STUDY GUIDE FOR

MNE3701

Entrepreneurship and Small Business Management

UNISA university of south africa

DEPARTMENT OF APPLIED MANAGEMENT

ENTREPRENEURSHIP AND SMALL BUSINESS MANAGEMENT

Only study guide for MNE3701

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Printed and published by the
University of South Africa,
Muckleneuk, Pretoria.

MNE3701

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WELCOME MESSAGE

Dear Student

It is a great pleasure to welcome you to the module in Entrepreneurship and Small Business Management (MNE3701). I hope that you will find this module interesting, meaningful and enriching. The field of entrepreneurship is extremely dynamic and challenging. The learning units, activities, additional reading and self-assessment questions contained in this online module will give you the opportunity to explore developments in the field of entrepreneurship and help you to complete the module successfully.

All the study material for MNE3701 is available online on the module site. You can download all the study resources from this site. You can also communicate with me and other students by means of the various functionalities of the site. Therefore, it is important for you to visit the site regularly.

Don’t hesitate to contact me by e-mail or to pay me a visit at my office. Should you wish to visit me on campus, please arrange an appointment beforehand (office hours: 08:00–16:00).

My contact details are as follows:

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E-mail: echirosj@unisa.ac.za

I wish you every success in achieving the outcomes of this module.

Your lecturer

Dr SJ Chiromo (PhD)

OVERVIEW OF THE MODULE

This module is divided into three topics, as outlined in table 1.0.

Table 1.0: Module framework

Topic number	Description
1 Developing a new venture business plan	1 Creating a business plan
	2 The marketing plan of a small business
	3 The organisation of a business
	4 The location plan of a small business
	5 Financial statements
	6 Projecting financial requirements
	7 A firm's sources of financing
2 Focusing on the customer: marketing growth strategies	8 Customer relationships
	9 Product and supply chain management
	10 Pricing and credit strategies
	11 Promotional planning
3 Managing growth in a small business	12 Professional management and leadership
	13 Human resource management
	14 Operations management
	15 Managing a firm’s assets
	16 Risk management

MODULE AIM

The primary aim of this module is to help you become an entrepreneur who can compile a comprehensive business plan that is acceptable to all stakeholders and manage a small business successfully. On successful completion of the module, you should be able to compile a business plan for a new venture and to manage the venture in the functional areas of marketing, operations and financial management. You should also be able to manage the growth of a small business.

MODULE OUTCOMES

By the end of this module, you should be able to

- develop a new venture business plan and to present it to investors
- apply small business marketing concepts and principles relating to customer relations, product, pricing, promotion and distribution channel strategies in the market environment

- manage the operations of a small business in an ethically and socially responsible manner with regard to professionalism, human resource management, operations management and computer-based technology
- demonstrate the ability to evaluate a small business's financial performance and to manage its assets
- understand the impact of business risk

LEARNING RESOURCES

Your study package consists of the following items:

- a study guide
- tutorial letters

The study guide

The study guide is a tool to guide you through this module and the prescribed book. I recommend that you read through the study guide to gain an overview of its contents and to familiarise yourself with the sequence and interrelatedness of the various topics. Thereafter, study the different topics in the study guide and the relevant sections in the prescribed book.

The prescribed book

The details of prescribed book for this module are as follows:

Longenecker, JG, Petty, JW, Palich, LE, Hoy, F, Radipere, S & Phillips, M. 2017. *Small business management: launching and growing entrepreneurial ventures.* South African edition. Cengage Learning.

ISBN: 978-1-4737-3448-7

Getting to know the prescribed book

The prescribed book is a learner-friendly tool. Every chapter has additional information to make the theory more practical and comprehensible. You need to apply the practical examples in a South African context (you will find the study guide helpful in this regard). At the end of each chapter, you will find relevant key terms and discussion questions.

Tutorial letters

Tutorial Letter 101

It is critical that you read Tutorial Letter 101 because it contains general information on academic and administrative matters, as well as the assignments and their due dates. It also contains a study plan that you can use as a guideline and timetable for your studies.

Additional tutorial letters

Tutorial letters are the main source of information on events that occur and issues that arise during the year. You should read the tutorial letters immediately; don't file them away with the intension of reading them later. The purpose of the tutorial letters is to provide feedback on assignments and to discuss anything else important that may arise during the study period.

HOW YOU WILL BE ASSESSED

Assessment questions are provided at the end of each topic. The purpose of these questions is to help you test your knowledge and understanding of each section you have studied. Make sure that you can answer these questions because they are the types of questions you can expect in the assignments.

In addition, a number of activities appear in the learning units. Read them carefully and then try to do them. By completing these activities, you will

- be able to activate your creative thinking about a task
- learn to apply the relevant principles or theory to a real-life situation
- learn to verify the validity of the relevant theoretical principles on the basis of a practical experience
- learn to analyse a situation and to draw the necessary information from it to make decisions, to design strategies or to take action
- learn to avoid making the same mistakes others have made

The purpose of studying this module is not simply to memorise facts, concepts or theories – it is to develop a deep understanding of key concepts and to learn how to apply them in real-life situations. To develop your understanding of key concepts, you have to deliberately process the information you read. As you read, you should try to identify the main ideas. You should then think about why they are important and how they are interrelated and reflect upon the implications they have for people in real work environments. You also have to test your understanding of the main ideas by trying to summarise them, explaining them to other people and finding examples of them in real situations.

Testing your understanding

As you work through each learning unit, it is important for you to know whether you understand the ideas it presents. You can test your understanding in several simple ways, such as

- identifying the main ideas in a section and trying to explain them to someone else
- trying to predict what questions you could be asked on the material in a section
- finding examples to illustrate the ideas presented in a section
- answering the assessment questions at the end of each learning unit

If you write down your responses to each of the activities, you will be able to check your answers and reasoning by referring to the prescribed book. This method of self-assessment is one of the most effective ways of mastering the material you need to cover in this module.

Applying your understanding

The best test of your understanding of the ideas that you learn about in this module is to try to apply them to real situations. The first step is to identify examples from your community (local or national) that illustrate the ideas you are studying. You could, for example, develop a business plan for your own business venture.

The assignments

You have to submit **six assignments** to complete this module. All information on the procedure to follow to submit the assignments will be made available on the myUnisa site for the module.

The due dates for the submission of the assignments, as well as the actual assignments, will also be made available on the myUnisa site for the module.

The assignments for the module are essay assignments.

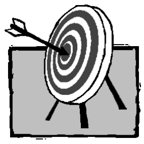
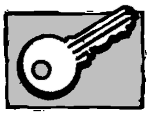
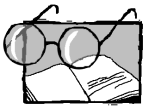
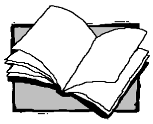
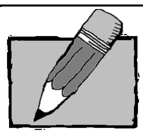
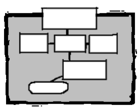
The assignment weighting for the module is 100%.

The examination

In this module, you will be assessed by means of continuous assessment. This means that you are not going to write an examination. All the assignments that you complete and submit throughout the year will contribute towards your final mark. Continuous assessment refers to the ongoing periodic and systematic assessment and evaluation of students during the process of learning with the aid of a variety of assessment methods throughout the tuition period. Continuous assessment is an alternative to a single, final summative assessment (examination), in that a number of assessments contribute cumulatively to a student’s final mark.

ICONS

The following icons are used in this module:

ICON	DESCRIPTION
	**Learning outcomes.** This icon indicates which aspects of a particular topic or learning unit you must master and be able to demonstrate you have mastered.
	**Key concepts.** This icon draws your attention to certain keywords or concepts that you will come across in a topic or learning unit.
	**Study.** This icon indicates which sections of the prescribed book or study guide you need to study and internalise.
	**Read.** This icon will direct you to certain sections of the prescribed book for background information.
	**Activity.** This icon refers to activities that you must do in order to develop a deeper understanding of the learning material.
	**Mind map.** Mind maps are provided to help you see the relationships between various parts of the learning material.
	**Self-assessment.** This icon indicates that you have to test your knowledge, understanding and application of the material you have just studied.
	**Feedback.** This icon indicates that you will receive feedback on your answers to self-assessment activities.

BACKGROUND FOR THE FEASIBILIY STUDY OF A NEW VENTURE BUSINESS PLAN

New ideas, opportunities or products and services have little value unless they are converted into products and services that satisfy the needs and demands of the market to such an extent that entrepreneurs can also make a profit. However, as discussed in the previous module (MNE2601), not all ideas or opportunities and new ventures are necessarily feasible. In other words, not all new ideas or opportunities have the potential to satisfy the market in such a way that the persons who came up with the original ideas can profit. Recent research indicates an extremely high failure rate in the small business sector. Many of these failures are the result of ideas that are simply not feasible. People who fail can be placed in two categories: those who thought but never did and those who did but never thought. For example, it may be a wonderful idea to provide meals on wheels for street children, but street children do not have the money to make the idea feasible. Therefore, conducting a feasibility study can prevent an entrepreneur from wasting valuable resources on an idea that has little chance of success.

Once a feasibility study provides an entrepreneur with enough information to take a rational decision about proceeding with a venture, it is time for him/her to convert the idea into a profitable product or service – that is, to translate the idea into reality by drawing up a business plan. The concept of a business plan and its components were discussed briefly in the previous module (MNE2601). In topic 1 of this module, we will examine the development of a business plan for a new venture in much greater depth.

From feasibility to planning

People start businesses in a variety of ways, for example, by coming up with original ideas, revitalising existing ideas or products, establishing brand-new businesses or inheriting existing businesses. These opportunities arise from changes in the environment and are often referred to as windows of opportunity. As discussed in the previous module, there are many factors that open or close a window of opportunity for an idea. It is therefore of the utmost importance for an entrepreneur to find out whether his/her idea or opportunity is feasible. A feasibility study is not the same as a business plan; it is merely an exercise that helps an entrepreneur to forecast whether an idea will eventually become a successful small business. Once an entrepreneur has assessed the feasibility of an idea, s/he can commit him-/herself to implementing it – in other words, s/he can then start the real planning phase of the venture, namely, compiling a business plan.

Keep in mind that **a feasibility study and a business plan are not the same thing**. A feasibility study is an exercise in which an entrepreneur scans the environment for more information for the purpose of taking a decision on whether to proceed with an idea. Once the entrepreneur has decided to go ahead with the venture, s/he has to plan the activities and resources that will be required. In other words, in order to set the venture in motion, the entrepreneur should write down the tasks to be completed. This activity is referred to as compiling, preparing or drawing up a business plan. More specifically, preparing a business plan involves researching a number of management areas. These areas will be discussed in this module.

The case study method

Several case studies are used in the study guide and prescribed book. A proposed methodology for tackling a case study is suggested below.

Using the case study method

The case study method brings reality into the learning environment. When developed and presented effectively, with rich and interesting detail, case studies keep conceptual discussions grounded in reality.

The case study method can help you to develop your analytical and judgement skills. Case analysis also helps you to learn how to ask the right questions. Those students who are aspiring to be managers and business owners can improve their ability to identify underlying problems, rather than focusing on superficial symptoms, by developing the skills required to ask probing yet appropriate questions. The set of cases in the prescribed book and study guide is designed to expose you to a wide variety of organisations and managerial situations. The case study approach broadens your experience base vicariously and provides insights into many types of situations, tasks and responsibilities. Finally, experience in analysing cases will definitely enhance your problem-solving skills.

Your communication skills will also be honed through the use of the case study method. Of course, these added skills depend on your preparation as well as your lecturer's facilitation of learning. Even so, the primary responsibility for learning is yours. A case discussion generally requires, at a minimum, a thorough mastery of case facts and a certain degree of independent analysis of those facts. The case study method, therefore, first requires you to read and think carefully about a given case. Additional comments about the preparation you should do to discuss a case study successfully appear in the next section.

Student preparation for case study discussion

If you are inexperienced with the case study method, you may need to alter your study habits. In distance education you have the latitude to work through assigned readings and to review lecture notes according to your own schedule. However, an assigned case study requires significant and conscientious preparation before submission of the assignment. Without it, you will be unable to contribute meaningfully to the discussion of the case. Hence, careful reading and thinking about case facts, as well as reasoned analyses and the development of alternative solutions to case problems, are essential. Recommended alternatives should flow logically from core problems identified through a study of the case.

Table 0.1 shows a set of steps that may help you to become familiar with a case, to identify problems and to propose strategic actions that increase the probability that a business will achieve strategic competitiveness and earn above-average returns.

Table 0.1: An effective case analysis process

Step 1	a	In general, determine who, what, how, where and when (that is, the critical facts of the given case).
Gaining familiarity with the case	b c	In detail, identify the places, persons, activities and context(s) of the situation. Recognise the degree of certainty/uncertainty of the acquired information.
Step 2	a	List all indicators (including stated "problems") that something is not as expected or as desired.
Recognising symptoms	b	Ensure that symptoms are not assumed to be the problem (symptoms should lead to the identification of the problem).
Step 3	a	Identify critical statements by major parties (e.g., people, groups, the work unit).
Identifying goals	b	List all goals of the major parties that exist or can be reasonably inferred.
Step 4	a	Decide which ideas, models and theories seem useful.
Conducting an analysis	b c	Apply these conceptual tools to the situation. As new information is revealed, refer back to steps a and b.
Step 5	a	Identify predicaments (goal inconsistencies).
Making a diagnosis	b c	Identify problems (discrepancies between goals and performance). Prioritise predicaments/problems according to timing, importance and so on.
Step 6	a	Specify and prioritise the criteria that will be used to choose action alternatives.
Doing action planning	b c d e f	Discover or invent feasible action alternatives. Examine the probable consequences of action alternatives. Select a course of action. Design an implementation plan/schedule. Create a plan for assessing the course of action to be implemented.

Source: Lundberg and Enz (1993:144)

Step 1: Gaining familiarity with the case

The first step in an effective case analysis process is to familiarise yourself with the facts featured in a given case. Initially, you should grasp the focal business's general situation (e.g., who, what, how, where and when). Thorough familiarisation demands appreciation of both the nuances and the major issues in the case.

Gaining familiarity with a situation requires you to study several situational levels, including the interactions between individuals in groups. Recognising relationships facilitates a more thorough understanding of the specific case situation. It is also vital that you evaluate information on a continuum of certainty. Information that is verifiable by several sources and judged along similar dimensions can be classified as a fact. Information representing someone's perceptual judgement of a particular situation is referred to as an inference. Information gleaned from a situation that is not verifiable is classified as speculation. Finally, information that is independent of verifiable sources and arises through individual or group discussion is an assumption. Obviously, case analysts and decision-makers prefer having access to facts as opposed to inferences, speculations and assumptions.

Personal feelings, judgements and opinions evolve when you are analysing a case. You need to be aware of your own feelings about the case and to evaluate the accuracy of perceived "facts" to ensure that the objectivity of your work is maximised.

Step 2: Recognising symptoms

Recognising symptoms is the second step of an effective case analysis process. A symptom is an indication that something is not as you or someone else thinks it should be. You may be tempted to correct the symptoms of problems instead of searching for true problems. True problems are the conditions or situations that require a solution before a business's performance can improve. Identifying and listing symptoms early in the case analysis process tends to reduce the temptation to label symptoms as problems. The focus of your analysis should be on the actual causes of a problem, rather than on its symptoms. Bear in mind that symptoms are indicators of problems – subsequent work will enable you to discover the critical causes of problems that your case recommendations should address.

Step 3: Identifying goals

The third step of effective case analysis is to identify the goals of the business and/or individuals in a given case. Completing this step successfully may be difficult. Nonetheless, the outcomes you derive from this step are essential for an effective case analysis because identifying goals, intent and mission will help you to clarify the major problems featured in the case and to evaluate alternative solutions to those problems.

Step 4: Conducting an analysis

The fourth step of effective case analysis involves acquiring a systematic understanding of a situation. A superficial or cursory analysis of a case could result from a busy schedule or the difficulty and complexity of the issues described in the case. If you are faced with time pressure, you might believe that you can understand the situation described in a case without a systematic analysis of all the facts. However, experience shows that gaining familiarity with the facts of a case is a necessary but insufficient step towards devising effective solutions. In fact, a cursory analysis typically results in an emphasis on symptoms instead of problems and their causes. To analyse a case effectively, you should be sceptical of quick or easy approaches and answers.

Step 5: Making a diagnosis

The fifth step in effective case analysis is diagnosis, that is, the process of identifying and clarifying the roots of the problems that have been identified in a given case by comparing goals with facts. In this step, it is useful to search for predicaments. Predicaments are situations in which goals do not match the known facts. When you evaluate the actual performance of an organisation or individual, you may identify over- or underachievement (relative to established goals). Single-problem situations are rare.

Effective diagnosis requires you to determine the problems affecting longer-term performance and those requiring immediate handling. Understanding these issues will help you to prioritise problems and predicaments, given the available resources and existing constraints.

Step 6: Doing action planning

The final step of an effective case analysis is known as action planning. Action planning is the process of identifying appropriate alternative actions. Of importance in the action planning step is selecting the criteria you will use to evaluate the alternatives you have identified.

Typically, managers satisfy evaluation criteria when selecting courses of action – in other words, they find acceptable courses of action that meet most of the selected evaluation criteria. A rule of thumb that has proven invaluable to decision-makers is to select an alternative that leaves other plausible alternatives available if the one that has been selected fails.

Once you have selected the best alternative, you must specify an implementation plan. Developing an implementation plan serves as a reality check on the feasibility of your alternatives – hence the importance of giving thoughtful consideration to all issues associated with the implementation of the selected alternatives.

TOPIC 1: DEVELOPING A NEW VENTURE BUSINESS PLAN

INTRODUCTION

Read the document titled "Feasibility study" to learn about the groundwork required for developing a business plan for a venture.

AIM

The aim of this topic is to help you master business planning as an entrepreneurial tool, to increase your understanding of the role of a business plan and to guide you through the process of preparing a business plan. To this end, you will learn

- how to develop a marketing plan for a small business
- how to select a dynamic management team
- how to choose a suitable location for a new venture
- how to plan the facilities of a new venture
- how to interpret financial statements
- how to determine a business's financial requirements
- how to find the right sources of financing for a small business

LEARNING OUTCOMES

Upon completion of this topic, you should be able to

- compile a business plan for a new venture
- prepare to present a business plan to prospective investors
- discuss the role of a business plan by explaining the concept and outlining the resources and preparations that are required
- develop a marketing plan and to estimate market potential
- choose a management team and a legal form of organisation
- select the location of a new venture and to plan the facilities of the venture
- interpret accounting statements
- project the financial requirements of a small business
- follow the process of finding the right sources of financing for a small business

TOPIC CONTENT

This topic consists of seven learning units, as shown in table 0.2 below.

