brown, 2002):

1. You may not know how to properly value the business.
2. The broker may be better able to present the business to the market.
3. A broker may be able to more efficiently find and qualify prospective buyers without risking the impending sale coming to the attention of employees, customers and competitors.
4. Professional business brokers may be able to create a competitive atmosphere in the mind of the buyer by discussing the business within a wider market context.
5. As an agent with a more neutral position the broker may be viewed as more trustworthy in the information they provide to the buyer about the business.
6. The broker is likely to more effectively negotiate the deal and avoid polarisation along rigid opposing lines.
7. The broker may be better placed to arrange financing for the buyer and finalise the legal and related transactions.
8. The broker may also be better able to close the sale.

14.8.1 Communication

Assuming that the business has been properly valued and its market environment and future earnings potential have been assessed, the owner-manager will still need to consider how best to communicate their company's benefits to a future buyer. In doing this the owner should identify a list of the key value criteria or value structure associated with the business. For example, you've got a vendor at one end of the continuum and a purchaser at the other end. In between them is a road, and any roadblock becomes an impediment to the sale. This value criteria may include such things as the balance sheet, tangible assets and components of the firm's goodwill, with reference to such things as the firm's operating location, quality of products, reputation, customer base, skills and expertise of employees and anything else that is deemed to comprise the true value of the business.

14.8.2 Timing

The small business owner should commence preparing for the sale of their business from the moment they buy it or establish it. By deciding on an exit strategy as early as possible, and preparing their business for sale by continuously adding value, they are more likely to be in a good position to secure a premium price for the business at time of sale. A well-developed business with a strong foundation of ongoing investment is similar to a house that has been well maintained and that has a garden that has been carefully tended and cultivated. At time of sale this home is more likely to secure a good price than one that has not been so well looked after.

The actual timing of a sale may not be totally under the control of the owner-manager so it is important that they be always ready to sell if possible. When it does become time to place the business on the market the owner of a small firm should take into consideration market conditions. A seasonal business that has significant fluctuations in its cash flows may require timing to ensure that it is not sold during a downturn. Some types of business have major assets that expire within a specified time period, e.g. a lease on the firm's operating location, hotel licences that require periodic renewal, or when capital equipment is nearing the end of its useful life. These factors might determine the best time to sell.

The impact of technological change should also be considered. If the business is dependent on technology for all or part of its competitiveness, any likely change to the existing technology base may force a significant level of future investment, or might risk loss of market share. These issues should be considered in the ongoing development of the business, but will likely be an issue at time of sale.

14.8.3 Brand Image

One of the most important long-term objectives for a business is to develop a strong brand image for the business and/or its products. A commitment to quality within the business, and a desire to lead by continuous innovation will serve to strengthen the firm's brand equity. However, the level of investment that has been made over the years into marketing and promotion will ultimately determine the brand image. Investment in advertising and promotion is therefore essential if the business is to have a strong brand. This should be based on a well-considered marketing strategy (see Chap. 5) and should ensure that the firm's corporate reputation and the reputation of its products are continuously enhanced and protected. For example, research into the value of intangible assets suggests that corporate reputation and product reputation rank as the first and second most important sources of sustainable competitive advantage according to the chief executive officers of major UK companies. Further, it is estimated that it takes an average of 10 years to build up a corporate reputation and about 5 years for a product's reputation (Hall, 1992, 1993).

14.9 Valuing the Business

As with property or houses, the valuation of a small business is determined in part by the economics of supply and demand, and in part by the negotiation skills of the vendor and buyer. The average small business does not have publicly listed share equity that allows a market valuation to be made of its share capital. Value in the average small firm is typically constituted by:

1. its tangible assets (e.g. fixtures and fittings);
2. property (e.g. buildings and land if sold with the business);
3. work in progress and inventory; and
4. its intangibles or goodwill (e.g. future earnings potential, brand reputation).

Other considerations may be the influence of taxation on the valuation of a business. This can include such things as:

- The nature of the business and its trading history since it was established.
- The industry in which the business is operating and the outlook for this sector and the firm.
- The book value of the stock (inventory), assets and financial condition.
- The future earnings potential of the business.
- The ability of the business to generate dividends for its shareholders.
- The presence and nature of any intangible assets (e.g. goodwill, brand reputation, IP assets).
- The amount of equity held by different existing shareholders.
- The general value of similar businesses within the same industry (Kissin & Zulli, 1988).