Table 0.2: Topic 1 structure

Learning unit	
1	Creating a business plan
2	The marketing plan of a small business
3	The organisation of a business
4	The location plan of a small business
5	Financial statements
6	Projecting financial requirements
7	A firm's sources of financing

LEARNING UNIT 1

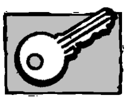
CREATING A BUSINESS PLAN
(Prescribed book: chapter 6 of Longenecker et al 2017)

CONTENTS

**LEARNING UNIT LEARNING OUTCOMES**

Upon completion of this learning unit, you should be able to

- explain what a business plan is
- explain the purpose and objectives of a business plan
- identify and explain all the components of a business plan
- explain what prospective investors look for in a business plan
- identify available sources of assistance in preparing a business plan
- maintain the proper perspective when writing a business plan

**KEY CONCEPTS**

Certain key terms/concepts will be introduced and explored in this unit. Here are a few key concepts you should familiarise yourself with:

- business plan
- dehydrated plan
- comprehensive plan

- executive summary
- product/service plan
- marketing plan
- operations and development plan
- management team
- offering
- exit strategy
- financial plan
- pro forma statements
- business model
- revenue model
- cost structures
- maximum investment

1.1 AN OVERVIEW OF A BUSINESS PLAN

A business plan is a written summary of an entrepreneur's proposed venture that sets out the marketing, operational and financial strategies that will be followed for the venture, the organisational form and management structure of the venture and a schedule or timetable for implementing the venture. Drawing up a business plan requires in-depth research and planning. A business plan serves as a road map that indicates the direction in which an entrepreneur should move in order to achieve his/her objectives. Moreover, a business plan is written proof that an entrepreneur has studied a business opportunity and researched the feasibility of a new venture adequately. There is no substitute for a well-prepared business plan and there are no shortcuts to formulating one.

Petty et al (2012) aptly describe a business plan as an entrepreneur's blueprint for creating a new venture. Longenecker et al (2017) describe a business plan as a document that outlines the basic concept underlying a proposed business and that describes how that concept will be realised. If an entrepreneur does not first mentally visualise the desired end result of a venture, it will not become a physical reality. Anything that is to be built – a house or an enterprise – requires a written plan. A blueprint essentially bridges the gap between an idea and reality. The role of a business plan is to provide a clear visualisation of what an entrepreneur intends to do to make a venture succeed. David Gumpert in Petty et al (2012:166) defines a business plan as a document that convincingly demonstrates that a business can sell enough of its product or service to make a satisfactory profit and to be attractive to potential backers. For an entrepreneur starting a new venture, a business plan is a written document aimed at achieving the following three basic objectives:

(1) The primary objective is to identify and describe the business opportunity or new venture.

(2) The next objective is to present a written plan of how the entrepreneur plans to exploit the opportunity. In this sense, the business plan explains the key variables for the new venture's success or failure: it is a guideline on the actions that should be taken to establish and operate the new venture. It provides many instruments in the form of the mission, goals and objectives, target markets, operating budgets, financial needs and so on that the entrepreneur and managers can use to manage the venture successfully. These instruments, which will help managers to keep the venture on track, form the key components of the business plan. The business plan is therefore also a valuable managerial tool to help the entrepreneur and his/her team focus on charting a course for the new enterprise.

(3) A third objective is to recognise factors that will determine whether the venture will be successful. Careful, thoughtful preparation can make the difference between success and failure when an entrepreneur shops in the capital market.

Apart from the above main objectives, a business plan has many benefits, as highlighted below.

- It is a systematic, realistic evaluation of the new venture's chances of success in the market.
- It helps to pinpoint the key variables that will determine the new venture's success and to identify the primary risks that may lead to failure.
- It is a game plan for managing the business successfully.
- It is a management instrument for measuring actual results against targeted performance.
- It is a primary tool for attracting money in the search for financial resources.

The overall importance of a business plan lies in its planning activities. Planning is the fundamental element of management that predetermines what an entrepreneur proposes to accomplish and how s/he will go about accomplishing it. Planning, and hence the whole idea of a business plan, is certainly not new. Large businesses have been preparing annual business plans for decades, especially for purposes of marketing new products, buying new enterprises or expanding globally. What is new is the increasing use of such plans by small businesses. Often, financial institutions compel small businesses to draw up a business plan before they will even consider offering any financial support. A business plan is also an ongoing planning activity. For example, an entrepreneur may open a small local enterprise and then realise there are opportunities to open additional branches or even to venture abroad.

A business plan may also be a response to some change in the entrepreneurial environment that may lead to new opportunities. However, entrepreneurs should think of planning (the creation of a business plan) as an ongoing process. This means that even if a business successfully survives the first few years, the business plan (which larger corporations refer to as the business or corporate strategy) should be updated continuously.

Learning unit 1 focuses on certain key aspects, such as the need for and the components of a business plan.

 Study pages 165 to 190 in Petty et al (2012).

1.1.1 The purpose of a business plan

A business plan is vital not only for entrepreneurs but also for their employees, potential investors, bankers, suppliers, customers and so on. Each group of "stakeholders/users" of a business plan will study it from a different perspective. Clearly, therefore, any business (especially a new venture) needs to have a business plan to answer any questions that the various stakeholders in the venture may have.

Entrepreneurs compile business plans for different reasons, as indicated below (Bygrave 1997:116; Longenecker et al 2017:146):

- **To convince themselves that starting a business is right for them.** The main stakeholders in any enterprise are its founders. First and foremost, entrepreneurs need to convince themselves that starting an enterprise is right for them – both from a personal and investment perspective.

- **To obtain bank financing.** Until the late 1980s, writing a business plan to obtain bank financing for a new venture was an option left up to the entrepreneur. Bankers usually adopted the approach that a business plan presented a business in a better light, but that it was not an essential component in a bank's decision-making process. However, nowadays, banks require entrepreneurs to include a written business plan with any request for loan funds. Hence, securing a bank loan is tougher than it has ever been, and a business plan is an essential component of any campaign to convince a bank of the viability of a new enterprise.

- **To obtain investment funds.** For many years now, a business plan has been the "ticket of admission" to venture capital or "informal capital" from private investors.

- **To arrange strategic alliances.** Joint research, marketing and other efforts between small and large enterprises have become increasingly common in recent years and all require a business plan.

- **To obtain large contracts.** When small enterprises seek substantial orders or ongoing service contracts from major enterprises, the large corporations often respond (somewhat arrogantly): "Everyone knows who we are but no one knows who you are. How do we know you'll be around in three or five years to provide the parts or service we might need to maintain your product?" It is at this point in the conversation that entrepreneurs can produce their business plans.

- **To attract key employees.** One of the major obstacles to attracting key employees that a small, growing enterprise faces is finding the best people to take the necessary risk. The enterprise's business plan could attract key employees and convince them that the enterprise will thrive and grow in the coming years.

- **To complete mergers and acquisitions.** No matter which side of the merger process one is on, a business plan can be invaluable if one wishes to sell one's enterprise to a large corporation.

- **To motivate and focus management teams.** As smaller enterprises grow and become more complex, a business plan becomes an important component in keeping everyone focused on the same goals.

Sources: Bygrave (1997:116) and Longenecker et al (2017:146)

Now that we have explored the purpose of a business plan, we need to ask the following question: What exactly is a business plan?

Petty et al (2012:149–152), in answering this question,

- provide a definition of a business plan
- explain the basic objectives of a business plan
- explain the role of a business plan as a game plan
- describe a business plan as a blueprint that bridges the gap between an idea and reality
- note that developing a business plan is an ongoing process
- note that a business plan is a work in progress and never a final product

Starting and establishing a new venture is no longer based on a "gut feeling", as in the past. Entrepreneurship and the entrepreneurial process have become a science. Longenecker et al (2017:146) mention two reasons for drafting a business plan, namely,

(1) for internal stakeholders, to serve as a basis of reducing the risk of failure
(2) to attract finance

The success of any new venture in the South African macroenvironment and market environment requires adequate planning, as well as the optimal combination of factors of production. Owing to the cost of capital and limited opportunities to obtain capital, an entrepreneur might have only one chance to obtain it, thus further emphasising the fundamental need for a proper business plan.

We now need to ask the following question: Who are the users of a business plan?

Exhibit 6-1 in Longenecker et al (2017:147) indicates that the users of a business plan can be divided into the following two groups:

(1) Insiders, comprising

- the entrepreneur
- the management team
- employees

(2) Outsiders, comprising

- potential customers
- suppliers
- investors
- lenders

1.1.2 Does an entrepreneur really need a business plan?

What is important is not *writing* a plan but *implementing* it. Three benefits of a business plan are highlighted in Longenecker et al (2017:146–147).

1.1.3 How much planning is required?

When it comes to the amount of planning required, Longenecker et al (2017:146) describe two types of business plans that are used for different purposes, namely,

- a short dehydrated plan, which is an abbreviated business plan that presents only the most important issues
- a comprehensive plan, which is a complete business plan that provides an in-depth analysis of the critical factors that will determine a business's success or failure, along with all the underlying assumptions

1.2 PREPARING A BUSINESS PLAN

Every entrepreneur needs to realise that a business plan for a new venture should be tailor-made in order to emphasise the venture's particular strengths. The following two elements are of primary concern in preparing a business plan:

(1) the content and format of the business plan
(2) the effectiveness of the written presentation

A brilliant business idea could fail if the business plan is not properly compiled. Effective written communication should be built into a business plan in order to satisfy the needs of the audience or readers' users.

1.2.1 The content and format of a business plan

Every venture will have its own, unique business plan. Even though there is no standard list of components to be included in a business plan, there is some degree of agreement on the content of such a plan, especially in the domain of financing. The main factors that play a role in determining the content of any business plan are the entrepreneurial team, the resources, the deal structure and "big picture", and the way in which the plan reflects the opportunity to which it relates.

Longenecker et al (2017:155) describe the basic interdependent factors that should be considered in the evaluation of an opportunity and represent them diagrammatically in exhibit 6-3, "The key factors for success".

Longenecker et al (2017:156) explain various components of a business plan and represent them diagrammatically in exhibit 6-4, "Abbreviated business plan outline". According to Longenecker et al (2017:156), a business plan should contain the following elements:

- a cover page
- a table of contents
- an executive summary
- an industry, target customer and competitor analysis
- a description of the company
- a product/service plan
- a marketing plan
- an operations and development plan
- a management plan
- critical risks
- an offering
- an exit strategy
- a financial plan
- an appendix of supporting documents

Read exhibit 6-5, "Table of contents for Cape Wine Adventures business plan" (Longenecker et al 2017:157) and exhibit 6-6, "Cape Wine Adventures overview" (Longenecker et al 2017:159).

Study pages 160 to 163 in Longenecker et al (2017). This section is critical since it discusses the components of a business plan.

1.2.2 Advice for writing a business plan

Study pages 163 to 166 in Longenecker et al (2017). A good concept may be destroyed by a presentation that fails to communicate the intended message effectively. The authors make six recommendations for avoiding some of the common mistakes that entrepreneurs make when writing a business plan:

- Analyse the market thoroughly.
- Provide solid evidence for claims.
- Think like an investor.
- Don't hide weaknesses – identify potential fatal flaws.
- Maintain confidentiality.
- Pay attention to detail.

Read "Living the dream – entrepreneurial experiences: Gwen and Thabo believe in writing a business plan" in Longenecker et al (2017:163).

1.2.3 The business model of a new venture

 Study pages 151 to 155 in Longenecker et al (2017).

The concept of a business model has become popular among entrepreneurs and their investors. A business model is intended to provide the best evidence of whether a business concept can be translated into a viable, profitable business and how large an investment will be required to make it happen. Exhibit 6-2 shows a basic business model framework. Three key elements make up the business model of a company – they are

(1) a revenue model, which defines the nature and types of the company's resources
(2) the cost structures that drive the company's costs and expenses
(3) the maximum investment that will be required to make the business profitable and the cash flows positive

1.3 RESOURCES FOR BUSINESS PLAN PREPARATION

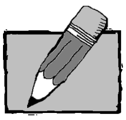
Writing a business plan nowadays does not have to be such an individual process because there are various resources that provide specific guidelines on the whole development process. However, it is advisable not to copy and adapt an existing business plan from another business.

The following resources can assist entrepreneurs in developing their own business plans:

- computer-aided business planning (e.g., Bizplan Builder and Bizplan Express)
- professional assistance in business planning (e.g., attorneys, marketing specialists, engineering and production specialists, accounting firms, incubators and academics in the field)

1.4 KEEPING THE RIGHT PERSPECTIVE

Writing a business plan is an ongoing process and not a means to an end.



ACTIVITY 1.1: Individual activity

(1) Name and describe various South African resources that could help you, as an entrepreneur, to compile a proper business plan.
(2) Analyse the business plan of Adgrove.com Inc provided below and then answer the questions that follow.

Raising capital for an adfomediary

Amy George is founding AdGrove.com Inc to assist businesses in their efforts to purchase advertising. However, launching the business will require significant capital, an amount far beyond her capabilities. Amy has prepared a business plan for purposes of raising the needed capital. The executive summary of the business plan is provided below.

AdGrove.com Inc: executive summary

Buying and creating advertising in any media is a time-intensive process reflecting hours of transactions between buyers, sellers and creative agents. If, for example, a buyer wants to advertise in the radio media, s/he targets a few radio stations with desired listener demographics, discusses contract options with a radio account executive, bids on an ad schedule, negotiates a price, creates ad copy, approves the final ad and pays for the service. For a skilled buyer, this entire transaction can take up to three weeks to complete. For a local deli or sporting goods shop with little or no demographic information, small purchasing power and less familiarity with radio advertising, this transaction process could take more than three weeks and cost the small business more money per ad than it would cost a large ad agency. For the seller, in this case the radio stations, the transaction costs of dealing with such small customers can prove to be cost ineffective.

AdGrove.com is an internet advertising infomediary ("adfomediary") that provides a one-stop shop for demographic information, ad rates, ad campaign schedule planning, ad buys and creative development, reducing transaction time and costs for buyers and sellers of advertising spots.

The company

AdGrove.com Inc ("the company") is a C corporation located in Austin, Texas. The company is located on the internet at www.AdGrove.com and is the first adfomediary dedicated to the needs of small businesses.

Products and services

AdGrove.com's featured product will be a user-friendly internet website that provides free and fee-based services to meet the needs of its customers – advertising buyers and sellers. The company's first product line will be dedicated to reaching the highly fragmented buyers and sellers of advertising space in the radio advertising sector. Qualified buyers and sellers are invited to join AdGrove.com's community as members. Membership is free and provides users with access to valuable customised services. Selling members receive an opportunity to list ads and gain access to the buying community. Buyers receive access to up-to-the-minute aggregated radio market information, ad campaign planning tools, creative services, ad space, buying discounts, monitoring services and account management. AdGrove.com's information-rich services reduce a buyer's time while enabling the development of a cost-effective advertising strategy. In addition, AdGrove.com buyers receive unique buying discounts, usually reserved for major ad agencies and companies, and an opportunity to participate in discounted "overcapacity" ads. Adgrove.com serves as a third sales channel for radio stations, complementing their national and local sales efforts. Unlike traditional sales methods, the internet offers radio stations access to a national market and 24-hour selling power. AdGrove.com provides radio station members with a listing and brokerage service, access to customers, online web advertising and monthly value reports. These monthly AdGrove.com value reports include buyer profiles, competitive analysis, market analysis and savings calculated.

Market and opportunity

AdGrove.com represents the intersection of two growing US markets: advertising and business-to-business electronic commerce. The advertising industry represents a $190 billion industry and is expected to grow at compound annual growth of 5,7%. The radio advertising market is a $17,7 billion sector represented by more than 12 275 radio stations in 268 major markets. Approximately 75% of radio advertising is purchased at the local level. Although there has been consolidation in the radio industry since the promulgation of the Telecommunications Act of 1996, the industry is still highly fragmented and growing at an annual rate of 8,5%. In addition, radio stations have generally been slow to adopt internet strategies. Business-to-business e-commerce revenues for 1998 were $17 billion and are projected to grow to $1,7 trillion by 2003. It is projected that by the year 2002, almost one-third of all business-to-business transactions will be performed via e-commerce.

Customers: As an intermediary agent, AdGrove.com has two primary customers, namely, radio stations and small business advertisers. AdGrove.com will target the top 4 000 radio stations, which represent 80% of the industry revenues. AdGrove.com will target small, high-growth businesses as its primary market. In the US, there are currently 24 million small businesses with approximately 885 000 new firms each year. These businesses represent 47% of all sales in the US. According to research, approximately 41% of small businesses are online and one in three conducts business transactions on the internet. Each of these firms represents an average of $3,79 million annual revenues, significantly more than the $2,72 million average.

Competitors: BuyMedia.com and AdOutlet.com are websites that have launched within the last 18 months that connect buyers and sellers of radio advertising space. However, AdGrove.com is the only website with customised services and a pricing model to meet the needs of small businesses. In so doing, AdGrove.com will expand the current advertising market.

Marketing strategy

AdGrove.com's marketing efforts are centred on strategic partnerships, an educational advertising and public relations campaign and a regional sales force. AdGrove.com will forge a strategic partnership with the Radio Advertising Bureau, the national association that represents 4 300 radio stations and 80% of US radio advertising revenues. AdGrove.com will forge an alliance with the US Chamber of Commerce, the world's largest business federation, which represents nearly three million companies, 96% of which are small businesses. AdGrove.com's marketing campaign will focus on driving volume to the website and converting visitors to buyers.

The start-up plan

AdGrove.com will follow a three-phase start-up plan. During the first phase, the AdGrove.com team will create a demonstration site, refine the product and service mix and conduct alpha testing among focus groups of buyers and sellers. During the second phase, AdGrove.com hopes to raise the required venture funding of $2 million to launch the site. The funds will be used to finalise the development of an integrated website; to negotiate strategic alliances and radio station partnership agreements; to launch a marketing and sales plan; and to launch the website in Austin, Texas. To meet the objectives of the first two phases, AdGrove.com will incrementally hire 16 additional staff and outsource the initial development of the website. The third phase will include a launch in 10 cities, including San Francisco, Atlanta, Washington, Seattle, Minneapolis, Boston, New York, Chicago and Miami.

Management

AdGrove.com's management team has extensive experience in the marketing, internet and high-tech sectors. Amy George, Chief Executive Officer, has seven years of professional experience in the field of marketing for small businesses and national clients in the telecommunication, real estate, multimedia and education industries. Alex Krishnan, Chief Operating Officer, has five years of experience in the high-tech industry in the areas of internet strategy, programme management, software design and development. Brink Melton, Chief Technology Officer, has three years' experience as a software developer and technology consultant. He has experience in launching a successful technology consulting partnership dedicated to serving the needs of small businesses in Austin, Texas. He is currently pursuing his MBA at the University of Texas, concentrating on information management and entrepreneurship. AdGrove.com's team of consultants are experts in the small business, radio, advertising, high-tech and internet start-up fields.

Financial overview

AdGrove.com's five-year financials are displayed in exhibit C6-1. The company derives its primary revenue from the following sources:

- Transaction fees for brokering the sale of radio advertising spots – this is the primary revenue stream, and the fee collected will be 5% of each transaction
- Fees for value-added market research information provided to buyers
- Advertisements and paid promotions

Because of the high investment needs in year 1 and year 2, the company will not achieve profitability until year 3. By year 5, revenues will grow to $26,9 million with a net income of $8,9 million. The company is seeking $2 million in first-round financing with a return on investment for investors of 70%.

Exhibit C6-1: Financial summary and operating statistics

Key operating statistics	Year 1	Year 2	Year 3	Year 4	Year 5
Employees	27	57	78	86	98
Financial statistics					
Revenue	$53 700	$2 625 000	$12 770 000	$19 200 000	$26 900 000
Expenses	$4 130 597	$8 029 597	$10 699 663	$14 315 827	$18 003 609
Net income	-$4 076 897	-$5 404 597	$2 070 337	$4 884 174	$8 896 391

Business plan example adapted from: http://www.businessplans.org/AdGrove/adgro00.html

Questions

(1) Does the above executive summary meet **all** the requirements? Discuss its strengths and weaknesses.