Many factors can influence the valuation of a small business, and their relative lack of transparency in the fact that they are privately owned and often engaged in local, niche markets, makes valuation difficult. However, of great importance is cash flow and the potential for future earnings, as this will significantly influence the goodwill value of the business. This is followed by the fair value of any fixed assets such as plant and equipment, office furniture and inventory (Monti, 2016).

Standards of Value

A useful starting point for understanding the process of valuation is to examine the nature of what *value* means. In general terms value can be defined as follows:

Value is, … a fair return or equivalent in goods, services, or money for something exchanged.

In business valuation at least four specific types of value are important:

1. *Fair market value:* refers to the value that a business would change hands between the buyer and the seller if both were willing, and not under any pressure or compulsion to either buy or sell, and where both parties have reasonable knowledge of any relevant facts.
2. *Fair value:* refers to the price that would be received for the business within a given market, under the most advantageous market conditions, but where the buyer and/or seller may not be fully willing or compelled to transact. It is commonly used where a business is sold and minority shareholders are compelled to sell their shares.
3. *Investment value:* refers to the value as perceived by a particular buyer, rather than the general buying population. This is not uncommon within the sale of small businesses, where a buyer is attracted by more personal (e.g. lifestyle) factors rather than more objective financial factors. It is commonly understood as: *how much is this business worth to me?*
4. *Intrinsic value:* refers to the value based on all the facts and circumstances of the business. It is commonly used in valuation of common stock where the list price is considered by analysts as being either lower or higher than the real value of the stock. It can be explained as; *value is in the eye of the beholder*.

Source: Trugman (2008).

14.9.1 Methods of Valuation for a Small Business

Carland and White (1980) outline three methods of valuing a small business: the value of saleable assets method (or book value method); the gross income multiplier method; and the discounted cash flow method. Each of these has its respective strengths and weaknesses. The simplest is the first although it does not always provide the true worth of the business. The third method is much more complex and less used within small business valuations. Each of these three valuation methods is discussed in more detail in the following sub-sections. It should be noted that a business valuation is not the same as the price at which a business is bought or sold.

Establishing a value is not the same as setting a price for the business. That is, the value is the assessment of the worth of the business by whomever is performing the valuation. The price, on the other hand, is the negotiated value agreed upon by the buyer and seller. Very seldom will the price at which the business changes hands be the same as the value determined by the buyer or seller. However, the computed value for the business in question provides a starting point for the selling price negotiations, and as such is certainly worth obtaining (Carland & White, 1980).

14.9.1.1 Book Value Method

The book value or value of saleable assets method is based upon the firm's balance sheet, which ideally should be independently audited prior to the valuation (Carland & White, 1980). In assessing book value, the major issues that need to be considered are the original purchase price, less depreciation, which can be undertaken using several measures. The depreciation methods used to determine book value should be stated in the company accounts. Write-downs of assets such as stock or even equipment can take place and should be outlined in the accounts.

A variation of this method is replacement value where the actual price that the company would have to pay to replace an item at market rates is the replacement value. This is usually much higher in price than the book value and can substantially increase the overall cost of the business. If the economy has experienced significant inflation over time the replacement value will be high. Table 14.3 outlines this method.

In the event that the business is experiencing a crisis and must be sold quickly the most common method is likely to be liquidation value. This is where the estimated worth of the company assets are determined as if they were offered for sale and purchased by knowledgeable buyers. Given that sale under these conditions is likely

Table 14.3 Book value method – example is a retail hardware store

Assets to be transferred:		
Inventory at replacement cost	$87,500	
Accounts receivable at cost	$650	
Equipment at replacement cost	$17,000	
Fixtures at cost	$6000	
Total		*$111,150*
Debt to be assumed:		
Accounts payable	$42,000	
7.5% current		
4.1% 30 days		
88.4% 60 days and over		
Bank loan balance	$48,000	
67 payments @ $818,55 (9%) secured by loan		
Total		*$90,800*
Estimated business value		*$20,350*

Source: Carland and White (1980)

to result in a substantially lower price than desired, this is the lowest overall value to be determined. Perhaps for this reason purchasers prefer this valuation if the firm is going out of business.