(2) Suggest possible improvements to the plan.

FEEDBACK

The following are possible answers to questions (1) and (2):

(1) The summary covers the primary issues of interest to an investor, namely, the opportunity, the critical resources, the management team, the proposed financing and the context of the investment. The two-page summary gives you a basic idea of the experience of the management team and the nature of the market. Hence it is fundamentally sound.

The strengths of the summary are as follows:

- The customers are identifiable in the sense that they provide recurring revenues.
- The competition is imperfect and fragmented.
- There is a large growing market.
- The summary acknowledges the need for the investors to earn a return on their investment, promising them a 70% rate of return.
- The management team appears to be satisfactory but not outstanding.

The weaknesses of the summary are as follows:

- It recognises possible resistance to change by radio stations, but there is no indication of how this resistance would be overcome.
- The competition is identified, but there is no compelling statement on AdGrove's competitive advantage, other than the statement that the firm will provide "customised services", which is not convincing.
- The success of the venture will rely heavily on AdGrove's ability to develop strategic relationships with the US Radio Advertising Bureau and the US Chamber of Commerce.
- The team is incomplete because there is no dedicated financial officer.

(2) The following changes would be required:

- The plan should state more clearly how AdGrove would be able to compete against established competitors and overcome the resistance to change that would be faced when trying to persuade radio stations to do business differently.
- The inadequacies in the current management team need to be recognised and a plan formulated to resolve the problems.
- The plan should explain what has been done to develop critical strategic relationships in the industry.

SELF-ASSESSMENT

(1) Explain what entrepreneurs mean when they talk about compiling a business plan.
(2) Describe each of the components of a business plan.
(3) When is it necessary to write a business plan? In what situations is a plan not required?
(4) Explain the two types of business plans. In what situation(s) would you use each type of plan?
(5) In what way could a business plan help with the recruitment of key management personnel?
(6) In what respect could an entrepreneur's perspective differ from potential investors' perspective in relation to a business plan?
(7) Do you think a sophisticated investor would really be able to make a decision on the strength of a five-minute perusal of a business plan?
(8) Investors are said to be more market-oriented than product-oriented. Explain this statement. What is the logic behind this orientation?
(9) What are the advantages of using a computer to compile the narrative sections of a business plan and to compile a financial plan?
(10) Describe the mistakes that entrepreneurs sometimes make in relation to writing a business plan.
(11) If the income statement of a financial plan shows that the business will be profitable, why is it necessary to provide a cash-flow statement?

Answers to self-assessment questions

(1) There is no one "correct" definition of a business plan, just as one plan does not work in all situations. In general, however, a business plan is a written document that outlines the basic idea underlying a business and related start-up considerations. A business plan is an entrepreneur's game plan – it crystallises the dreams and hopes that motivate him/her to take the plunge and start a business. A business plan for a new venture should state the basic idea for the venture, describe where the entrepreneur is now, indicate where s/he plans to go and outline how s/he intends getting there. It can also be defined as a document that convincingly demonstrates that a business will be able to sell enough of its product or service to make a satisfactory profit and to be attractive to potential backers.

(2) The components of a business plan are described in Longenecker et al (2017:157–162).

(3) A written plan helps to ensure systematic coverage of the main factors to be considered in starting a new business. By identifying the variables that could affect the success or failure of the business, the business plan becomes a model that helps the entrepreneur and any employees to focus on important issues and activities for the new venture.

In addition, a business plan is essential when additional capital from outside investors will be needed at some time in the foreseeable future.

In some start-up situations, the environment is simply too turbulent for extensive planning to be beneficial. In other situations, there may be too little information on which to base an acceptable business plan, in which case adaptability may be more important than a careful plan for the future. It would be extremely unwise to show unwillingness to adapt if and when necessary. Sometimes, investors become so focused on the "plan" that they insist that the entrepreneur not deviate from it. Planning may also pose a problem when the timing of the opportunity is a critical factor. Becoming operational as quickly as possible may have to take priority over in-depth planning. However, timing should never be used as an excuse not to plan.

(4) The two types of business plans are a dehydrated plan and a comprehensive plan. A dehydrated plan is an abbreviated business plan that presents only the most important issues and plans for a business. It focuses mainly on market issues such as pricing, competition and distribution channels. It provides little in the way of supporting information. A dehydrated plan is adequate if large amounts of outside financing are not required. A dehydrated plan can determine when to gauge investor interest to see if a full-length plan is worth the time and effort.

When entrepreneurs and investors speak of a business plan, they usually refer to a comprehensive or full business plan that provides an in-depth analysis of the critical factors that will determine a firm's success or failure, along with all the underlying assumptions. Such a plan is useful for

- describing a new opportunity (start-up)
- making provision for significant changes in the business or external environment (e.g., changing demographics, new legislation or developing industry trends)
- explaining a complex business situation

(5) A well-developed business plan indicates the types of professional and managerial skills that are required for a venture. Such a plan would make a favourable impression on potential employees with regard to the professional calibre of management and the prospect of success.

(6) Entrepreneurs and investors have totally different interests. An entrepreneur would be willing to accept risk in an effort to establish an enterprise because of its potential for success. Given his/her personal involvement with the venture, s/he should have no trouble viewing the business plan with optimism. By contrast, potential investors would be more sensitive to the enterprise's potential for failure and would therefore be more cautious in their evaluation of the business plan. It is vital for the entrepreneur to anticipate this difference in perspective so that the business plan is written with potential investors' likely reactions in mind. If potential investors' perspective is factored into the business plan, it is more likely to attract outside capital.

(7) A five-minute perusal of a business plan would serve as a first screening step. A potential investor would not invest in an enterprise without a more thorough analysis of projects that look promising. An investor could make a serious mistake and throw away a promising opportunity by failing to make a detailed study of a business plan.

(8) This basically means that investors' main concern is market acceptance and demand. A new product may be clever and even patentable but not useful or attractive to customers. Investors are interested in products and services that will sell.

(9) Using a computer simplifies the revision of the narrative text of a business plan. An initial draft can easily be revised a number of times without retyping the whole thing. Since parts of a financial plan are interwoven, a change in one part will affect the entire plan. Using a computer enables you to do all of this electronically.

(10) Entrepreneurs sometimes make the following mistakes when writing a business plan:

- There is no clear plan to indicate progress. Too often, entrepreneurs make broad, unsubstantiated statements without reliable and solid data to support them. Prospective investors need facts to support every statement made and every figure included in projections. Vague ideas and rambling statements simply do not work.
- Some entrepreneurs fail to describe their product or service in laypeople's terms. There is a temptation to use too much industry jargon. The product or service should be described in simple, comprehensible terms.
- There is a lack of market and competitor research. Everyone has competitors, and to state that "we have no competition" is a recipe for disaster. It is necessary to show where a business will fit into the market and to include details of the competitors' strengths and weaknesses. If possible, estimates of their market shares and profit levels should also be included.
- The financial statements provided are sometimes either too detailed or too

flimsy. Entrepreneurs tend to err either by providing incomplete financial statements or including page after page of monotonous financial data. Either extreme is unacceptable. All of the following should be provided: pro forma income statements, balance sheets and cash flow statements, together with a complete list of the assumptions underlying the financial facts. Most importantly, the figures should make sense.

- Some business plans try to hide possible weaknesses. This is one of the more difficult aspects of writing a business plan – and there is no doubt that every business has weaknesses. While an entrepreneur wishes to make a good impression, ignoring or glossing over a negative issue could prove damaging and even fatal when trying to raise capital. If there are weaknesses in a plan, prospective investors will find them. At that point, a prospective investor's next question will probably be: "What else haven't you told me?" The best way to handle problems and weaknesses is to be open and straightforward and to have an action plan that effectively addresses any problems. In other words, integrity can save the day.
- Some entrepreneurs fail to see the fatal flaws that most opportunities invariably have. It is tempting for an entrepreneur to become so infatuated with an opportunity that s/he overlooks such flaws. For instance, one might need to ask: "What is the possible impact of new technology, e-commerce or changes in consumer demand on the proposed venture?"
- Nothing puts off a prospective investor more than a poorly written business plan – hence the need to find a competent editor, and review, review, review!
- The bottom line is not to write a long business plan but an excellent one. People who read business plans appreciate brevity and view this as an indication of an entrepreneur's ability to identify and logically describe the important factors that will determine the success of the proposed business.

(11) This question focuses on the difference between the two financial statements. A potentially profitable business may run into difficulties because of cash-flow irregularities. Growth in inventories or accounts receivable, for example, may soak up all the profits and require additional funds. Also, there may be a delay in collecting accounts receivable, leading to a delay in realising profits in the form of cash.

SUMMARY

In this learning unit you were introduced to the role of a business plan in the entrepreneurial process. The fundamental importance of a business plan was highlighted, and the internal and external users of a business plan were explained. The basic content of a business plan and the resources that an entrepreneur can enlist to draft a proper business plan were outlined. The next learning unit deals with the development of a marketing plan.

LEARNING UNIT 2

THE MARKETING PLAN OF A SMALL BUSINESS
(Prescribed book: chapter 7 of Longenecker et al 2017, pages 175–193)

CONTENTS

INTRODUCTION

This is the second learning unit of topic 1, as shown in table 0.2 below.

Table 0.2: Topic 1 structure

Learning unit	
1	Creating a business plan
2	**The marketing plan of a small business**
3	The organisation of a business
4	The location plan of a small business
5	Financial statements
6	Projecting financial requirements
7	A firm's sources of financing

LEARNING UNIT LEARNING OUTCOMES

Upon completion of this learning unit, you should be able to

- describe small business marketing
- identify and analyse the components of a formal marketing plan
- discuss the nature of the marketing research process
- define market segmentation and its related strategies
- explain the different methods of forecasting sales

KEY CONCEPTS

- small business marketing
- market analysis
- marketing mix
- customer profile
- marketing research
- secondary data
- primary data
- market
- market segmentation
- segmentation variables
- benefit variables
- demographic variables
- unsegmented strategy (mass marketing)
- multi-segment strategy
- single-segment strategy
- sales forecast
- breakdown process (chain ratio method)
- build-up process
- direct forecasting
- indirect forecasting

OVERVIEW

Certain activities that form the basis of a business may occur simultaneously. In the previous learning unit, we discussed the structure and content of a business plan. Strictly speaking, a business plan can only be finalised once a market analysis has been conducted in order to determine whether there is, in fact, a market for the product or service in question. If there is, how can the market be exploited? In other words, once an entrepreneur is convinced of a significant market potential in a particular segment of the market, how will the product or service reach the market, or what marketing strategy will be adopted?

An entrepreneur runs the risk of becoming infatuated with his/her product or service and simply believing or hoping that there is a market for it. This euphoria can be extremely costly, if not devastating, for a new venture with limited resources. Analysing a new venture's market and developing a marketing strategy involve a great deal more than simply writing one's ideas down on paper.

Study Longenecker et al (2017:175–193).

Read “In the spotlight – SNAPnSAVE” in Longenecker et al (2017:176).

2.1 WHAT IS SMALL BUSINESS MARKETING?

Small business marketing can be seen as a window that links an entrepreneurial venture with a customer or group of customers. Marketing therefore consists of business activities that are directly related to

- identifying a target market
- determining the target market's potential
- preparing, communicating and delivering a bundle of satisfaction to the target market

A restaurant, for example, not only sells food to its target market; indirectly, it also sells atmosphere as part of the bundle of satisfaction.

Note that market segmentation, marketing research and sales forecasting are integral parts of a market analysis. Product, pricing, promotion and distribution activities form part of a firm's marketing mix (the 4 Ps of marketing). Exhibit 7-1 in Longenecker et al (2017:179) shows the three levels of a product and/or service.

2.1.1 Marketing philosophies make a difference

An entrepreneur should indicate his/her marketing philosophy. The following three basic marketing philosophies have developed over time:

(1) a product orientation (the focus is on the product)
(2) a sales orientation (the emphasis is on personal selling and advertising)
(3) a consumer/customer orientation (the needs of customers are placed first)

2.1.2 A consumer orientation: the right choice

Any small business without a consumer orientation will definitely not even survive the initial phases of the start-up process. Longenecker et al (2017:178) highlight three reasons why small businesses fail:

(1) Small business managers tend to focus on production during the early stages while there is no competition and demand is high.
(2) Small business managers may be strong in production or selling but weak in other areas.
(3) Small business owners are simply too focused on the present.

The service quality levels in South Africa are deemed to be relatively low in certain sectors. A focus on customer needs will give an entrepreneur a competitive edge, without any major expenses to the company as such. How much does it cost a salesperson to be friendly?

2.2 A FORMAL MARKETING PLAN

The completion of a final market analysis will enable an entrepreneur to draft an accurate marketing plan. Exhibits 7-2, 7-3 and 7-4 in Longenecker et al (2017:190–191) show the major elements that should be included in a marketing plan.

2.2.1 Market analysis

A market analysis should contain the following elements (the example relates to the market for quality clothing):

- a customer profile (e.g., females between the ages of 18 and 25)
- the major customer benefits (e.g., quality material in clothing)
- additional target markets (e.g., males between the ages of 18 and 25)
- a sales forecast

2.2.2 The competition

Competitors may target the same potential customers as an entrepreneur's company, making it is essential for the entrepreneur to analyse the competitive nature of the role players in the same market. The following variables should be studied (the example relates to selling quality clothing):

- the profile of competitors (e.g., Pep Stores, Jet and Ackermans)
- the strengths and weaknesses of competitors (e.g., low material quality as a weakness; low pricing and cost structures as a strength)
- the related products of competitors (e.g., shoes)

2.2.3 Marketing strategy

This section of a venture's business plan indicates how the venture will achieve the set marketing objectives as part of the entrepreneur's vision. It includes information about what is traditionally known as the **4 Ps of marketing** – product, place (distribution), price and promotion. The 4 Ps are outlined below.

(1) **The total product and/or service.** How is the basic product and/or service transformed into a total product and/or service offering?
(2) **The promotional plan.** How will the entrepreneur create customer awareness?
(3) **The distribution plan.** How will the product and/or service reach the customer?
(4) **The pricing plan.** What is the acceptable exchange value of the total product and/or service?

ACTIVITY 2.1: Case study (an ice-cream truck)

This activity is designed to help you apply concepts related to a marketing plan in a business environment.

Instructions

Read the case study below and then answer the questions that follow.

> The brothers Josh and Seth Frey bought a former postal vehicle and converted it into an ice-cream truck. They operate the ice-cream truck between semesters at the University of Wisconsin. Seth, a senior, plans to join the corporate world after graduation, but Josh is enjoying being his own boss. However, he doesn't want to be the neighbourhood ice-cream guy for the rest of his life.
>
> What else can he sell? Care packages. Josh is impressed that the new dorms at the university offer care packages for parents to send to their kids. How can Josh improve the product? The care packages should be offered campus-wide, he thinks.

Questions

(1) What type of research could Josh do to estimate the demand for the care packages?
(2) How could he develop a sales forecast for his product?

FEEDBACK

(1) First, Josh should define his information needs. He should then decide whether he will need primary or secondary data to move forward. Although secondary data are not as expensive to gather and are available from numerous sources, they are often dated, incompatible or less than credible. Both primary and secondary data may be of use in this case, but primary data are likely to be necessary if Josh is to answer the questions that are relevant to his specific enterprise. If Josh decides that primary data are required, he will need to determine whether observational or questioning methods would prove most useful.

(2) There are two general starting points for developing a sales forecast – breakdown and build-up. The breakdown process begins with a large variable and then systematically works down to the sales forecast. When applied to Josh's venture, the breakdown process would begin by determining the size of the entire potential market (e.g., all parents of students at universities in Wisconsin), and he would then forecast sales by estimating the percentage of that market that is likely to buy care packages. The build-up approach would start by identifying all potential buyers in relevant submarkets and then adding up the estimated demand. In order to do this, Josh may want to calculate the number of parents of students at the University of Wisconsin in Madison and then compute potential demand by estimating the percentage of parents who are likely to be interested in purchasing care packages. By applying this percentage (or a figure adjusted to specific conditions) to other campuses, Josh would be able to forecast total sales.

Read "Living the dream – entrepreneurial experiences" in Longenecker et al (2017:183).

2.3 MARKETING RESEARCH FOR A SMALL BUSINESS

True entrepreneurs are individuals or groups of individuals who have the entrepreneurial skill to take calculated risks. Venturing into a new market without proper market information involves high-risk decision-making. Marketing research therefore supplements entrepreneurs' business decisions with accurate information. The marketing research process emphasises the need to gain knowledge of a certain market environment and to supplement an entrepreneur's intuitive judgement.

ACTIVITY 2.2: EconoAccounting case study

This activity is designed to help you determine the value of a business and to apply a marketing and distribution strategy.

Instructions

Read the EconoAccounting case study below and then answer the two questions that follow.

> Keith Levenstein is passionate about his product. While interviewing him, I could see he was struggling to contain his excitement about it. He believes he has a winner.
>
> Now he has to convince others. Levenstein has owned a number of businesses. His last one, CEG Software Consultants, he sold to the AST group in 1999. That company was an internet service provider that specialised in e-mails. In 2000 he started his latest venture, Econoserv SA, which designs and sells branded software for the small business market. One of the first products developed was SMS321, which sends SMS messages from computers to cellular phones and back.
>
> Clients include dentists who send reminders to patients about appointments, alerts if an IT system goes down and car dealers who send a message to customers when their car is ready. The system is also used to alert the help desk if ATM systems go down.
>
> Another product is EconoMail, a bulk e-mail system used for newsletters and subscriber content, such as the Medical Association of SA's newsletter to members. Levenstein describes this product as being simple and easy to use. There is only a once-off purchase charge and he does not charge per mail sent, for training or for support services. He has also used this model for his next product, EconoAccounting.
>
> This is the package that Levenstein is convinced has huge potential. It is an accounting system aimed at small businesses. But its competitive advantage lies in its data capture abilities. It is able to source information directly from electronic bank statements and enters that information in the relevant area in the books.
>
> "It has been in development for about two years, and we finished it early this year", he says. However, the concept has been at the back of his mind since the early 1980s when he started his first business. "I realised then that the first step for good accounting was to check your bank account. I made sure I knew

what was in my account at all times because the majority of transactions appear on your bank statement. In those days it often meant phoning your bank every morning or even going to the ATM to get a statement. I realised that if I could manage my bank statements, I could have my finances up to date at all times", Levenstein says.

With the growth in internet banking, Levenstein's concept became possible – all the banking information is now available on the computer. "It is a waste of time to manually input that information into an accounting system again", he says. "That procedure also opens the way for errors to creep in. If you enter R36,50 instead of R35,60, it will take you ages to discover your error."

"Another real problem is that the average small business owner is not a trained accountant and often enters a transaction in the wrong place. It is not that easy to use a regular accounting system."

The EconoAccounting system imports information directly from the bank statement and allocates it to the appropriate place. It recognises all regular transactions, which Levenstein says usually makes up about 80% of all transactions. Therefore, only about 20% of all transactions have to be entered manually.

"It is important for small business owners to manage their own accounts", says Levenstein. "It's no good giving a shoebox of papers at year end to an accountant and asking him or her to sort out the mess. If you do it yourself, your finances are always up to date, and you have control."

Going forward, Levenstein has a number of options in mind, none of which he is certain is the right course of action. What he does know is that he has to get the product to market effectively and that he probably needs a good sales and marketing team to do this. "We are not marketing this as it deserves", he says. "I am unsure of how to take the next step to do this thing properly."