14.9.1.2 Gross Income Multiplier Method

This method of valuation assumes that the gross profitability of the business is the most important consideration in the small business. As a result, the gross profit margin (see Chap. 11) becomes the key measure in the valuation. This type of valuation can be particularly useful in the buying or selling of small retail or wholesale operations (Carland & White, 1980). An important consideration in this valuation method is the firm's past earnings. The previous track record of the business in generating profits should be considered when placing a value on the firm and determining final price. Calculations of gross and net profit and retained profits would all assist in such determinations.

Carland and White (1980) note that in retail businesses the stock or inventory is frequently the firm's most significant asset. As a result, this valuation method will need to focus on the value of the stock and the stock turnover ratio. Also, of importance to this method is an accurate estimate of the firm's future sales revenues. Historical records of the firm's past trading performance and industry benchmarks (if available) are also valuable.

In making estimates of future sales when buying an established business, it is important to determine how dependent these sales are on the current owners. For some retail stores this is not an issue, as customers are likely to keep coming to the business regardless of the management due to location or the products sold. Manufacturers are also likely to be less dependent on the owners as sales people, particularly if the business has well established contracts and quality products. However, small businesses that operate in the service sector are likely to be highly dependent on their owner-managers. For example, a professional services firm will be likely to be highly dependent on its principals in the amount of business it secures from its clients (Table 14.4).

14.9.1.3 Discounted Cash Flow Method

The discounted cash flow method of business valuation places its focus not on the gross profit within the business, but on the cash flow that the business can generate. Discounted cash flow or net present value (NPV) is commonly used in capital budgeting within large firms. It recognises that an investment needs to return a positive value in terms of the income generated over a specific time period. A key element in the NPV process is to determine an interest rate or 'discount rate' that is the investor's anticipated rate of return. Any investment needs to generate a positive NPV and this rate of return should ideally be superior to what can be generated from alternative investments.

The discounted cash flow method involves four steps:

1. estimating the expected cash flows;
2. determining an 'appropriate' discount rate;

Table 14.4 Gross income multiplier value method – example is a retail hardware store

Gross sales:		
Year 1 – actual	$166,000	
Year 2 – actual	$171,000	
Current year – annualised	$160,000	
Future year expected sales forecast	$167,000	
Gross profit margin		
Industry average	27%	
Year 2 – average	28%	
Current year – actual	27%	
Future year expected gross margin	27%	
Stock turnover – industry average		(2.7)
Estimated business value (2.7 × $45,000 gross profit)		*$121,700*
Established fixed costs	$28,400	
Rent	$8200	
Insurance	$2000	
Wages (.0015% × $8 million)	$12,000	
Fringes	$1200	
Utilities	$4800	
Proforma contribution margin (to variable expenses and owner's equity)		*$16,600*

Source: Carland and White (1980)

3. determining a 'reasonable' life expectancy for the business; and
4. calculating the value of the business by discounting the estimated cash flows by the 'appropriate' discount rate over the expected life of the business (Carland & White, 1980).

This method is less commonly used to value small firms than the other two methods due to its complexity and the difficulties associated with acquiring the input data. It is a general principle that the higher the overall cash flow through the business the better, however, the application of these funds and the level of profit generated from them should be considered.

There should be a considered analysis undertaken with respect to debtors, creditors and creditor strain as a percentage of sales (see Chap. 7), which should also assist it evaluating the firm's cash flow.

14.9.1.4 Estimating Expected Cash Flows

Where a business has an established track record of trading and operates within a fairly stable industry environment it is obviously going to be easier to estimate future cash flows. For newly established businesses, or those with more volatile trading histories, the accuracy of the cash flow forecasting may be problematic. The firm's profit and loss statements over the previous two or three trading years will be a main starting point for estimating the cash flows. By averaging the growth rates an expected future growth rate can be estimated (Carland & White, 1980).

For example:

$$\left(CF^{2} - CF^{1}\right) \div CF^{1} = g^{1}$$

where:

CF^{1} = first year cash flow

CF^{2} = second year cash flow

g^{1} = growth rate

According to Carland and White (1980) it is accepted practice to assume constant growth. The forecast for future cash flows would involve a calculation where the past year's cash flow is CF°, and next year's anticipated cash flow is:

$$CF^{1} = CF^{\circ}\left(1+g^{1}\right), \text{and } CF^{2} = CF^{1}\left(1+g^{2}\right)$$

Assuming a constant rate of growth:

$$CF^{2} = CF^{1}\left(1+g\right) = CF^{\circ}\left(1+g\right)\left(1+g\right) = CF^{\circ}\left(1+g\right)^{2}$$

Discounted Cash Flow Formula

The formula for the discounted cash flow method is:

$$PV^{\circ} = CF^{1} \div \left(1+R\right) + CF^{2} \div \left(1+R\right)^{2} + \ldots CF^{n} \div \left(1+R\right)^{n}$$

where:

PV° = value of all future cash flows discounted to the present
CF = expected cash flow for a given year
R = the discount rate
N = number of years of the expected life of the business

Source: Carland and White (1980).