Most previous marketing has been done by word of mouth, small adverts in suburban newspapers, and websites and flyers in post boxes. None of these methods have been hugely successful, but the flyers have been the most effective.

He is running a special offer, until the end of this year, selling the product at R1 150 including VAT. His target is to sell 5 000 by the end of next year. So far, he has sold fewer than 20.

"I have the capital to hire one sales rep. I am thinking of getting a tele-rep to start off with to generate leads for me to go close the deal. Later on, I want to hire a full-time rep. What I need, though, is a sales and marketing manager and up to three reps to meet my target. But I need guidance on finding the right people. I have hired reps before but not with much success."

Another strategy he is considering is approaching retail chains to sell EconoAccounting through them. To really launch a successful attack on the market to meet the target, Levenstein needs funding. He is considering approaching venture capitalists and has calculated he needs about R800 000 for marketing and to pay salaries. He does not have enough collateral for a bank loan.

Questions

(1) How would Levenstein determine a value on his business and the best funding route to pursue?
(2) What would be the best marketing and distribution strategy for EconoAccounting?

FEEDBACK

Many people have great ideas for a new business. Unfortunately, a good idea in itself is not always enough to develop a successful business. A business idea is merely somebody's vision that needs to be developed into a viable business proposition. Whether the business proposition that has been developed by an entrepreneur is going to succeed depends on two major factors:

(1) Is the entrepreneur able to translate the idea into a viable business? Levenstein's history provides ample evidence of his ability to turn an idea into a viable business.

(2) Is the market ready for the idea and are the market circumstances favourable for it? This second issue is of greater concern.

The EconoAccounting system is particularly relevant for people with a large number of bank transactions per month, which means the business market. Although South African business owners tend to adopt new technologies relatively quickly (consider the fast penetration and high usage of internet banking and cellular phones), they need a lot of convincing.

Business owners do not have the time or inclination to adjust the way they do things in order to use something that sounds "good on paper". For instance, Standard Bank developed interfaces between its internet banking system and the major bookkeeping systems available in South Africa years ago. The take-up was so low that it had to cancel the service.

Hence it is not enough to let the market know about the product – Levenstein will have to convince the market of the usability of his product. He has to create sufficient word-of-mouth marketing, which is the most effective way of addressing the small business market. Only when he has managed to convince enough early adopters to use his product should he consider distributing it through retail chains.

At this stage, advertising, large-scale packaging and distribution of the product are premature and will prove to be too ambitious an investment. Levenstein should consider making the package freely available to a number of accountants and bookkeepers who service small businesses. Apart from recommending the product to their customers, they will also be able to provide feedback on its usability and the amount their customers are willing to pay for it.

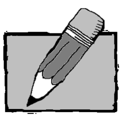
Only after he has determined the marketability and the price the market is willing to pay for his product should he consider approaching a venture capital provider for finance. In order to qualify for venture capital, he will have to provide information on the market opportunity, the expected growth of the business and the projected return on investment.

2.3.1 The nature of marketing research

Read Longenecker et al (2017:184–187).

Marketing research can be defined as the process of gathering, processing, reporting and interpreting market information. When an entrepreneur decides to conduct marketing research, s/he should consider the following factors:

- whether it is necessary to hire an expert
- the internet – an excellent resource for obtaining secondary marketing research data
- the cost–benefit trade-offs of marketing research



ACTIVITY 2.3: Identifying marketing data (mini research)

This research activity invites you to explore various South African search engines in order to identify marketing data.

Resource

Choose one: Use a personal notebook **or** the H5P documentation tool provided below to record your thoughts. Your responses can be exported for your records.

Instructions

Using South African search engines (on the internet), identify sets of marketing data on the following topics:

(a) Clubs for South African entrepreneurship students
(b) demographic information on the Gauteng region and its population
(c) the potential for importing clothes from China for the South African market

Note-taking

Document key insights, innovative practices and any significant statistics or findings regarding the topics stipulated above.

Summarise your findings

Summarising your research in a coherent format will solidify your understanding and allow you to share your insights with peers or instructors if you so choose.

Record your findings

Use your chosen resource (notebook or H5P tool) to document your findings.

FEEDBACK

(1) Information on the South African Students Entrepreneurship Club can be found at http://www.up.ac.za/academic/economic/business/Sasec.html.
(2) The following website contains demographic information on the Gauteng region: http://www.statssa.gov.za/.
(3) Look for importing and exporting opportunities at http://www.brain.org.za/.

2.3.2 Steps in the marketing research process

The following four steps in the marketing research process will enable an entrepreneur to obtain relevant and accurate market information:

Step 1: Identify the information needs of the venture

When the entrepreneur specifies the information needs of the venture correctly and in detail, the marketing research will produce more meaningful results.

ACTIVITY 2.4: Determining information needs (question and answer)

Suppose you, as an entrepreneur, are analysing an opportunity to provide low-cost clothing to the lower end of the market. What would your research questions or information needs be in this instance?

FEEDBACK

You need to ask the following questions:

- Who will my target market be?
- How much would they be willing to pay for clothes in relation to their disposable income?
- What is their gross income/disposable income?
- Where do they live (geographic information)?
- What are their buying patterns and behaviour (seasonal or non-seasonal)?
- What level of quality would they prefer?

Step 2: Search for secondary data

Secondary research is less expensive than primary research, and the internet makes it much more accessible. Secondary data comprise market information that has been compiled previously.

Various sources of market data, such as the following, are available in South Africa:

- Statistics South Africa (Stats SA)
- the Bureau of Market Research (Unisa)
- search engines such as Ananzi and Aardvark
- the World Wide Web business yellow pages

Secondary data tend to have the following shortcomings:

- The data may be outdated.
- The units of measure may not fit the requirements.
- The credibility of the sources may be questionable.

Step 3: Collect primary data

Primary data are collected by means of observational and questioning methods. The following considerations are vital in conducting primary research:

- the differences between observational and questioning methods
- the high value of personal observation in a small business (e.g., analysing trends in the marketing environment by walking around in shopping malls)

Note the following considerations in relation to observational and questioning methods:

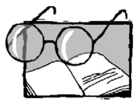
- Observation has three main benefits – it provides useful information, is economical and avoids potential bias.
- Surveys and experimentation are examples of questioning methods.
- There are four types of surveys (mail, telephone, personal interview and electronic mail).
- A questionnaire is the basic instrument for guiding a researcher and respondents through a survey.

Longenecker et al (2017:186) mention six considerations to keep in mind when designing and testing a questionnaire:

- Ask questions that relate directly to the issue under consideration.
- Select the form of question (e.g., open-ended or multiple-choice questions) that would be most appropriate for the subject and the conditions of the survey.
- Carefully consider the order of the questions. Asking questions in the wrong sequence could produce biased answers to later questions.
- Ask the more sensitive questions near the end of the questionnaire. Age and income, for example, are usually sensitive topics.
- Carefully select the words in each question. The questions should be as simple, clear and objective as possible.
- Pretest the questionnaire by administering it to a small sample of respondents who are representative of the group to be surveyed.

Step 4: Interpret the data gathered

The collected data must be transformed into usable information for purposes of making sound business decisions. Specialised computer programs are designed to summarise large quantities of data and to perform descriptive statistics.


Study Longenecker et al (2017:187–189).

2.4 UNDERSTANDING POTENTIAL TARGET MARKETS

A market is defined as a group of customers with purchasing power and unsatisfied needs. The term "market" has three meanings:

(1) A market is a physical location where buying and selling takes place (e.g., the City Deep fresh produce market in Gauteng central or even a supermarket like Hyperama).
(2) The verb "to market" means the process of offering a product for sale (e.g., "We must market the T-shirts aggressively").
(3) A market can be a group of customers or potential customers who have both

purchasing power and unsatisfied needs (e.g., in South Africa, the target market for cell phones was estimated at approximately six million buyers in 2003).

2.4.1 Market segmentation and its variables

Market segmentation is the process by which a heterogeneous market is subdivided into smaller, homogeneous groups with comparable needs.

The following variables form part of market segmentation:

- benefit variables (e.g., a car radio, which has a comfort benefit)
- demographic variables (e.g., age, gender, occupation and income)

2.4.2 Marketing strategies based on segmentation considerations

The market can be segmented in three different ways. The following types of segmentation strategies will help an entrepreneur to aim his/her marketing actions in the right direction (study these strategies in conjunction with exhibits 7-2, 7-3 and 7-4 in Longenecker et al (2017:191)):

- an unsegmented strategy, where the total market is the target market
- a multi-segment strategy, where a unique marketing mix is developed for each target market
- a single-segment strategy, where the focus is on the most profitable target market

2.5 ESTIMATING MARKET POTENTIAL

The existence of an adequate market for a product means that the product will serve a large enough target market to yield high profit and sustainability. A sales forecast indicates the potential of a market to generate income on a viable and continuous basis.

2.5.1 A sales forecast

A sales forecast is a prediction of how much of a product or service will be purchased by a specific market in a defined time period. For example, suppose that the total market for cellular phones in 2012 will be 15 million buyers. If a new cellular phone provider forecasts a 10% market share, it will need to sell 1 500 000 cellular phones in that year.

2.5.2 Limitations to forecasting

Forecasting is a highly complex and difficult exercise for any entrepreneur. Ask yourself this question: Where will I be in five or ten years? Longenecker et al (2017:192) identify the following three practical reasons why small firms use forecasting less frequently:

(1) Each and every forecasting exercise is unique. New and unique ideas (new businesses) do not have historical figures that can be used as a base.
(2) Small business managers may be unfamiliar with quantitative analysis methods.
(3) The typical small business entrepreneur lacks familiarity with the forecasting process.

2.5.3 The forecasting process

Sales forecasting is a multi-step process with two main dimensions, as explained below.

The starting point involves the following two processes:

(1) **The breakdown process (chain ratio method).** This step starts with the population figure of the target market and involves determining percentages that can be served.
(2) **The build-up process.** The market potential of all likely segments is estimated and combined in this step.

The predicting variable has two elements:

(1) In **direct forecasting**, sales are the forecasted variable (e.g., the expected sales for a given period such as a year).
(2) **Indirect forecasting** takes place when surrogate variables are used to project the sales forecast. For instance, there is no market information on the number of lawnmowers sold in a given period. An entrepreneur can estimate the market potential by multiplying the number of gardens in a specific geographic area by the average replacement time of lawnmowers.

ACTIVITY 2.5: Speciality Cheese case study

Read the Specialty Cheese case study and then answer the questions that follow.

Speciality Cheese

Marketing research as the cornerstone of a successful business

According to the Agricultural Marketing Resource Center at Iowa State University, US per capita cheese consumption is around 31 pounds (14 kg), a figure that continues to increase because of heightened interest in ethnic cooking and the growth in specialty cheeses, among other things. The specialty cheese industry generates nearly $3 billion in annual US sales, and Specialty Cheese of Lowell, Wisconsin, is constantly increasing its contribution to that total. Started by Paul and Vicki Scharfman, corporate refugees from Oscar Meyer and Colgate-Palmolive, Specialty Cheese works out of the oldest continuously operating cheese factory in the state of Wisconsin, where the number of cheese factories has plummeted from 4 000 not so long ago to 150. Even with 35 cheese types, Specialty Cheese considers itself a niche marketer threatened by rising global competition and higher selling prices.

The Scharfmans are working to manage threats to their company's marketing environment and to reverse the outflow of cheese manufacturing from their state. What started with a $45 000 agricultural grant over 10 years ago has grown into a multimillion-dollar business. The Scharfmans have increased the number of employees nearly fivefold, from 24 to 110, and now boast 10 licensed cheesemakers. The company makes mostly ethnic cheeses, for example, 14 Hispanic cheeses and seven Middle Eastern cheeses. One product alone, Just the Cheese, accounts for millions of dollars in annual sales.

This amazing growth was the result of a well-conceived marketing plan derived from a customer orientation. The Scharfmans used numerous marketing research techniques to identify markets for their products. And they always listened to what customers were telling them about their products, packaging and promotions. Paul Scharfman says: "The competitive model for industry breaks down in small business. We ought to be more collaborative than competitive. We try not to copy our competition but to innovate. We try to build markets. We try to work with our partners and our suppliers and our companies around us. We try to find win-wins all the time. The little local cheesemaker down the street, who's making Colby, and I – other than the fact we're both buying raw milk, we might as well be in different businesses. We are not competitors."

If other smaller cheesemakers are not competitors for Specialty Cheese, who is the company's competition? The specialty cheese industry is highly fragmented. This means that numerous individual companies own entire markets for the product area in which they specialise. Specialty Cheese is one example. Although the company has an impressive roster of ethnic cheeses, it is not exhaustive. Nor can the company compete at the same level across multiple geographic locations. That is, there may be a small cheesemaker in New York who is better positioned geographically to meet the needs of the Mexican market in Manhattan than Specialty Cheese is in Lowell, Wisconsin. But overall, the niche markets in which Specialty Cheese sells product are small enough to be dominated by one or two companies that make a highly specialised product.

The biggest competition to makers of specialty cheeses may, in fact, be mainstream cheese producers, like Kraft, that are able to generically position the most popular types of cheese as acceptable substitutes for specialty cheeses. In the video, Paul talks about how the cheese should not run out of a genuine Mexican enchilada, but many Americans are used to melted (probably cheddar) cheese running out the end. If consumers ultimately decided that runny, melted cheese was preferable to soft cheese that stays inside an enchilada, then Specialty Cheese would see its market shrink or disappear. Specialty Cheese, and other niche cheesemakers, must work against the standardisation of cheese offerings in order to be successful.

As an epilogue to the video: In 2004, Paul Scharfman developed a plan to consolidate multiple small cheesemaking operations into a central location, or condominium, where specialty cheesemakers could share space and costs. He anticipated the cooperative to be up and running by 2008.

Questions

(1) What sources of information did Paul and Vicki use to develop their marketing plan?
(2) What kind of market segmentation strategy do the Scharfmans use?

FEEDBACK

(1) Paul and Vicki used both secondary and primary data to construct their marketing plan. The main source of their secondary data was US Census Bureau statistics. You will recall from the discussion above that secondary data comprise market information that has been compiled previously. Paul and Vicki used the census database to research the location of different ethnicities across the USA and the size of the ethnic population in each location. The Scharfmans also conducted cultural research to determine which ethnicities incorporated cheese into their diets. By combining these two types of secondary data, Paul and Vicki were able to think more creatively about cheese products that would meet the needs and wants of highly segmented markets.

In addition to secondary data, the Scharfmans used primary data. In other words, they gathered new marketing information themselves to satisfy their particular research needs. Once Paul and Vicki had several prototypes for new cheese products and packaging, they used focus groups to make sure they were on track. The video shows this near the end of the case, when Paul and Vicki talk about the "packaging fumbles" they had with their Just the Cheese™ product.

The Scharfmans credit their success to continually asking what the customer wants. In the video, Vicki talks about leading with the product as being an absolutely backward approach to marketing. Many people think they have a great invention that is going to appeal to huge numbers of people, but once it is on the market, it just sits there, and they cannot understand why. Vicki knows the reason: the marketer did not have the right information. "Marketing says: 'Find out what your consumer wants, what your consumer needs and what they're not getting from the current offerings in the marketplace and go out and tailor your dream to what they want.' And that's going to be the right fit that sells product." Paul echoes Vicki when he says: "The gist of it is simple: ask."

(2) Market segmentation is the division of a market into several smaller groups with similar needs. Petty et al (2012) discuss three popular segmentation strategies: an unsegmented strategy, where the total market is defined as the target; a multi-segment strategy, where different preferences of individual groups within the total market are identified; and a single-segment strategy, where a company recognises the existence of multiple segments but focuses exclusively on the most profitable one. The Scharfmans use a multi-segment strategy. Although their main focus is on ethnic cheeses, they also create unique cheese products that are attractive to a broader market, for example, Just the Cheese™.

The Sharfmans began the process of identifying their target markets by building on the foundation of the Heim Cheese Company. When Paul and Vicki bought Heim, the company made good cheese, and a kind of Cuban cheese in particular. The couple then expanded on the notion of Cuban cheese, quickly moving into Hispanic cheese. Further segmentation came through detailed marketing research. The Scharfmans paid someone to conduct a library search and to find out what languages are spoken at homes across the USA. The couple then determined which of the cultures represented in their research eat cheese. Armed with the list of cultures in the USA that eat cheese, Paul and Vicki were able to develop products that specific consumer groups needed and wanted.

SELF-ASSESSMENT

(1) What is the scope of small business marketing? Has it always been as broad as it is now? Why or why not?
(2) In what way do the three marketing philosophies differ? Select a product and discuss marketing tactics that could be used to implement each philosophy.
(3) What are the obstacles to adopting a consumer orientation in a small firm?
(4) Briefly describe each of the components of a formal marketing plan.
(5) What are the steps in the marketing research process?
(6) What are the major considerations in designing a questionnaire?
(7) Briefly explain the three components of the definition of a market, as set out in this learning unit.
(8) What types of variables are used for market segmentation? Would a small firm use the same variables as a large business? Why or why not?
(9) Explain the difference between a multi-segment strategy and a single-segment

strategy. Which one is more likely to appeal to a small firm? Why?

(10) Explain why forecasting is more widely used by large firms than small ones.

Answers to self-assessment questions

(1) Small business marketing consists of those business activities that are directly related to

- identifying a target market
- determining target market potential
- preparing, communicating and delivering a bundle of satisfaction to a target market

Marketing in a small business has not always been so sophisticated. At one time, marketing was considered to be little more than selling, and some entrepreneurs continue to view it in this limited way. In reality, a well-executed marketing effort involves numerous activities, many of which need to happen even before a product has been produced and prepared for distribution or sale.

(2) The philosophies differ in the degree of emphasis placed on the consumer and the point at which this concern is manifested. Because students will choose different products when answering this question, the marketing tactics they offer will also differ. Some students may also emphasise different areas of marketing.

Marketing information tactics for a business that markets refrigerators could be expressed as follows:

Philosophy	Marketing information tactics
Production-oriented philosophy	“Let's survey our distribution system to find out why it costs so much."
Sales-oriented philosophy	“Let's survey customers to find out how we can motivate them to buy our product."
Consumer-oriented philosophy	“Let's survey customers to learn what benefits they seek from refrigeration so we can satisfy their needs.”
If pricing is emphasised, you might answer as follows:	
Philosophy	**Pricing tactics**
Production-oriented philosophy	“We must charge RX,XX because our production costs have already been worked out as RX,XX.”
Sales-oriented philosophy	“We need to discount the current price in order to sell more.”
Consumer-oriented philosophy	“Customers are willing to pay about RX,XX for a product that offers these benefits.”

(3) In most cases, the failure of small firms to adopt a consumer orientation can be

explained by one or more of the following three factors: Firstly, firms are likely to adopt a production efficiency emphasis if competitive pressure is weak and/or demand exceeds supply. Under these conditions, firms have little justification for focusing on customer needs because they can already sell the entire product they can produce. Secondly, if small business managers have particularly strong production skills, the firms will naturally lean towards a production emphasis. Likewise, if small business managers have strong selling skills, the firms will lean towards a sales orientation philosophy. Thirdly, some managers are too focused on the present to adopt a consumer orientation. They may, for example, emphasise a high-pressure selling approach in order to move merchandise, which is likely to have a negative effect on consumer satisfaction in the long run.

(4) A formal marketing plan should contain detailed information on the market analysis, the competition and the marketing strategy. The four areas of the marketing strategy are the description of the total product or service, the promotional plan, the distribution plan and the pricing plan.

(5) There are typically four steps in marketing research:

- Step 1: Identify the information needs of the venture.
- Step 2: Search for secondary data.
- Step 3: Collect primary data.
- Step 4: Interpret the data gathered.

(6) The major considerations in designing a questionnaire are as follows: Ask only those questions that relate to the issue of concern. Select the form of question (e.g., open-ended or multiple-choice questions) that would be most appropriate for the questionnaire and its application. In addition, consider the order in which the questions are presented (since one question could influence the responses to subsequent questions); sensitive questions should always come last. Word the questions carefully so that they are as simple, clear and objective as possible. Finally, pretest the questionnaire using a representative sample.

(7) A market can be defined as a group of customers or potential customers who have purchasing power and unsatisfied needs. A market requires all three components – customers, purchasing power and unsatisfied needs. The components of a market have a multiplicative relationship, which can be expressed as follows:

market = customers x purchasing power x unsatisfied needs

If any one component is zero, the value of the market will also be zero. For example, assume potential customers have no purchasing power. Then

market = customers x 0 x unsatisfied needs = 0

(8) Segmentation variables are used to identify particular dimensions of a market. The two basic types of segmentation variables are benefit variables and demographic variables. Since resources are limited and the products and services of a small firm are usually specialised, the use of segmentation variables is more important for small firms than for large businesses.

(9) A multi-segment strategy involves approaching two or more homogeneous market segments with a tailor-made strategy for each segment. A single-segment strategy involves targeting one segment that a firm believes will be most profitable. A single-segment strategy usually allows small firms to use their limited resources more efficiently.

(10) Firstly, forecasting circumstances in a new business are unique. Secondly, a small business manager is likely to be less familiar with methods of quantitative analysis. Finally, the typical entrepreneur lacks familiarity with the forecasting process.

SUMMARY

The information in this learning unit will help you, as an entrepreneur, to develop a final marketing plan as part of a total business plan. Various tasks, including marketing research, market segmentation and sales forecasting, need to be performed in order to complete an adequate and meaningful marketing plan. The success of the final marketing plan will depend on whether relevant and accurate data and information were gathered in these tasks. The next learning unit deals with building a management team for a business and selecting a legal form of organisation.

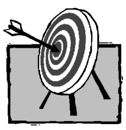
LEARNING UNIT 3

THE ORGANISATION OF A BUSINESS
(Prescribed book: chapter 8 of Longenecker et al 2017, pages 198–230)

CONTENTS

INTRODUCTION

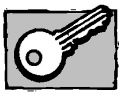
This is the third learning unit of **topic 1**.



LEARNING UNIT LEARNING OUTCOMES

Upon completion of this learning unit, you should be able to

- describe the characteristics and value of a strong management team
- explain the common legal forms of organisation used by small businesses
- identify and analyse factors to consider in choosing from the primary legal forms of organisation, including tax consequences (in a South African context)
- describe the unique features and restrictions of specialised organisational forms
- explain the nature of strategic alliances and their uses in small businesses
- analyse how a board of directors and an advisory council can be used effectively



KEY CONCEPTS

- management team
- social network
- social capital
- reciprocation
- sole proprietorship
- unlimited liability
- partnership
- partnership agreement
- close corporation
- legal entity
- limited liability
- strategic alliance
- private companies
- public companies
- board of directors
- advisory council

OVERVIEW

Unless an enterprise is in its micro phase (which is normally the case with a new start-up in South Africa), the entrepreneur who establishes the venture will not be the only person to manage it. In general, the management team – that is, both managers and key people who give the venture its direction – make a significant contribution to the new venture's success. The management team's experience and track record, reliability, sense of responsibility and ethical standards are all vital considerations for stakeholders and investors alike. This learning unit describes the role of the management team of a small business and briefly elaborates on the legal forms of business in a South African context. Since the MNE2601 module provides an in-depth analysis of the legal forms of business, this learning unit merely indicates the different forms in table format.

Study Longenecker et al 2017 (2017:205–213).

The prescribed book is based on the USA's legal system and is therefore somewhat irrelevant in the South African business context. However, some of the principles covered are relevant in this country. The relevant South African legal considerations should be studied.

3.1 BUILDING A MANAGEMENT TEAM

The management team of a small business includes managers, professionals and key persons who give direction to the business's activities. A new venture (especially in the start-up phase) initially has only one manager, the entrepreneur him-/herself. Most microenterprises do not have teams – hence the need to recruit the most suitable managers during the growth and development phases, bearing in mind that investors assess the management team when evaluating a business plan. The advantages of a management team are twofold:

(1) A team provides diversity of talent.
(2) A team provides greater assurance of continuity.

3.1.1 Achieving balance

When building a management team, the following variables are vital:

- The competencies required in a management team depend on the type of business (e.g., a venture with a strong marketing drive needs skilled marketers).
- The stage of business growth is also vital since it defines the skills set and expertise requirements.
- A proper range of abilities is needed, including minimal skills in basic operations, marketing and finance. Balance is critical.
- Personal cooperation and compatibility are essential.
- Issues that team members need to address and specify at the outset include organisational structure, ownership share and compensation, and the growth plan.

If the management staff or the board of directors is too small or limited (especially during the start-up stages), it is advisable to use the expertise of external professionals. Practical assistance is available from governmental institutions, such as

- the Department of Small Business Development (DSBD)
- the National Empowerment Fund (NEF)
- the Industrial Development Corporation (IDC)
- the National Youth Development Agency (NYDA)
- Khula Enterprise Finance
- the Small Enterprise Development Agency (SEDA)

Assistance can also be sought from

- business partners
- banks

- academics in the field of entrepreneurship
- business consultants
- attorneys on the legal side

A management plan should define the interrelationships between the members of the organisation and explain the hiring process, job descriptions and compensation.

3.1.2 Expanding social networks

Longenecker et al (2017:203–205) discuss the following concepts:

- social network
- social capital
- reciprocation

Read "Living the dream – entrepreneurial experiences: entrepreneurs get by with a little help from their network friends" in Longenecker et al (2017:204).

3.2 CHOOSING A LEGAL FORM OF ORGANISATION

It is an entrepreneur's responsibility to choose the appropriate form of business for a new venture.

The various forms of business relevant to South Africa were covered in detail in the second-year module on entrepreneurship and small business development and are only summarised in this section.

3.2.1 A sole proprietorship

Longenecker et al (2017) describe a sole proprietorship as the most basic form of business – it is a business that is owned by one person. They also mention the advantages and disadvantages of this form of organisation.

3.2.2 A partnership

Longenecker et al (2017) examine the following issues concerning partnerships:

- the partners' qualifications
- the partners' rights and duties
- the termination of a partnership

They also discuss the advantages and disadvantages of partnerships (Longenecker et al 2017:206).

3.2.3 A close corporation

We will not cover this topic in this section since a close corporation is not found in South Africa.

3.3 CRITERIA FOR CHOOSING AN ORGANISATIONAL FORM

Longenecker et al (2017:213–215) mention seven criteria to consider when choosing an organisational form.

Table 3.1 summarises the differences between the various legal forms of business in South Africa with regard to seven factors that influence the choice of form.

Table 3.1: A comparison between the various forms of business

Choice factor	Sole proprietorship	Partnership	Private company	Public company	Close corporation	Agricultural cooperative	Business trust
Membership	One	Two to twenty	One to fifty	Seven to unlimited	One to ten	Seven to unlimited	One to twenty
Legal prescriptions	Few legal formalities	Few legal formalities, except the possibility of a contract	Many regulations, but fewer than with a public company Requires a (CA) accountant	Multiple legal regulations that must be adhered to Requires a (CA) accountant	Simple legal requirements An accounting officer needs to be appointed	Any prescriptions must be complied with	
Liability for debt	Unlimited	Unlimited for ordinary partners	Limited to not fully paid-up shares	Limited to not fully paid-up shares	Limited	Limited	Limited to assets
Continuity	Terminates at death or insolvency of owner	Discontinues when partners die or step down	Unlimited life, but the transfer of shares is not	Unlimited shareholding, which may change hands easily	Unlimited life, with approval of new member	Unlimited life Same as company	
Financing possibilities	Usually limited capital	More partners have more capital	More capital than in a close corporation or a partnership	Greatest capital mobilisation	Better than in a sole proprietorship and a partnership but poorer than in a private company	Lack of sufficient equity	Dependent on the extent of a donation or loan
Management	Owner has autonomy in decisions	Fellow partners are consulted: decisions take longer	Board of directors decides	Usually, all members participate	Directors decide	Directors decide	Trustees decide
Income tax	Scale for natural persons	Scale for natural persons	The fixed rate on taxable income				Not a legal person

Source: Adapted from Marx, Van Rooyen, Bosch and Reynders (1998:159)

3.4 SPECIALISED FORMS OF ORGANISATION

The forms of organisation discussed in this section in Longenecker et al (2017) do not apply to South Africa.

3.5 FORMING STRATEGIC ALLIANCES

A strategic alliance is a form of cooperation that links two or more independent businesses in a common endeavour (e.g., a large building project in which several businesses provide different services). These businesses normally share common critical resources but avoid the risk of legally merging the entities, thus enjoying flexibility.


Study Longenecker et al (2017:220–224).

3.5.1 Strategic alliances with large companies

Many smaller businesses are becoming involved in this way of conducting business because of the benefits of joining forces with larger entities. The success of any joint venture depends mainly on the following factors:

- the accurate assessment of the parties involved
- the synergy between the partners
- reasonable expectations of results
- the timing of such a venture

The following are examples of strategic alliances in the history of business:

- Boeing/Mitsubishi/Fuji/Kawasaki (the entities entered into an alliance to cut costs on the production of small aircraft)
- General Motors and Toyota (the entities entered into an alliance as a cost-cutting strategy)

3.5.2 Strategic alliances with small companies

Small businesses can form strategic alliances with other small businesses to capitalise on benefits such as

- sharing technology
- cutting costs
- entering new and/or foreign markets (internationalisation)
- raising capital
- conducting cooperative research

3.5.3 Setting up and maintaining successful strategic alliances

Longenecker et al (2017: 221) describe six steps for improving the chances of success when setting up alliances.

3.6 MAKING THE MOST OF A BOARD OF DIRECTORS

A board of directors is the governing body of an entrepreneurial firm, elected by the shareholders. In certain circumstances, the board is elected by the entrepreneur to fulfil a legal requirement or as a means of luring investors. It is common for entrepreneurs to establish a board of directors, especially as their firms grow and attract more stakeholders. Some entrepreneurs do not use a board of directors because of the following reasons:

- Establishing and maintaining a board of directors can be costly and complex, especially for early-stage start-ups.
- Entrepreneurs may feel they are relinquishing control over their company, particularly if the board has significant influence over strategic decisions.
- It can be challenging to find qualified individuals who are willing to serve on the board, especially for smaller companies with limited resources.

In this section, Longenecker et al (2017:222–224) discuss the contributions made by directors, the selection of directors, the compensation of directors and, as an alternative to a board of directors, an advisory council.

SELF-ASSESSMENT

(1) Why would investors favour a new business led by a management team over one headed by a single entrepreneur? Would this preference be justified?
(2) Does the concept of limited liability apply to a sole proprietorship? Why or why not?
(3) Suppose a partnership is set up and operated without a partnership agreement. What problems could arise? Explain.
(4) Evaluate the three major forms of organisation in respect of management control by the owner and the sharing of the firm's profits.
(5) Why are strategic alliances important for many small businesses?
(6) What steps can an entrepreneur take to create strategic alliances and to prevent their failure?
(7) In what way could a board of directors be of value to management in a small corporation? What qualifications are essential for a director? Is the ownership of shares in a firm a prerequisite for being a director?

(8) What could account for the failure of most small corporations to use boards of directors as more than rubber stamps?
(9) In what way does an advisory council differ from a board of directors? Which would you recommend to a small company owner? Why?

SUMMARY

This learning unit dealt with the vital role that an effective management team can play in the success of a small business venture. Bear in mind that the majority of new ventures do not start out with a full management team. Usually, an entrepreneur initially performs all the managerial functions of a new venture. We also considered the factors that influence the selection of a legal form of business, bearing in mind that this learning unit is applicable to the South African context. The unit concluded with a discussion of strategic alliances and their benefits for entrepreneurs. The next learning unit deals with the location plan of a small business and the planning of facilities.

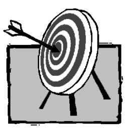
LEARNING UNIT 4

THE LOCATION PLAN OF A SMALL BUSINESS
(Prescribed book: chapter 9 of Longenecker et al 2017)

CONTENTS

INTRODUCTION

This learning unit deals with the major factors that should be considered when choosing a location and setting up physical facilities for a small business. Starting a home-based business and launching a business on the internet have become very popular options and are covered in some detail in the unit. Regardless of how the location of a start-up is selected, a discussion of key location factors and how they support the location decision should be included in the business plan. Keep in mind that the depth of this discussion will vary from plan to plan, depending on the nature and specific needs of the new venture.



LEARNING UNIT LEARNING OUTCOMES

Upon completion of this learning unit, you should be able to

- describe the five key factors in locating a start-up business
- discuss the challenges of designing and equipping a physical facility
- explain both the attraction and challenges of creating a home-based start-up
- discuss the potential benefits of locating a start-up on the internet

KEY CONCEPTS

- brick-and-mortar store
- enterprise zones
- business incubator
- general-purpose equipment
- special-purpose equipment
- home-based business
- zoning ordinances
- e-commerce
- electronic customer relationship marketing (e-CRM)
- business model
- business-to-business (B2B) model
- business-to-consumer (B2C) model
- 24/7 e-tailing
- auction sites
- content/information-based model
- transaction-based model

OVERVIEW

The choice of location for a business is one of the management decisions that could determine entrepreneurial success or failure. The type of product or service has a direct influence on the choice of location. Factors such as access to customers, suppliers, transportation, zoning regulations and access to skilled and less-skilled employees have a specific impact on all retailers, producers and service-oriented businesses. Retail and service companies should have access to the "feet" of their target markets. Producers' proximity to their suppliers will yield certain cost benefits. Location options for a start-up are illustrated in exhibit 9-1 (Longenecker et al 2017:234).

The cost of locating a business strategically (especially in the retail sector) has increased dramatically in the past 10 years. Retail space in a well-known shopping mall in the eastern suburbs of Pretoria can cost up to R500 per square metre per month. With an average shop size of 120 m^2, the rent will be R60 000 per month. Imagine how many cups of coffee a coffee shop needs to sell just to break even on the rent expenses (at an average cost of R11 per cup, this adds up to 5 454 cups of coffee per month!).

Study Longenecker et al 2017 (2017:231–255).

Read "In the spotlight: Yuppiechef" in Longenecker et al (2017:232).

4.1 LOCATING A BRICK-AND-MORTAR START-UP

The choice of location is generally a one-off decision, although subsequent relocation may become necessary for various reasons.

4.1.1 The importance of the location decision

The best product at the lowest price will not sell if it is inaccessible. An entrepreneur should take into account that customers continuously analyse variables such as convenience, cost, reliability, quality, parking facilities, service levels and even security.

4.1.2 Key factors in selecting a good location

An entrepreneur's choice of location for a business should be guided by five key factors, as summarised in exhibit 9-1 (Longenecker et al 2017:234) and explained below.

(1) **Customer accessibility.** Customers of retail and service businesses are particularly interested in customer accessibility. Customer accessibility is also a key factor when the cost of shipping is high relative to a product's value when selling to a niche market.

(2) **Business environment conditions.** These conditions would include factors such as the weather, competition, crime, legal requirements and tax structures.

(3) **Availability of resources.** Of significance here are considerations such as a business's proximity to raw materials (e.g., a furniture manufacturer needs to be close to a wood supplier); the suitability of the labour supply (e.g., high-skilled employees in a technology-driven industry); and the availability of transport (e.g., a milk farmer would require access to refrigerated haulers).

(4) **Personal preference of the entrepreneur.** These preferences could mean the choice of a local site or a location offering a unique lifestyle advantage. Some entrepreneurs might, for instance, prefer establishing a fish restaurant close to the sea, while others may wish to exploit the need for seafood in an urban or metropolitan area.

(5) **Site availability and costs.** This factor is normally based on the nature of the business, that is, whether it is close to the customer (e.g., retail) or the supplier (e.g., a supplier of intermediate goods). The cost of a site will influence an

entrepreneur's profit margin and is therefore a fundamental factor in the location decision. Leasing an operating space is normally advisable because, firstly, a large cash outlay is avoided and, secondly, avoiding substantial investment reduces risk. Many entrepreneurs have made the mistake of investing in inner city regions (e.g., Johannesburg and Pretoria), where the value of property has decreased considerably because of various environmental factors. Consequently, the return on their investment has been negative, invariably resulting in insolvency.

4.2 DESIGNING AND EQUIPPING THE PHYSICAL FACILITIES OF A START-UP

Once the location decision has been made, it is necessary to plan the process of installing the physical facilities. Furniture, equipment, machines and the building itself are included in the process of designing the facilities, which should be based on the needs and convenience of the customer, in the case of retail, and efficiency, in the case of manufacturing units. Since cost-saving benefits form part of the process, the following considerations are important:

4.2.1 Challenges in designing the physical facilities

An entrepreneur should avoid occupying a space that is too large or too small for the operations of his/her business. Practicality is therefore a vital consideration because the size of the business premises will affect the profit-making process. The kind of product to be produced and the type of activities to be performed will also determine the design of the facilities.

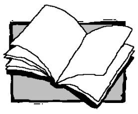
4.2.2 Challenges in equipping the physical facilities

Entrepreneurs are faced with a decision whether to lease or buy physical equipment. Most entrepreneurs believe that it is better to buy than to lease. The three main types of equipment are manufacturing equipment, retailing equipment and office equipment. Manufacturing equipment can be either general-purpose or special-purpose equipment.

Fitting the right equipment in a facility is the last step before the actual business processes can start. The kind of business will determine the types of equipment needed. A manufacturing unit is equipped with far more specialised technology-driven equipment than, say, a fish-and-chips outlet. Manufacturing equipment includes general-purpose equipment (e.g., saws and drilling machines). Lighting, rugs and chairs will be more suitable in a retail store that sells luxury products. Office equipment may include computers, fax machines and telephone systems. All equipment should contribute to productivity and profit generation in a cost-effective manner. The building should project the appropriate image to customers.

4.2.3 Business image

The building should project the correct image of the business.


Read exhibit 9-2, "Small business owners choose buying over leasing", in Longenecker et al (2017:240).

4.3 LOCATING A BUSINESS AT HOME

An increasing number of entrepreneurs are no longer using conventional business locations. The current trend, especially in South Africa, is to establish a business in a residential or home-based environment.


ACTIVITY 4.1: Creating a home-based start-up (case study)

This activity is designed to help you gain a deeper understanding of the attraction and challenges of creating a home-based start-up.

Instructions

Read the case study below and then answer the questions that follow.

Entrepreneur Karin Moore wishes to start a catering and decorating business to bring in money to help support her two young children. As a single parent working in the banking industry, she has always wanted to start her own business. She enjoys catering and decorating for friends' parties and has frequently been told: "You should do this professionally. You have such good taste, and you are definitely a people person."