14.9.1.5 Determining the Appropriate Discount Rate

After the estimation of future cash flows the second element of the discounted cash flow valuation is to determine an appropriate discount rate or rate of return that the potential investor will be satisfied with. The discount rate assists the investor to identify what part of their investment is principal and what is interest generated from the investment.

For example, a deposit of \$100 into an investment account paying 50% interest after 10 years will generate a return of \$150. Here the discount rate is:

$$0.5 \div (1 + 0.5) = 33.3\%$$

Of the final pay-out of $150, 66.7% is principal and 33.3% is interest.
To determine a discount rate involves using the formula:

$$d = i \div (1 + i)$$

where:

d = discount rate
i = interest rate

Therefore, if an investment into a government bond of $80 over one year will pay $100 the discount rate on this investment will be (100 − 80) ÷ 100 = 20%. Where the interest rate on the cash flow is calculated using 80 as a base the formula is (100 − 80) ÷ 80 = 25%.

The discount rate used in the valuation is likely to depend on the alternative investment opportunities available. If the business being valued can be compared with benchmark data on the industry average, or comparable firms in other industries the opportunity cost of the investment can be assessed. Carland and White (1980) suggest that a useful 'rule of thumb' is to base the discount rate on a benchmark investment, for example by placing the money into a capital guaranteed term deposit over the same time period. If the business is considered to be twice as risky as the term deposit then the discount rate for the business will need to be twice the rate of the capital guaranteed term deposit.

How long the business is to exist into the future is also problematic and in determining this element of the formula it is probably worthwhile for the owner-manager to determine how long they wish to continue running the business prior to their own exit. For example, an owner who decides that they wish to operate a business for 15 years prior to retirement might use this as the time dimension in the formula.

14.9.2 Who Does the Valuation?

According to Trugman (2008) business valuations can be undertaken by a range of professionals. This includes business valuation analysts, accountants, business brokers, commercial real estate agents, bankers and some other experts such as university professors. The first two of these are accredited finance professionals and will offer both expert and objective advice. In the case of the accountant, they will also be able to provide advice on taxation issues relevant to the company and its future structure, write down of assets, and treatment of any profits or losses, dividends and future income generated. Business brokers and real estate agents typically work on behalf of the seller and earn a commission from the sale that is usually a percentage of the final settlement cost. Trugman (2008) cautions that many brokers may be prone to using *rules of thumb* when making a valuation, and might be less expert in some of the more complex types of business valuation methods. He also suggests that commercial real estate agents may not be fully expert in the accounting aspects of financial reporting, and may not be as experienced in the valuation of small businesses. Banks, in particular investment banks, might also provide valuations on a business. However, most are typically used in large scale investment deals rather than for SMEs. Finally, the use of other experts, such as academics, may be possible, but while they may have a good understanding of the theory associated with business valuation, they may lack the necessary industry experience required. In some cases, they apply too complicated processes for small businesses and can confuse the final outcome or even generate an incorrect valuation (Trugman, 2008).

14.10 Problems in Small Business Valuation

The valuation of a small business can be complicated by the lack of reliable financial reporting and record keeping within the business. Few small firms are subject to independent audits of their books. Another problem is the absence of reliable benchmarks that can be used when seeking to make comparisons. Winter (2006) did a study of 267 small businesses that had been sold in South Australia over the period 1997–2005. This sample was taken from both rural and urban businesses using a standard valuation template. He found that most of the valuations were inaccurate and unreliable.