Karin has decided to take the plunge but is unsure whether to locate her business in a commercial site or at her home, which is in rural central Gauteng. She is seriously thinking of locating the business at home because she would like to spend more time with her children. However, she is concerned that the home-based location is too far away from the city, where most of her potential customers live.

Questions

(1) What do you see as the major benefits of a home-based business for Karin?
(2) How could Karin use technology to help her operate a home-based business?

FEEDBACK

(1) One of the obvious benefits of a home-based business in the above example is that it would permit Karin to spend more time with her children, which is important to her. In addition, locating the business at her home would also significantly reduce her costs by eliminating the need to rent office space. This is a vital consideration when an entrepreneur is starting a business "on a shoestring" and does not have an established client base to ensure rapid cash flow, which appears to be the case in this situation.

(2) Advancements in technology help to blur the perceptual distinctions between home-based and other businesses. A personal computer, a fax machine, e-mail, voice mail and other technological tools are sure to prove helpful in this situation. Karin will require a personal computer to keep track of business receipts and disbursements and an e-mail account to maintain contact with current and potential clients. At little additional cost, she could purchase internet access and post a website to promote her business and to provide information (e.g., available prices and services) that customers would find helpful.

4.3.1 The attraction of a home-based business

Establishing a home-based business has two basic advantages:

(1) **Financial considerations.** The shared-cost benefit of living in and conducting business from the same location can increase an entrepreneur's profit margin. The bond that is payable will also cover office space, with certain tax benefits.
(2) **Family lifestyle considerations.** A trend among predominately female entrepreneurs is to operate their businesses from home while also managing their households. This affords them the opportunity to spend more time with family members within certain work parameters.

Longenecker et al (2017:243–244) discuss the reasons why entrepreneurs operate from home.

4.3.2 The challenges of operating a business from home

The idea of operating a business from home and managing the household at the same time may sound idyllic, but there are specific limitations, as highlighted below.

- **Professional image.** The type of business will determine what image is expected of all stakeholders. A professional image is compulsory in a business venture that provides personal services to clients (e.g., a business consultant), especially when clients need to visit the business location frequently. Spatial and nonspatial boundaries should be in place to prevent conflict. The cry of a baby in the background while speaking to important customers may lead to difficult communication situations. A specific space should be set aside for business activities. Business hours are also compulsory – being "at home" does not mean that one can sleep in until 10 every morning! Finding a reasonable balance between family matters and customer needs will ensure a beneficial situation.

- **Legal considerations.** The City of Tshwane (previously Pretoria) Metropolitan Municipality, for example, has laid down the following legal requirements for operating a business from home:

  - The person practising the occupation must occupy the dwelling unit.
  - The practice of such occupation may not cause any sort of nuisance or disturb the amenity of the area.
  - There should be no increase in traffic.
  - No goods may be exhibited, displayed or stored without the written permission of the local authority.
  - The use of more than 25% of the floor area of the dwelling for the practice of such occupation is not permitted.
  - Not more than two employees in a maintenance or support role or two agents may be employed (unless written consent is obtained from the local authority).
  - No occupation may be practised from outbuildings (unless written consent is obtained).
  - No shop may be operated from outbuildings (unless written consent is obtained).

  A person planning to start a home-based business should also justify the following in his/her application:

  - the specific activities to be exercised
  - the number of clients expected to visit the business daily
  - the reasons for using an area larger than 60 m^2
  - any potential disturbances to neighbours and how such disruptions would be minimised
  - the times and number of deliveries of items resulting from the home-based business

4.4 LOCATING A START-UP ON THE INTERNET

The term "e-commerce" is short for "electronic commerce" and refers to the paperless exchange of business information via the internet. E-commerce is an alternative means of conducting business transactions that have traditionally been performed by telephone, mail and face-to-face transactions in brick-and-mortar stores.

E-commerce makes it possible to do business in any location without a person being required to be present physically at a particular location.

4.4.1 Benefits of e-commerce for start-up businesses

The benefits for start-up businesses are as follows:

- Small firms can compete with larger businesses on a more level playing field. They do not need all the resources.
- The sales cycle is shortened or compressed in the sense that most sales are credit card sales, which means that money flows in immediately.
- One-on-one customer relationships are possible through electronic customer relationship marketing (e-CRM).

4.4.2 E-commerce business models

A business model describes a group of shared characteristics, behaviours and goals that a firm should have, such as the following (illustrated in exhibit 9-3 of Longenecker et al 2017:248):

- **Types of customers served.** Three types of models apply here:

  (1) The business-to-business (B2B) model involves selling to businesses.
  (2) The business-to-consumer (B2C) model enjoys the advantages of speed of access and transaction and "24/7 e-tailing" (e.g., Amazon.com).
  (3) The consumer-to-consumer (C2C) model, also called the auction-site model, applies to web-based businesses that sell products by auction (e-Bay is a classic example).

- **Degree of online presence.** Four models exist:

  (1) In the content-based model, a website provides access to company information, but the site cannot conduct buy or sell transactions.
  (2) In the information-based model, a website provides information about a business, its products and other related matters but does not charge for its use.
  (3) In the transaction-based model, a website provides a mechanism for buying or selling products or services.
  (4) In the emerging model, a blog is used as an easy and attractive platform to promote the sale of an overstocked item.

ACTIVITY 4.2: Locating a start-up business on the internet – The Chocolate Farm (case study)

This activity is designed to help you gain a deeper understanding of running an online business.

Instructions

Read the case study entitled "The Chocolate Farm" and then answer the questions that follow.

The Chocolate Farm

Evan and Elise Macmillan really are small businesspeople. At ages 16 and 13, respectively, they know about running and growing a successful business. They could even teach a few lessons to owners of burnt-out dotcoms: Keep overheads low and don't think a Web address ensures success.

As co-founders of The Chocolate Farm – the business they started in 1999 in Denver, Colorado – they're harvesting some serious lunch money, mostly from their website, http://www.thechocolatefarm.com. Though their site has had more than one million visitors, Elise says they worked hard "not to get caught up in the whole Web craze" and just to offer products that would make money. "All those failed companies thought success was a sure thing if you stuck a dotcom at the end of the business's name", says Elise. "The Web is and will only continue to be a venue for conducting business, never a business model."

The internet allows The Chocolate Farm to buck the traditional chocolate company approach of high-rent storefronts by taking orders and shipping directly to customers. "We're definitely going the low-cost route", Evan says.

The company sells recipes, animal moulds, and kits showing customers how to create their own chocolate-selling business. "We don't see those who want to make chocolate as competition", Evan says. "We want to give customers choices."

The Chocolate Farm sprouted three years ago when Elise and Evan took part in an event put on by The Young Americans Education Foundation, which teaches young people about free enterprise (and the organisation that lent the farm its initial $5 000). The event let young people sell products at booths, and Elise and Evan decided to sell chocolate.

The siblings did so well that they started selling chocolate at weddings, parties and banquets, giving their business a farm theme. Once they had put up a website, the business evolved to be mainly online, where they can keep overheads low.

With a pool of 30 to 40 part-time workers, the company makes imaginative confections in a huge commercial kitchen provided by the Denver Enterprise Centre – a non-profit business incubator that is guiding the teens on running the business and outsourcing what they cannot do themselves.

Today, so many orders are coming in that they buy raw chocolate by the ton, and they've filled orders from as far away as New Zealand. The tepid economy has not dampened production. "If anything, business has gotten better. People seem to want comfort food", says Evan.

The company is private so the two will not reveal revenue, but Evan says the company has been profitable since day one and each quarter its income has doubled. Apart from the initial $5 000 business loan, all growth has been self-funded.

During the school year, the teens work part time on the company. In the summer, they are full time. "I think about the business a lot, and it's really cool that it's doing so well", Evan says. "But for now, school comes first."

Both say their parents are supportive and occasionally give advice and lend a hand (Mom runs another small business and Dad works in the computer industry). As for the future, it's too early to say. "I wouldn't be surprised if I study business in college", says Evan.

Source: http://www.thechocolatefarm.com

Questions

(1) Which, if any, of the five key location factors discussed in chapter 9 of Longenecker et al (2017)do you believe were considered before the decision was made to locate this venture on the internet?

(2) In what additional areas could these entrepreneurs possibly obtain valuable assistance from the business incubator?

(3) After visiting the website of this business at http://www.thechocolatefarm.com, comment on the material you found there. Is the business an example of transaction-based e-commerce? Give reasons for your answer.

(4) Do you think the business is large enough to warrant an e-CRM system? Give reasons for your answer.

SELF-ASSESSMENT

(1) What are the key attributes of a good business location? Which of these attributes would probably be most important for a retail location? Why?

(2) What is the special appeal of an enterprise zone to an entrepreneur who is looking for the best site for his/her business?

(3) What resource factors would be vital to a new manufacturing venture that produces residential home furniture? Why?

(4) Is the hometown of an entrepreneur likely to be a good business location? Is it logical for an entrepreneur to allow personal preferences to influence his/her choice of business location? Explain your answers.

(5) Discuss the conditions under which a new small manufacturer should buy
   - general-purpose equipment
   - special-purpose equipment

(6) In what conditions would it be most appropriate for a new firm to buy rather than rent a building for its business operations?

(7) What factors should an entrepreneur evaluate when considering a home-based business? Be specific.

(8) Discuss how zoning and tax laws could affect an entrepreneur's decision to start a home-based business.

(9) Discuss the two different ways of categorising business models for e-commerce.

(10) Compare B2B and B2C businesses. Identify some of the reasons customers give for not using online shopping.

SUMMARY

The importance of selecting the right location for a small business was explained in this unit. The emphasis was on customer-needs recognition as part of the location selection process. The characteristics, benefits and limitations of a home-based business were also outlined. It was pointed out that designing the physical facilities and choosing the equipment for a start-up should always be in line with cost effectiveness and productivity. Learning unit 5 focuses on the financial statements of a small business.

LEARNING UNIT 5

FINANCIAL STATEMENTS
(Prescribed book: chapter 10 of Longenecker et al 2017)

CONTENTS

INTRODUCTION

Understanding accounting has more to do with experience than ability. In this learning unit, you will learn how to construct a statement of profit or loss and other comprehensive income, a statement of financial position and a statement of cash flows. Equally important, you will learn the basics of interpreting what these financial statements, or accounting statements, tell you about a business.

LEARNING UNIT LEARNING OUTCOMES

Upon completion of this learning unit, you should be able to

- explain the purpose and content of a business's income statement, balance sheet and cash flow statement
- evaluate a firm's financial performance by using ratios

KEY CONCEPTS

- financial statements (accounting statements)
- income statement (profit and loss statement)/statement of comprehensive income
- cost of goods sold
- gross profit
- operating expenses
- operating income
- financing costs
- earnings before tax
- net income available to owners (net income)
- depreciation expense
- balance sheet
- statement of net worth
- current assets (gross working capital)
- accounts receivable
- inventory
- fixed assets
- depreciable assets
- gross fixed assets
- accumulated depreciation
- net fixed assets
- other assets
- debt
- current debt (short-term liabilities)
- accounts payable (trade credit)

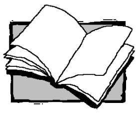
OVERVIEW

A financial analysis constitutes another crucial component of a business plan. An entrepreneur's projections of a new venture's profits, its required assets and its financial requirements over the next one to five years should be supported by substantiated assumptions and explanations on how the costs, profits and financial requirements are to be determined. In order to make the necessary financial projections, an entrepreneur should first have a good understanding of financial statements and know how to interpret them.

An analysis of the market (based on market research) tells us how many products or services (market potential) can possibly be sold over a specific period of time (market forecast). This does not mean that a new product or service will be an instant success simply because a market analysis shows that there is potential for that product or service. The key questions to ask are as follows:

- Will the new product or service be competitive?
- Can it be manufactured and sold at a profit?
- Will it produce a profit that is large enough to justify the investment?

An entrepreneur and potential investors need answers to these questions to determine whether a new venture is both feasible and attractive.


Read "In the spotlight – Tau Mining Consultants" in Longenecker et al (2017:262).


Study Longenecker et al (2017:261–300).

5.1 UNDERSTANDING FINANCIAL STATEMENTS

Because an accounting (financial) statement provides information, it can be regarded as a management decision tool. Entrepreneurs do not always prepare financial statements themselves but need to understand them and know how to interpret them.

Three important financial statements can be used for decision-making in a business: an income statement, a balance sheet and a cash flow statement. Students who have studied accounting subjects will have an in-depth knowledge of these statements and their preparation. For the purposes of this module, however, it is sufficient to know how to interpret such statements. The key financial statements are briefly outlined below.

5.1.1 Income statement or statement of comprehensive income

An income statement shows the profit or loss of a business over time and is clearly set out in exhibit 10-1 (Longenecker et al 2017:268). An income statement provides information on the following broad topics:

- revenue
- cost of goods sold
- operating expenses
- financing costs
- payment of taxes

An example of an income statement appears in exhibit 10-2 in Longenecker et al (2017:269).

5.1.2 Balance sheet

A balance sheet is a snapshot of a business's financial position at a certain point in time and includes both assets and liabilities, as set out in exhibit 10-3 (Longenecker et al 2017:273).

The assets of a business fall into three categories:

(1) current assets – liquid assets (e.g., cash, accounts receivable and inventory)
(2) fixed assets – capital-intensive assets (e.g., land and buildings)
(3) other assets – intangible assets (e.g., intellectual capital)

The right-hand side of a balance sheet indicates the ways of financing the assets given on the left-hand side. The debt and equity side consists of the following sources:

- short-term debt – accounts payable (trade credit); accrued expenses (credit not yet paid for); and short-term notes (cash borrowed on a short-term basis)
- long-term debt – bank loans (longer than 12 months); and mortgage (long-term loan for property)

Ownership equity is made up of owners' investment and cumulative profits less cumulative dividends paid to owners.

5.1.3 Cash flow statement

Effective cash flow in any small business normally ensures the survival of the business over a period of time. A cash flow statement shows the sources and uses of a firm's cash for a given period. It therefore describes the difference between cash accounting and accrual accounting. A business's cash flow generated from operating the business must equal its financing cash flows, which are the cash flows paid to or received from investors. Note the following two calculation options:

(1) **Computing cash flows from assets.** The after-tax cash flows generated from operations less the business's investment in assets are calculated as follows:

    Cash flows from assets = (after-tax cash flows from operations) --- (investment in operating working capital) --- (investment in long-term assets)

(2) **Computing cash flows from operations.** The after-tax cash flows generated from operations are calculated as follows:

    After-tax cash flows from operations = net income + depreciation expense + interest expense

Changes in operating working capital involve the money invested in current assets less accounts payable and accruals, and are calculated as follows:

Operating working capital = current assets --- accounts payable and accruals

Changes in long-term assets involve the following: When money is invested in long-term assets (e.g., land or buildings), a decrease in cash flow will occur. If an entrepreneur purchases a building for R600 000 and decides on a bond repayment amount taken over a 20-year period, the monthly cash flow will be influenced negatively by approximately R7 000 (based on a 14% interest rate plus administrative expenses).

The process of computing cash flows from financing is based on the payment made or received by investors. Exhibit 10-7 in Longenecker et al (2017:286) shows a calculation of cash flow.

5.2 EVALUATING A FIRM'S FINANCIAL PERFORMANCE

This section provides a framework for interpreting financial statements and partly corresponds with the material in learning unit 6.

Four aspects need to be considered in measuring a firm's financial performance. The aspects are outlined below.

(1) A firm's ability to pay its debt

To be able to answer the question of whether a firm is able to pay its debt, the firm's liquidity has to be determined. A firm's liquidity depends on the availability of cash for the firm to enable it to meet maturing debt obligations. A firm's liquidity can be measured in two ways, namely,

(i) by comparing the firm's assets that are relatively liquid with the debt that will fall due in the near term
(ii) by examining the timeliness with which liquid assets, primarily accounts receivable and inventories, are converted into cash

Study the formula for the current ratio in Longenecker et al (2017:290).

(2) The profitability of a firm's assets

Of concern to the owners and investors of a business is whether the company's operating profits are sufficient relative to the total amount of assets invested in the company.

These profits are discussed on page 290 and illustrated in exhibit 10.8 (Longenecker et al 2017:290). The formula for calculating the return on assets appears on page 290 of Longenecker et al (2017).

(3) Debt

The use of debt or financial leverage can increase a company's return on equity but carries some financial risk. The debt ratio is used to calculate a firm's debt or equity financing. The formula appears on page 392 of Longenecker et al (2017).

(4) Return on equity

If an entrepreneur is looking for start-up finance from potential investors, the latter will normally ask the following critical question: "What will our return on investment be?" The potential investors are interested in the rate of return they will earn on the money they invest in the business. The owner, too, is interested in knowing whether the earnings available to him/her are attractive compared with the returns of owners of similar companies in the same industry. Therefore, the return on equity has to be calculated (see the formula in Longenecker et al 2017:292).

If the return on equity is below the industry norm, a number of factors could have contributed to this situation.

All the financial ratios (and their formulas) discussed in this learning unit appear in exhibit 10-8 (Longenecker et al 2017:290) under the following four headings:

(1) A company's ability to pay debt as it comes due

- current ratio

(2) A company's profitability relative to its assets

- return on assets
- operating profit margin
- total asset turnover

(3) The amount of debt a company uses

- debt ratio

(4) The rate of return earned by a company's owners on their equity investment

- return on equity

SELF-ASSESSMENT

(1) What is the relationship between an income statement and a balance sheet?
(2) Explain the purposes of an income statement and a balance sheet.
(3) Distinguish between gross profit, operating income (earnings before interest and taxes) and net income available to owners.
(4) Why is a firm's cash flow not equal to its profit?
(5) Describe the three major components of a cash flow statement.
(6) Distinguish between owners' equity capital and debt.
(7) Explain the following ratios:
   - operating profit margin
   - total asset turnover
(8) Explain the relationship between these ratios: return on assets, operating profit margin and total asset turnover.
(9) What determines a firm's return on equity?

SUMMARY

In this learning unit, the financial statements of a small business were explained. The basic contents of the financial statements, namely, the income statement and balance sheet, were highlighted. The evaluation of a firm's financial performance was also discussed. Learning unit 6 deals with the subject of projecting the financial requirements of a firm.

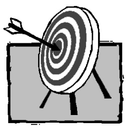
LEARNING UNIT 6

PROJECTING FINANCIAL REQUIREMENTS
(Prescribed book: chapter 11 of Longenecker et al 2017)

CONTENTS

INTRODUCTION

A good idea may or may not be a good investment opportunity. A good investment opportunity requires a product or service that meets a definite customer need and creates a sustainable competitive advantage. To be attractive, an opportunity must generate strong profits relative to the required amount of investment. Therefore, projections of a venture's profits, asset and financing requirements and cash flows are essential in determining whether it is economically viable.



LEARNING UNIT LEARNING OUTCOMES

Upon completion of this learning unit, you should be able to

- describe the purpose of and need for financial forecasting
- develop a pro forma income statement to forecast a new venture's profitability
- determine a company's asset and financing requirements based on a pro forma balance sheet

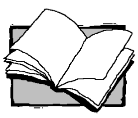
- forecast a firm's cash flow
- give suggestions for effective financial forecasting

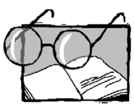
KEY CONCEPTS

- financial forecasting
- pro forma financial statement
- cost of goods sold
- gross profit
- operating expenses
- interest expenses
- taxes
- working capital
- net working capital
- bootstrapping
- percentage of sales techniques
- liquidity
- current ratio
- debt ratio
- forecasting cash flows
- cash budget

OVERVIEW

A financial analysis constitutes another crucial component of a business plan. An entrepreneur's projections of a new venture's profits, its required assets and its financial requirements over the next one to five years should be supported by substantiated assumptions and explanations on how the costs, profits and financial requirements are to be determined. In order to make the necessary financial projections, an entrepreneur should first have a good understanding of financial statements and know how to interpret them.