According to Winter (2006) the most common valuation method used is the future maintainable income multiple. The future estimated maintainable income of the business is multiplied by a given multiple (e.g. 2, 2.5, 3, or 4), plus the value of the tangible assets. The size of the multiple used in the calculation is contingent upon the perceived risk associated with the business. A multiple of 1.5 reflects a higher risk than a multiple of 3. Thus, a small business with an estimated future maintainable income (FMI) of \$300,000, with \$75,000 in tangible assets, and with a multiple of 3 would be valued as follows:

$$\text{Value} = \left(\text{FMI} \times 3\right) + \text{tangibles}$$

$$\$975{,}500 = \left(\$300{,}000 \times 3\right) + \$75{,}000$$

While simple, this formula is criticised because it fixes risk and makes earnings the only variable. The concept of fixing risk is bizarre and reflects an inability to measure risk as well as a lack of understanding of risk. Even a simple risk analysis will provide a more accurate outcome than can ever be achieved through the use of formulas (Winter, 2006). Assessing the potential risk of a business for valuation purposes is suggested with at least five risk classes—strong, good, reasonable, difficult, and poor. Each of these will be weighted using a capitalisation rate mid-point. The five risk categories are then formed into two groups, the first encompassing good, reasonable and difficult, and the second strong and poor. Most businesses are likely to fall into the Group 1 categories, while the Group 2 categories are for extreme cases and provide high and low benchmarks for future valuation. Further distinguishing between the five categories with additional risk factors such as dependence on a few customers, changes to technology, and the growth potential of the business is also recommended (Winter, 2006). Table 14.5 illustrates these elements.

The percentages shown in Table 14.5 represent a mid-point capitalisation rate, which is a divisor (usually a percentage) that is used to convert income into value. Capitalisation is therefore the process of converting the cash flows or future earnings of the business into an indicated value (Moss, 2006). The warning provided by this research highlights the need to assess risk within the valuation process rather than relying purely on past performance. While the past performance of a business is a useful guide to future earnings potential the valuation must also consider the capacity of the firm to continue such trading into the future, particularly when under new management. The likely reaction of competitors and also customers or even employees when the business is in new hands needs to be assessed. It is also relevant to consider alternative businesses and even other investments when determining the market value of a small firm.

No amount of care can guarantee that the price paid for a business is absolutely correct. Reasonable care in the exercise of the investigation and valuation of a business are the best insurance of reaching a sound price. Failure to make a thorough search or failure to obtain the advice and assistance of the appropriate professional may be the costliest omissions from an otherwise well-designed business acquisition. But instinct about the people involved and their personal situations are that extra bit of difference that distinguishes really good evaluators from mere number crunchers (Johnson, Lindbeck, & McVea, 1994).

14.11 The Goodwill Factor

Most established businesses will include within their price a value of the intangible assets commonly referred to as goodwill. It is a complex issue but one that frequently determines whether the purchase price is higher or lower (Grant, 1996a). Within the accounting literature the term is generally used to define intangible assets not otherwise covered within the assets of the balance sheet. When a business is sold a value is placed on the goodwill of the company. In this

Table 14.5 Risk classes

Group 1		Group 2	
Good	29.5%	Strong	22%
Reasonable	39.5%	Poor	80%
Difficult	62%		

Source: Winter (2006)

instance goodwill refers to 'the capitalised value of its established reputation and profit potential' (Ma & Mathews, 1979, p. 286).

For most accounting purposes the concept of goodwill appears to have little to do with the firm's reputation. Goodwill appears in a company's accounts 'only when the company has purchased some intangible and valuable economic resource' (Anthony & Reece, 1989, p. 30). As regards its recognition by accountants it usually relates to the identification of intangibles that another party is willing to pay a premium for beyond book value.

Despite this approach it is clear that issues such as reputation *do* have some relevance to goodwill. The willingness of another party to pay a premium for a company's stocks is linked to their appreciation that the company has valuable intangible assets. As noted in the above quotations this can include reputation although it is not exclusively measured by it.

The issue of defining goodwill from an accounting perspective is complex and beyond the scope of this chapter. Within accounting circles, it has been a somewhat controversial issue, primarily because it is about trying to value intangible assets. A generally accepted definition of goodwill has not been identified. In a review of the concept, Seetharaman, Balachandran, and Saravanan (2004) noted that the earliest attempts at finding a definition for goodwill date back to the 1880s, with academic debates appearing in the early 1890s.

Over the past thirty years, accounting standards around the world have sought to define goodwill and also to determine how it should be treated by accountants. In the 1990s, a new approach to defining goodwill emerged known as the 'residuum approach'. Under the residuum approach, goodwill is defined as the difference between the purchase price and the fair market value of an acquired company's asset. Goodwill is a leftover amount that cannot be identified, after a thorough investigation, as any other tangible or intangible asset (Seetharaman et al., 2004).