 Read "In the spotlight – business growth" in Longenecker et al (2017:302).

 Study Longenecker et al (2017:301–325).

6.1 THE PURPOSE OF AND NEED FOR FINANCIAL FORECASTING

The pro forma statement indicated in exhibit 11-1 in Longenecker et al (2017:306) underlines the importance and utility of financial forecasting. A pro forma statement is a projection of a business's financial condition.

The purpose of a pro forma statement is to help an entrepreneur answer the following three questions about a business:

(1) How profitable could the business be?
(2) What will determine the amount and type of financing that is procured?
(3) Will the firm have adequate cash flows (say, to pay bonds and other expenses)?

The entrepreneur needs to complete forecasts on the firm's profitability, asset and financing requirements and cash flows to answer these questions.

6.2 FORECASTING PROFITABILITY

Profit is seen as the return that an entrepreneur or investor receives for investing in a venture. Profit does not necessarily mean that a business has healthy cash flow. An entrepreneur should therefore have a clear understanding of the following factors that drive profits:

- the amount of sales (the price of the product times the number of units sold)
- the cost of goods sold
- operating expenses (fixed and variable costs)
- interest expense (cost of capital)
- taxes (a percentage of taxable income)

Study exhibit 11-1 in Longenecker et al (2017:306) for an example of a pro forma income statement.

6.3 FORECASTING ASSET AND FINANCING REQUIREMENTS

An entrepreneur should assess his/her financial asset requirements before starting a venture. Overinvestment in certain assets can easily lead to cash-flow problems. Note the following two methods that can used to estimate the asset requirements of a business:

(1) industry standard ratios
(2) the cross-checking of rand amounts by means of break-even analysis

An entrepreneur's personal financial situation should be considered in conjunction with the amount of capital needed to start and establish a new venture. In order to forecast asset requirements, entrepreneurs need to understand the relationship between projected sales and necessary assets. Exhibit 11-2 in Longenecker et al (2017:310) indicates the asset-to-sales relationship.

The following methods can be used to determine the asset requirements of a new venture:

- the percentage-of-sales technique
- the major areas of asset requirements (e.g., cash requirements, inventory requirements, accounts receivable requirements and fixed asset requirements)

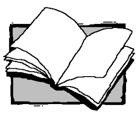
Every rand projected for assets needs a rand to finance it. The following five guidelines should therefore be adhered to in financing a business:

(1) The more assets a business has, the higher its financing requirements will be.
(2) Growth should be financed within liquidity boundaries. The current ratio is used to analyse a business's liquidity position.
(3) A business's debt ratio should be sound; the financing institution will base its financing decision on the entrepreneur's debt situation.
(4) Spontaneous financing should be in place in order to oversee short-term debts such as accounts payable, which tend to increase spontaneously in relation to increased sales (e.g., a short-term increase in sales requires an increase in inventory).
(5) The two possible sources of equity capital (external and internal sources) need to be evaluated. These factors are discussed in study unit 15.

The total asset requirements of a business can be calculated mathematically as follows:

Total asset requirements = total sources of finance = retained earnings + spontaneous sources of finance + external sources of debt and equity

6.4 FORECASTING CASH FLOWS



Read "Living the dream – entrepreneurial experiences: financial planning makes a difference at Reecycle" in Longenecker et al (2017:308).

Ways of projecting a company's cash flows include

- using the information from the pro forma income statement and balance sheet to develop a pro forma statement of cash flows

- preparing a cash budget

Read exhibit 11-6, "Three-month cash budget for MD Project", in Longenecker et al (2017:319).

6.5 THE USE OF GOOD JUDGEMENT IN FORECASTING

Longenecker et al (2017:320–322) put forward eight practical suggestions for making financial forecasts, as set out below.

(1) Develop realistic sales projections.

(2) Build projections from clear assumptions about marketing and pricing plans.

(3) Do not use unrealistic profit margins.

(4) Do not limit your projections to an income statement.

(5) Provide monthly data for the upcoming year and annual data for succeeding years.

(6) Avoid providing too much financial information.

(7) Be certain that the numbers reconcile – and not by simply plugging in a figure.

(8) Follow the plan.

SELF-ASSESSMENT

(1) What determines a company's profitability?
(2) Discuss how the asset and financing requirements of a retail business, a service company and an information system-based venture might differ.
(3) Why is it important to consider an entrepreneur's personal finances when conducting the short- and long-term financial forecasts of a firm?
(4) Describe two ways of projecting a venture's cash flows and distinguish between the circumstances in which each one would be used.

SUMMARY

In this learning unit, you learnt about the purpose of and need for financial forecasting and how to develop a pro forma income statement to forecast a new venture's profitability. In addition, you learnt how a company's asset and financing requirements can be determined based on a pro forma balance sheet. You also learnt about the forecasting of a firm's cash flows. The unit concluded with suggestions for effective forecasting. Learning unit 7 deals with a firm's sources of financing

LEARNING UNIT 7

A FIRM'S SOURCES OF FINANCING

(Prescribed book: chapter 12 of Longenecker et al 2017, pages 326–352)

CONTENTS

INTRODUCTION

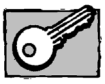
This learning unit deals with how much financing is needed by small businesses and which types of financing are available for them. The different sources of financing are explained.

LEARNING UNIT LEARNING OUTCOMES

Upon completion of this learning unit, you should be able to

- explain how the nature of a firm affects its sources of financing
- evaluate the choice between debt financing and equity financing
- analyse the typical sources of financing used at the beginning of a new venture
- discuss the basic process for acquiring and structuring a bank loan
- explain how business relationships can be used to finance a small firm

- describe the two types of private equity that investors offer in financing small companies
- identify and discuss some of the agencies that offer loans to small business enterprises in South Africa



KEY CONCEPTS

- informal capital
- business angels
- trade credit
- equipment loan
- asset-based loan
- factoring
- line of credit
- term loan
- real-estate mortgage
- prime rate
- limited liability
- venture capital

OVERVIEW

Upon determination of a venture's financial needs, namely, the amount of funding required in cash, as well as its current assets and fixed assets, it is necessary to answer other two vital questions and to include this information in the business plan:

(1) What would be the best way to finance the venture's financial or capital needs (types of financing)?
(2) What sources of finance are available?

This learning unit focuses on sources of spontaneous and external financing.

Study Longenecker et al 2017 (2017:326–352).

7.1 THE NATURE OF A FIRM AND ITS SOURCES OF FINANCING

The nature of a firm is closely intertwined with its sources of financing since the type of business, its operations and its goals significantly influence how it finances its activities. Any small business can be financed. The type of financing will be based on the four factors discussed below.

7.1.1 Economic potential

If the rate of return of a business is envisaged as potentially high, the ability of the business to create value for its investors will be regarded as high. Therefore, the business will be an attractive investment opportunity.

7.1.2 Company size and maturity

During the start-up phase, a business will have difficulty attracting finance or investment. Because of the high failure rate of small businesses during this phase, investors and/or financial institutions tend to be risk averse. An older and growing business entity will be in a better position to attract investment.

7.1.3 Types of assets

Financial institutions (e.g., banks) finance two types of assets, namely, tangible and intangible assets. Tangible assets include equipment, inventory, land and buildings. Intangible assets include research and development, goodwill and intellectual capital. Businesses and/or individuals with a strong tangible asset base will acquire finance far more easily than those without it. Bear in mind that South African banks do not include motor vehicles as collateral in their financing evaluations.

7.1.4 Owner preference for debt or equity

It is clear from the prescribed book (Longenecker et al 2017) that entrepreneurs in the USA can easily acquire financing to start up a business. However, it is not that easy in South Africa. An entrepreneur who is starting a new business generally does not have much of a choice between debt and equity financing. Financial institutions are low risk-takers and are normally reluctant to finance a small business without collateral. An entrepreneur therefore has to make use of equity finance and sell shares or membership to external investors.

7.2 DEBT OR EQUITY FINANCING?

Every new start-up finds itself in the position of having to determine the amount of financing that will be needed. This situation was discussed in learning unit 5. The question then arises: "What type of finance is available?" The financial requirements are usually adapted to the amount that can be obtained. The decision about what sources of finance to utilise will depend mainly on the type of business, its financial strength and the economic environment (e.g., interest rates). The choice between debt and equity financing involves the following specific trade-offs for founding entrepreneurs:

- **Potential profitability.** Debt as a source of finance provides some benefits such as allowing entrepreneurs to retain full ownership of their companies, meaning that they do not have to share profits with outside investors. However, the cost of debt (interest payments) can reduce net profitability, especially if a business is not generating sufficient returns.
- **Financial risk.** Debt increases a firm's financial risk because it requires regular interest payments, regardless of the firm's profitability. High levels of debt can lead to financial distress or even bankruptcy if the company cannot meet its obligations. On the other hand, equity financing doesn't require repayments, but it dilutes the entrepreneur's ownership stake.
- **Voting control.** Equity financing typically involves giving up a portion of ownership, which may dilute founders' control over their companies. This can be a significant consideration for entrepreneurs who want to maintain decision-making authority. Debt financing, on the other hand, allows an entrepreneur to retain full control but comes with the obligation to meet debt repayments.

ACTIVITY 7.1: Title (short answer

Instructions

Study exhibit 12-2, "Trade-offs between debt and equity", in Longenecker et al (2017:330).

Question

What does this figure mean?

Submission

FEEDBACK

The figure indicates potential profitability compared with financial risk and/or voting control when equity or debt financing is utilised.

Each of these factors will now be discussed.

7.2.1 Potential profitability

The use of debt increases a business owner's rate of return on his/her investment. This is illustrated in the discussion of "Able Lending" in Longenecker et al (2017:341) and exhibit 12-3, "Debt versus equity at Asbil", in Longenecker et al (2017:332).

Read "Living the dream – entrepreneurial experiences" in Longenecker et al (2017:363).

7.2.2 Financial risk

Although debt financing produces a higher rate of return for a business owner when the business is doing well, obligations to service debt yield increase business risk when the business is doing badly, whereas equity is less demanding. Study the way in which the Levine Company analyses the financial risk of debt.

7.2.3 Voting control

Equity financing requires some loss of owner control. It is necessary for an entrepreneur to decide whether it is worth losing control over something that could have cost a lot of work, time and passion! Analyse the Levine Company from this perspective.

ACTIVITY 7.2: Carter Dalton

Instructions

Read the case study on Carter Dalton and then answer the questions that follow.

Carter Dalton is well on his way to starting a new venture, Max Inc. He has projected a need for R350 000 in initial capital. He plans to invest R150 000 himself and to either borrow the additional R200 000 or find a partner who will buy stock in the company. If Dalton borrows the money, the interest rate will be 12%. If, on the other hand, another equity investor is found, he expects to have to give up 60% of the company's shares. He has forecasted earnings of about 18% in operating income on the firm's total assets.

Questions

(1) Compare the two financing options in terms of the projected return on owner's equity investment. Ignore any effect arising from income taxes.
(2) What if Dalton is wrong and the company earns only 5% in operating income on total assets?

FEEDBACK

In the first scenario:

Owner's return on equity investment = net income

If equity is issued:

$$\text{Owner's return on equity investment} = \frac{(\text{R350 000 x 18\%})}{\text{R350 000}}$$

$$= 18\%$$

If debt is issued:

$$\text{Owner's return on equity investment} = \frac{([\text{R350 000 6 18\%}] -- [\text{R200 000 6 12\%}])}{\text{R150 000}}$$

$$= 26\%$$

In the second scenario:

If equity is issued:

Owner's return on equity investment = (R350 000 6 5%) / R350 000

= 5%

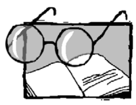
If debt is issued:

Owner's return on equity investment = ([R350 000 6 5%] -- [R200 000 6 12%]) / R150 000

= -4.3%

7.3 SOURCES OF FINANCING

The majority of all start-ups are funded by personal savings. In the past, if an entrepreneur needed financing, the usual approach was to obtain a business loan from a banking institution. This situation has changed dramatically over time, and various sources of finance now exist in South Africa. Remember that funds invested in a business (owner's equity and creditor capital) are represented on the right-hand side of a balance sheet. The sources of finance available in South Africa are discussed in the subsections below.


Study exhibit 12-4, "Sources of funds", in Longenecker et al (2017:334).

7.3.1 Sources close to home

Entrepreneurs have access to the following sources of early financing:

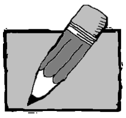
- **Personal savings.** Personal savings represent the most frequently used source of equity in start-ups.
- **Friends and family.** The financial backing of friends and family is a convenient source of finance, but also frequently a dangerous and stressful option.
- **Credit cards.** The use of credit cards to finance a business has become

increasingly common among entrepreneurs. Using credit cards, unlike approaching a bank for finance, has the advantage of speed.

7.3.2 Bank financing

Commercial banks are the main providers of business loans, but the fact remains that they have certain preferences about whom they are prepared to lend money to and for what purposes. The following three types of loans are available:

(1) lines of credit
(2) term loans (short term, medium term and long term)
(3) mortgages – real estate

**ACTIVITY 7.3: Research**

Instructions

As a potential or existing entrepreneur, contact any commercial bank in your region and find out what a banker needs to know in order to decide whether to grant a loan to a start-up.

**FEEDBACK**

The different banks will ask different questions. The basic requirements, however, involve a business plan and the five Cs of credit, which will be explained below.

All the major commercial banks in South Africa (Nedcor, ABSA, First National Bank and Standard Bank) have a small business development division with specialised staff who support smaller businesses from the start-up to growth phases. Some banks even allow entrepreneurs to apply for business loans via the internet (see www.nedbank.co.za). When approaching a bank manager or consultant, one needs to understand the bank's perception and approach. Because a bank is also a business, it is concerned with its return on investment and the risk potential of a loan agreement.

Commercial banks use the five Cs of credit to evaluate a potential customer:

(1) the **character** of the entrepreneur
(2) the entrepreneur's **capacity** to repay the loan
(3) **conditions** in the industry/economy
(4) the **capital** invested by the entrepreneur (normally a 50% norm)
(5) **collateral** (security, normally in the form of cash or fixed assets)

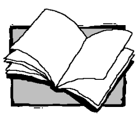
In addition to the above, the entrepreneur needs to

- foster a personal relationship with the banker
- provide accurate information in support of the loan request
- submit a well-prepared written presentation
- select a bank on the basis of its range of available services, location and lending policies
- negotiate a loan

When negotiating a loan, the parties involved need to agree on the following four loan terms:

(1) the interest rate – a negotiable variable
(2) the loan maturity date – depends on the need
(3) the repayment schedule – either equal or decreasing monthly or annual payments
(4) the loan covenants – restrictions to ensure loan repayment, such as

    - the provision of monthly statements
    - a limitation on managers' salaries
    - a limitation on financial ratios
    - a personal guarantee of the loan



Read exhibit 12.6, "Sample written loan request", in Longenecker et al (2017:339).

7.3.3 Business suppliers and asset-based lenders

Entrepreneurs can make use of the following three types of credit:

(1) **Accounts payable (trade credit).** This form of lending is based on short-term funds in the form of accounts payable. The term of payment varies between 30 and 120 days.

(2) **Equipment loans and leases.** Various businesses make use of an option to lease or loan equipment according to a medium-term framework. The term may vary between three and five years. These kinds of loans normally include office equipment such as copy machines, facsimile machines or computers; even vehicle finance is based on this option. There are three reasons why this is a feasible option for a small business:

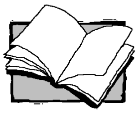
- Cash is freed up for other purposes.
- Lines of credit can be applied for other purposes.
- Old technology-driven equipment is replaced with the latest equipment (obsolescence), that is to say, the leaser replaces old equipment when its functions become redundant.

(3) **Asset-based lending.** Asset-based lending is a line of credit that is secured by assets such as accounts receivable or inventory. The most popular form is known as factoring, which is a process in which an entrepreneur sells his/her accounts receivable (debtors) to another firm in exchange for a cash amount.

7.3.4 Private equity investors

Private equity markets are the fastest-growing source of equity financing and can be categorised into the following two groups:

(1) Business angels are private individuals who invest in other people's entrepreneurial ventures.
(2) Venture capitalist firms are individuals who form limited partnerships to raise capital from large institutional investors.

 Read "Living the dream – entrepreneurial experience: Shark Tank: changing the game of angel investing" in Longenecker et al (2017:347).

7.3.5 Government-sponsored and non-governmental programmes and agencies

The South African government grants loans through the following financing vehicles:

- Khula Enterprise Development provides 80% of the collateral required by a bank for a loan. For the collateral it provides, Khula charges additional interest, as arranged with it. Khula further specialises in providing small loans that are not profitable for or popular with South African banks
- The Industrial Development Corporation (IDC) is a key implementing agency of industrial policy. It identifies sector development opportunities aligned with policy objectives and develops projects in partnership with stakeholders (visit the IDC's website at www.idc.org.za).
- The Southern Africa Enterprise Development Fund (SAEDF) provides funding to stimulate the creation and expansion of small and medium-sized businesses throughout Southern Africa.
- The Small Business Development Corporation (SBDC) has been replaced by Business Partners, an organisation that offers various investment and loan options to entrepreneurs. Visit the SBDC's website at www.businesspartners.co.za to see the ways in which it services the entrepreneurial sector.
- For information about the government's other entrepreneurship support programmes, go to www.dti.gov.za.

7.3.6 Where else to look

Entrepreneurs can also approach the following sources for funds:

- Large corporations in South Africa have corporate social investment funding that is sometimes allocated to entrepreneurial development.
- Stock sales, that is, the selling of stock to outside investors could generate the required funding.

SELF-ASSESSMENT

(1) In what way does the type of business affect its sources of financing?
(2) In what way does debt differ from equity?
(3) Explain the three trade-offs that guide the choice between debt financing and equity financing.
(4) Assume that you are starting a business for the first time. What, in your opinion, are the greatest personal obstacles to obtaining funds for the new venture? Give reasons for your answer.
(5) If you were starting a new business, where would you look for capital?
(6) Explain how trade credit and equipment loans can provide initial capital funding.
(7) Describe the different types of loans granted by commercial banks.
(8) What does a banker need to know in order to decide whether to grant a loan to a start-up?
(9) What advice would you give an entrepreneur who is trying to finance a start-up?

SUMMARY

In this learning unit we looked at the process of acquiring finance for any phase of small business development. This is a daunting task. The main decision that an entrepreneur faces is to choose between debt financing and equity financing. Various financing options exist in South Africa, ranging from bank loans to venture capital.

TOPIC SUMMARY

Topic 1 covered all the factors that play a role in developing a business plan for a new business venture. The role of a business plan was discussed, with specific reference to the stakeholders involved and the correct format of a written plan. The marketing plan of a business was dealt with in a separate learning unit but should be studied as part of the main business plan. Entrepreneurs tend to lack basic management skills, which is why learning unit 3 provided information on how to manage a small business by means of the compilation of management teams, the structuring of an effective organogram and the identification of strategic alliances. The correct location decision was covered in unit learning unit 4, with specific reference to all the relevant factors that should be considered in choosing and planning the best business facilities. Financial management in a small business context may fundamentally influence the level of risk that entrepreneurs are prepared to take on. A proper analysis of the projected financial requirements of a small business is therefore essential in order to provide the basis for obtaining the most suitable sources of financing. Topic 2 deals with small business marketing growth strategies.