Definitions of Goodwill

A common attribute of 'goodwill' in most definitions is its measurement of future rather than current value. This is illustrated in such definitions as:

Goodwill – future benefits from unidentifiable assets (Kenley, 1989, p. 204).

Goodwill may be defined as the capitalised value of that portion of future profits which exceeds a normal return on investment…goodwill is measured as the difference between the value of the firm as a going concern and the sum total of the current values of individual net assets (Ma & Mathews, 1979, p. 255).

Under international financial reporting standards, it's defined as the excess of the cost of acquisition over a group's interest in the fair value of the identifiable assets and liabilities of a subsidiary, associate or jointly controlled entity at the date of acquisition (Dogra, 2005).

This debate and the attempts to define goodwill continues. In Australia, goodwill is defined in Australian Accounting Standards (AASB 1013) as the future benefits from unidentifiable assets. It should also be noted that, while goodwill can be officially recorded as an asset within the accounting standards used by Australia, New Zealand, Canada and the US, and amortised over time, this is not the case for all countries (Seetharaman et al., 2004).

According to Leo (1996) goodwill is not an intangible asset under this definition and as such international and Australian definitions appear to disagree. Examples of unidentifiable assets include—market penetration, effective advertising, and good labour relations. It generally does not include intangible assets that are capable of 'being both individually identified and separately recorded, such as patents and licences' (Grant, 1996b).

Only goodwill arising from the acquisition of a business is usually eligible for recognition as an asset. Since January 2005 the amortisation of goodwill within a firm's balance sheet is no longer permitted under international accounting standards (Dogra, 2005). Only goodwill generated from the purchase of a business is recognised for amortisation and goodwill, in the United States, can only be treated via an impairment method[1] over 20–40 years (Siegel, 2002).

An examination of goodwill within the valuation of a business was undertaken by Muller and Supina (2002). They note that a firm's goodwill capital in each year equals its market value in that year less the book value of its total tangible assets and the estimated values of its R&D and advertising stocks (Muller & Supina, 2002).

Their assessment of 450 firms in the US concluded that goodwill was an important and 'very real' asset. However, almost half the firms they surveyed had negative goodwill. This highlights the problems of trying to measure goodwill and intangible assets in general. They point to the possibility that goodwill assets may not actually exist, but may simply be a reflection of the other assets within the business. Expenditure on employee training, brand development and intellectual property are all likely to result in enhanced goodwill within the business. The role of organisational culture was also seen as playing a potentially important role in the firm's goodwill.

Is 'Goodwill' Reputation?

Goodwill arises only as part of a purchase transaction. In most cases, this is a transaction in which one company acquires all the assets of another company for some consideration other than an exchange of common stock. The buying company is willing to pay more than the fair value of the identifiable assets because the acquired company has a strong management team, a favourable reputation in the marketplace, superior production methods, or other unidentifiable intangibles.

Source: Anthony & Reece (1989, p. 241).

[1] Impairment-only method = reduction in company's stated capital.

Despite the many definitions that can be found, the concept of goodwill remains difficult to accurately define. For goodwill to be valuable within a small business there must be evidence that the business has the capacity to make excess earnings in the future, and that it has a competitive advantage that will allow this situation to be maintained in the face of competition (Gomes, 1988). As shown in Fig. 14.1 the capacity for a business to generate goodwill is where it can offer an above average return on assets at a below average risk. In essence the ability of the business to generate profits at a rate greater than the industry average is the firm's goodwill.

According to Gomes (1988), the goodwill that might be paid for a business will depend on the vendor's ability to make a case that the business has this additional value due to it being 'already bundled into a productive operating system'.

Therefore, when deciding on the value of any goodwill the following questions might be asked:

- How long would it take to set up a similar business and the expense and risk associated with such a venture?
- How much additional income is likely to be generated by purchasing the established business as opposed to setting up a new business?
- Does the goodwill value reflect what other similar businesses might charge for their goodwill?

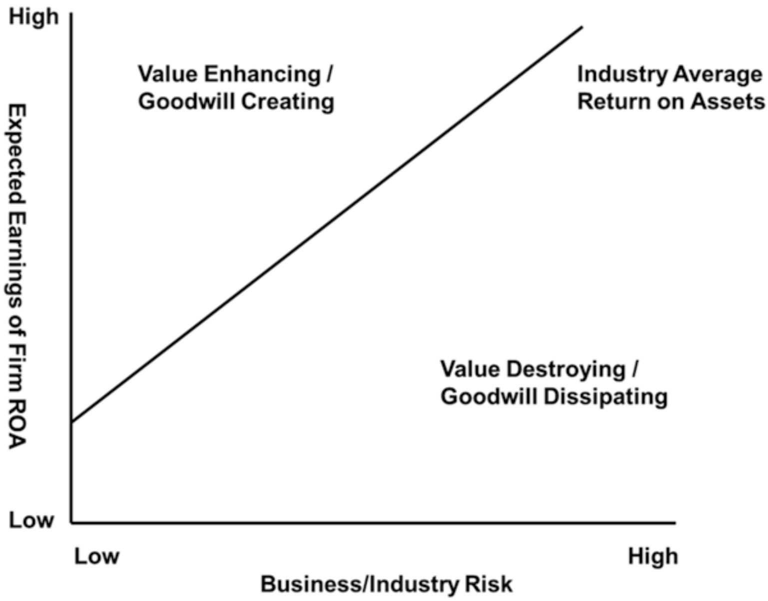

Fig. 14.1 Earnings, business risk and goodwill
Source: Gomes, 1988

14.12 A Holistic Approach to Valuation

The ultimate purpose of undertaking a company valuation is to place a financial value on the business prior to sale or purchase, or the issuing of equity. The final financial value of any business is ultimately what someone is willing to pay for the business in the market place. The valuation methods discussed in the previous sections provide an important framework for undertaking business valuations, but they are only as good as the assumptions upon which they have been based and the quality of the data used in their calculation. While there are many financial models for the valuation of a business, the majority of privately-owned SMEs are difficult to assess with conventional accounting and valuation processes that apply to most publicly listed firms:

> **For example, …** The financial theory based on the public market, as presented in the valuation of the closely held business, is not representative of the "real world"; nor is there any evidence of its usage in actual sales. The only substantiation is the fact that this is the way it was done before (Karsh, 2012 p. 158).

The true value of a small business is determined not just by the figures in its balance sheet, P&L and cash flow forecast, but also a proper review of its management and operating systems, the quality of its products or services, the quality and loyalty of its customer base and the composition and character of its human resources. Other important considerations in determining the value of a small firm are its possession of long-term commercial contracts and leases (e.g. with customers or suppliers, and over property, plant and equipment). The firm's ownership of intellectual property (e.g. trade marks, patents) and the value of these are also important, particularly with manufacturers. With respect to the firm's human capital it is worthwhile considering the skill levels and experience of the employees, and whether there has been regular investment in education and training. Many of these things are intangibles that are often difficult to quantify, but may comprise some of the most valuable assets within the business (Sveiby, 1997).

In essence the true value of a business lies in more than just its financials, although the current measures, which are relatively imperfect, are still the most reliable guide. It needs to be recognised that while a standard valuation method might be used across several different companies, the results can be quite different because not all companies are identical. What is needed is a holistic approach to company valuation. This requires a systematic assessment of all the factors associated with the business, its potential to generate income, the risks associated with it, and the anticipated life cycle over which any assumptions relating to these first two criteria are likely to hold. Getting the best price for a business at sale is likely to depend on how well the small business owner prepares their firm for sale, and how well they can communicate the benefits it has to offer to the buyer.

14.12.1 System or People Dependent

It can be seen from the previous discussion on valuation methods that the most common approaches used in the valuation of small firms are those based on future maintainable income or gross income multipliers. The future earnings potential of a small firm is likely to be highly dependent on many factors. These might include both internal factors such as the quality of products, management systems, personnel and ability to innovate, and external factors like industry trends, competitor behaviour and even government regulation. Also important is how dependent the business is upon people or how dependent it is on systems.

A business is dependent on systems when it can be operated successfully regardless of its ownership, or its employees. Well-designed business format franchises are an example of a predominately systems driven model. These firms maintain fully documented methods for their operations and management that can be replicated with adequate training. The success and survival rates of well designed, systems driven businesses are typically high.

By comparison a business that is dependent on people is one in which the firm's overall value and success is contingent on the presence of its owners or key employees. This can be the case with many professional services businesses where the skills of the principal partners may determine how successful the firm is. As a general rule, businesses that are overly dependent on people are likely to have less value than those that are systems dependent.

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