TOPIC 2: FOCUSING ON THE CUSTOMER: MARKETING GROWTH STRATEGIES

AIM

The previous topic dealt with all the components of a business plan and the entire business planning process. This topic focuses primarily on one of the fundamental business skills all entrepreneurs need to acquire, namely, marketing a small business. The marketing function exposes a business to the market environment and helps to introduce a business's products, services or processes in line with customer needs. This topic emphasises the importance of customer satisfaction and, therefore, a market-oriented approach. The fundamental aspects of the marketing function, namely, pricing, credit strategies, promotion and distribution strategies will also be covered.

Every learning unit in this topic includes a South African case study. These case studies are examples of the larger success stories in the private business sector. The firms dealt with in the case studies are large in both size and turnover, but bear in mind that most corporate giants, like most entrepreneurs, started small.

LEARNING OUTCOMES

Upon completion of this topic, you should be able to

- explain customer relationship management
- describe the development of a product strategy and distribution strategy for a small business
- determine the pricing strategy and credit strategy of a small business
- discuss the development of a promotional strategy in a small business context

TOPIC CONTENT

This topic consists of four learning units, as shown below.

Learning unit	
8	Customer relationships
9	Product and supply chain management
10	Pricing and credit strategies
11	Promotional planning

LEARNING UNIT 8

CUSTOMER RELATIONSHIPS

CONTENTS

INTRODUCTION

Managing customer relationships pays great dividends. Long-term customers usually stay with a business because they trust it, and that trust naturally translates to increased sales. Loyal customers tend to buy a business's more expensive products, are less sensitive to price increases and bring their friends in to the business. This unit explains how to create and maintain vital connections that will satisfy a business's customers, enhance the reputation of a business and generate superior company performance.

LEARNING UNIT LEARNING OUTCOMES

Upon completion of this learning unit, you should be able to

- define "customer relationship management" (CRM) and explain its importance in a small firm
- discuss the significance of providing extraordinary customer service
- illustrate how technology, such as the internet, can improve customer relationships
- explain the techniques for creating a customer profile
- discuss consumers as decision-makers and explain why this aspect is important to understanding customer relationships
- discuss psychological influences on consumer behaviour
- analyse sociological influences on consumer behaviour

KEY CONCEPTS

- customer relationship management (CRM)
- transactional relationship
- customer profile
- evaluative criteria
- evoked set
- cognitive dissonance
- needs
- perceptions
- perceptual categorisation
- motivation
- attitudes
- culture
- social classes
- reference groups
- opinion leaders

OVERVIEW

Corporate marketing may differ from small business marketing. Textbooks can easily create unrealistic expectations, such as that a business should always use television as a promotional medium. Take the example of a small hamburger outlet that costs R80 000 to establish. Would it be wise to spend R650 000 to advertise the business on television? Definitely not. The small business environment differs considerably from the corporate sector – not only in respect of the physical size of the businesses but also in respect of the approach followed in managing small units effectively. The marketing of a small venture is also different from that of a large company, but the basic principles applied in the market environment will always be the same. However, the rules of the game are always changing – one only has to look at the increasing importance of internet marketing.

> The customer is more than a target. This requires a consistency of approach, a dedication to believing in the customer as more than a sales target, being driven by them and their needs. Delivering against expectations each and every day, and being prepared to go that extra bit. It requires a willingness to become engaged, to enter into a relationship, whether that relationship is fleeting, a single transaction, or is over the long haul. That is what a service is, a relationship – and good service is a good relationship. (Irons 1997:7)

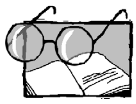
The above quotation has one fundamental message, namely, the importance of the relationship between the business and the customer (it is almost like a marriage!). Since the 1990s, South Africa has seen an increase in the number of competitors in the market environment. Think back to the 1980s. How many competitors did Wimpy, BMW and Edgars have? Nowadays, customers have many more choices in the market, and if they are not satisfied with a certain product or the quality of a particular service, they can change to another product or service. This fact has a large impact on small business owners. In order to secure customer loyalty, a customer-oriented approach should be the core activity in day-to-day and long-term time frames. This learning unit deals with the customer service, product strategy and distribution strategy of a small business.

 Study Longenecker et al 2017 (378–400).

8.1 WHAT IS CUSTOMER RELATIONSHIP MANAGEMENT?

Customer relationship management (CRM) focuses on

- customers rather than products
- changes in company processes, systems and culture
- all channels and media involved in the marketing effort, from the internet to field sales

For a definition of CRM, as well as a discission of the benefits of CRM for a small firm and essential materials for a CRM programme, study pages 380–381 in Longenecker et al (2017) and exhibit 14-2.

8.2 CREATING POSITIVE TRANSACTIONAL RELATIONSHIPS THROUGH EXTRAORDINARY SERVICE

The following causal chain is evident in the process of satisfying the customer:

Superior customer service → customer satisfaction → customer loyalty

A small business owner or manager is in a favourable position to create customer loyalty because of his/her proximity to the customer. Therefore, a small business is in a better position to render superior customer service than a large company. What are the components of customer satisfaction?

Study exhibit 14-1, "Sources of the next sale", in Longenecker et al (2017:381) and exhibit 14-2 on the essential materials of a successful CRM programme.

8.2.1 Managing customer satisfaction

Small businesses are in an ideal position to offer exceptional service. A small business can deliver exceptional service in the following ways:

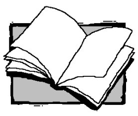
- Doing business on a first-name basis.

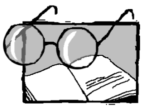
- Keeping in touch – personal interactions are key to building relationships.
- Finding ways to help – helping clients may not lead to immediate sales but can be good for business.
- Customising services to meet customer preferences. This will increase the value of what the business offers while also showing the clients that they are important to the business.
- Attending to problems promptly. When issues arise, the business should take steps to resolve them quickly. This will show the customers that they are important.

Study "Managing customer satisfaction" in Longenecker et al (2017:382–385).

8.2.2 Evaluating a firm's customer service health

As mentioned earlier, a small business can excel in customer service because of its size and flexibility.

Read exhibit 14-3, "Customer service strategies", in Longenecker et al (2017:385).

Study exhibit 14-4, "Consumer options for dealing with product or service dissatisfaction", in Longenecker et al (2017:387).

**ACTIVITY 8.1: Question and answer**

Access www.sewell.com to search for additional information on the significance of providing extraordinary customer service. As you explore the website, focus specifically on the four areas of customer satisfaction and what businesses can do to render exceptional service. As you read, summarise the key points, identify the main arguments and note any pertinent statistics or case studies. Write a reflection on how this information contributes to your understanding of a firm's customer service health.

FEEDBACK

Exceptional service

(1) Do business on a first-name basis.
(2) Keep in touch.
(3) Find ways to help.
(4) Customise services to meet customer preferences.
(5) Attend to problems promptly.

Study exhibit 14-4, "Customer options for dealing with product or service dissatisfaction", in Longenecker et al (2017:387).

8.3 USING TECHNOLOGY TO SUPPORT CUSTOMER RELATIONSHIP MANAGEMENT

Modern technology creates opportunities for businesses to improve their customer service drastically. Different kinds of media and machines bring customers closer to service providers (e.g., e-mail, landline phones, cellular phones, WAP phones and computer data processing). The traditional visit to one's banking branch can easily and conveniently be replaced with internet banking. Customer service has seen drastic changes as a result of advanced technology, with the emphasis on speed, convenience and cost.

ACTIVITY 8.2: Mini research

This activity is designed to enhance your intellectual growth by giving you an opportunity to explore a topic in depth and to expand your knowledge base.

Instructions

(1) **Resource:** Study exhibit 14-4 in Longenecker et al (2017:387).

(2) **Prepare for the interview:**
   - Choose a business in which your are interested.
   - Jot down questions for an interview with the marketing manager of that business.
   - Arrange an interview with the marketing manager.
(3) **Conduct the interview:** During the interview, ask questions that will enable you to evaluate the company's customer service strategy.
(4) **Note-taking:** Keep a record of the information you gather during the interview. Highlight interesting facts and any emerging trends related to your investigation.
(5) **Reflection and analysis:** Reflect on the information you have gathered. Consider how it relates to what you have learnt in the learning unit so far and what implications it might have for the field of customer service,
(6) **Summarise your findings:** Create a summary or an overview of your mini research. Presenting your findings in a structured format (such as a written summary, a mind map or a short video presentation) could enhance your understanding of the topic.

8.4 BUILDING CUSTOMER PROFILES FOR A CRM PROGRAMME

A customer profile is a collection of information about a customer, including demographic data, attitudes, preferences and other behavioural characteristics, as defined by CRM goals (Longenecker et al 2017:389). The following four major categories of information have been identified in respect of a customer profile:

(1) transactions
(2) customer contacts
(3) descriptive information
(4) responses to marketing stimuli

Keep in mind that high service quality will promote word-of-mouth marketing.

8.5 CUSTOMERS AS DECISION-MAKERS

Understanding customers forms the basis of customer satisfaction and, if addressed correctly, will lead to customer loyalty. An entrepreneur therefore needs to know how customers think when they make purchasing decisions.

According to the model of consumer behaviour shown in exhibit 14-6 (Longenecker et al 2017:393), consumer decision-making comprises the following four stages:

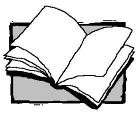
- **Stage 1: problem recognition.** Some problems are recognised routinely (e.g., buying food for the month), while others are not (e.g., craving a chocolate). Study the factors that influence a customer's recognition of a problem in Longenecker et al (2017:393).

- **Stage 2: information search and evaluation.** A customer has a set of evaluation criteria that is used to identify the characteristics of a product or service (e.g., brown genuine-leather shoes). This set will always be used to choose from various brands. A customer also has an evoked set of criteria, which is a group of brands he/she is aware of and will consider in order to satisfy a specific need (e.g., Spur, Steers, McDonald's, Mimmo's or Ocean Basket can all satisfy the customer's need for a meal). When new products are introduced (e.g., cellular phones, DVD players and palmtop handsets), the whole evaluation process will take much longer. Advertising that stimulates awareness will change customers' criteria over time (e.g., an advertisement explaining the benefits of a DVD player in terms of quality will inspire customers to purchase one).

- **Stage 3: purchasing decision.** Upon evaluating all brands and features, a customer will decide where (e.g., a retail outlet at a mall) and how (e.g., physically visiting the outlet or purchasing via the internet) the purchasing action will take place. The store layout, sales personnel and point-of-purchase displays should make the purchasing decision worthwhile to ensure the retention of business.

- **Stage 4: post-purchase evaluation.** The payment for goods by a customer is not the end of the purchasing process (although many South African businesses have different views on this!). After a customer has purchased a product from a business, the entrepreneur or sales team is responsible for retaining the customer and ensuring future sales. It is also the entrepreneur or sales team's responsibility to avoid customer post-purchase cognitive dissonance (see the definition in Longenecker et al 2017:395). An example of cognitive dissonance would be buying a white car and, after driving several kilometres on the highway, observing many cars of the same make but only in the colour red. The colour red now looks sportier, and you wish you had bought a red car. Cognitive dissonance will kick in and you will feel dissatisfied with your purchase (also referred to as "post-purchase trauma"). Some vehicle manufacturers try to overcome this phenomenon by writing an aftersales letter to their customers, with a highly personalised message, such as one in which they congratulate customers on the purchase of the white model. The way in which complaints are handled will also have a negative or positive impact on post-purchase evaluation. Remember the golden rule: if a customer leaves a telephone message about a product complaint, return his/her call immediately.

Study exhibit 14-7, "Post-purchase activities of consumers", in Longenecker et al (2017:396).

Read Longenecker et al (2017:395), "Living the dream – entrepreneurial experiences: little brother is watching, but he only wants to help".

8.6 UNDERSTANDING PSYCHOLOGICAL INFLUENCES ON CUSTOMERS

The mind is the managing unit of a customer's decision-making processes. Four psychological factors influence these processes, as explained below.

(1) **Needs.** The existence of a need is the initial step in the purchasing process. A need can also be described as a problem that should be solved. The four basic needs are described as physiological (e.g., hunger), social (e.g., fitting into the social structure of society or wearing certain types of clothing), psychological (e.g., thinking that a certain style of dress or stretch denims will suit one's figure) and spiritual (e.g., buying a CD that will make one feel emotionally uplifted, thus creating an atmosphere or a mood).

(2) **Perceptions.** Perceptions are individual processes that give meaning to stimuli. When a person wears a red dress, many perceptions will be formulated of that person. Some people will assess this act as aggressive, while others may see it as a reflection of happiness. Customers normally react to large amounts of stimuli

through perceptual categorisation (see the definition in Petty et al 2010:381). When you walk down a street in an urban environment, you will see that at least 60% of the people have cell phones on them. This creates the impression that everyone needs a cell phone and that owning a handset has certain benefits.

(3) **Motivation.** What motivates someone to buy a specific brand? Why do people drink coffee in coffee shops rather than at home? Motivation is an intrinsic or extrinsic force that organises and gives direction to the tension created by unsatisfied needs or problems.

(4) **Attitudes.** Consumer attitudes towards products or services have a large impact on customer behaviour. An attitude is an enduring opinion based on knowledge, feelings and behavioural tendencies. What is the broad public's attitude towards smoking in South Africa? What is a customer's attitude towards restaurants that ignore legislation on smoking in public areas? Customer attitudes can be a major obstacle, especially when a new product/idea with a highly controversial value is introduced (e.g., selling beer in supermarkets in South Africa).

8.7 UNDERSTANDING SOCIOLOGICAL INFLUENCES ON CUSTOMERS

Sociological factors are the last set of influences in the customer behaviour process. The following four variables influence customers on a social level:

(1) **Culture.** Culture is defined as the social heritage of humanity and is reflected in behavioural patterns and values. South Africa is one of the countries in the world with the most diverse cultural make-up. For example, we have 11 official languages, various religious preferences and customs that are unique to our cultures. This fact makes the whole marketing action fairly complex, but also interesting. Ignoring the primary market's cultural beliefs and customs may be offensive and lead to decreases in turnover and market share.

ACTIVITY 8.3: Culture

Instructions

Analyse your culture and then answer the following questions:

Questions

(1) What is unique about your culture?
(2) How does the uniqueness of your culture influence your purchasing decisions?
(3) Why does Iwisa Maize advertise at football games?
(4) Why does Sasol sponsor rugby teams and matches?
(5) Why did M-Net start an Afrikaans channel, kykNET?
(6) Why is Isidingo such a success as a true South African "soapie"?

FEEDBACK

The answers to the questions in this activity will be based on your own judgement and perceptions. Many companies try to incorporate cultural characteristics into their product range to capture a specific cultural group as a target market. However, all marketers have a social responsibility to evaluate every marketing action in a culturally sensitive way.

(2) **Social classes.** Social classes are divisions or groups of people in society with diverse levels of social prestige. The social class of an individual is determined by the following factors: occupation (e.g., a medical doctor versus a clerical worker); possessions (e.g., a three-storey mansion versus a bachelor flat); source of income or income level (e.g., R1 million/annum versus R19 000/annum); and education (e.g., a doctorate in nuclear physics versus a certificate in bodybuilding). Social class influences the types of products purchased (e.g., a luxury car versus a bus ticket) and the actual purchasing process (e.g., cash payment versus monthly instalments).

(3) **Reference groups.** A reference group is a group of individuals that influences the purchasing behaviour of individuals in a marketing context. Examples of reference

groups are friends, family, classes at school and business associates. Reference groups wield different types of power, such as reward, coercive, expert, referent and legitimate power (study the explanations of these concepts in Longenecker et al 2017:399). How many young people are influenced by reference groups to use drugs? How many business people are influenced by reference groups to play golf? Entrepreneurs can use the power of reference groups to steer the purchasing behaviour of their target markets.

(4) **Opinion leaders.** Opinion leaders are individuals in society who have a leadership and communication advantage in their fields. They are normally highly visible, knowledgeable and exposed to the media. Why did so many clothing outlets sell Nelson Mandela shirts between 1992 and 1996? Why do Spur restaurants use well-known cricket/rugby players in their advertisements? Entrepreneurs should continually assess the media to identify opinion leaders that could be involved in the promotion of their products.

ACTIVITY 8.4: Entrepreneur to formalise lobola process (case study)

Instructions

Read the case study titled "Lebogo: entrepreneur to formalise lobola process" and answer the question based on it.

Adapted from: http://www.realbusiness.co.za

The subject of a marriage contract is a touchy one, even in so-called modern societies. A marriage contract is viewed as a forecast of troubled times, which no couple in love believes is a possibility. If marital problems or a death occurs, one cannot be grateful enough for that moment of sense when the contract was signed and sealed. In African cultures, there is more to marriage than simply the binding of two people in matrimony.

Marriage may serve as a relationship-building tool between feuding families and tribes, with the lobola negotiations acting as the first step in the process. Lobola payments have, so far, been based on the good word of the people involved. However, with the introduction of money rather than barter goods, the system has become open to corruption, while unexpected issues, such as a death, have never been accommodated. Official contracts or receipts are unheard of and in the case of a misfortune, the woman can be left the victim with no proof of payment and, therefore, no ties to her partner's family.

Mpho Lebogo, a risk custodian at FNB corporate property finance, has started a sideline business, African Innovation, that writes up contracts specifically for the lobola procedure. He says he has come across numerous problems with the current system based on observations of various family members. Since the introduction of civil law in South Africa, there has been a lack of clarity on the status of lobola payments; some regard it as a marriage in itself while others view it only as an indication to marry. Once half the lobola has been paid, the partners are considered to be engaged.

Complications often arise when greed creeps in, and the bride's family may forget the importance of half of the lobola, which should be used for the white wedding or final marriage session known as *dihlabiso*. There may be conflict if one of the prospective spouses dies. According to the Sepedi custom, the living partner is "married" to the family of the deceased. Another problem is that the recording of proceedings and consensus reached between the families is poor. Documents often do not correspond, and gifts involved in the negotiation process are not identified and quantified. Even the partners might not be identified, although the families' surnames are mentioned. Cultural beliefs also come into play.

Lebogo tells of an incident where the Sotho tribe was in lobola negotiations with the Xhosa tribe, which refused to write the agreement on paper based on the belief that it would lay a curse on the tribe. Without documentation, it becomes an issue for the groom whether he may risk losing the lobola money and possibly his wife. The solution, says Lebogo, is to base the procedure on a contract, recording proceedings. He says details should be provided of the *pula molomo* or "mouth opener" (a small gift to open negotiations); prescript items; the amounts agreed, paid and outstanding; and the full names and signatures of the potential spouses and witnesses. Lebogo has drawn up such a contract that confirms a customary marriage for the purposes of registering the marriage with the Department of Home Affairs and has been endorsed by the Proudly South African campaign. The agreement for both monogamous and polygamous marriages serves the same purposes as that of a civil law marriage contract to be issued with a marriage certificate.

Civil law marriage has never accommodated lobola, but the contract that Lebogo intends to market will serve as a customary marriage agreement. It also claims the assets of a late spouse if the marriage has not yet been registered with the Department of Home Affairs and can be used in a court of law should any dispute arise. Lebogo says that, at a recent presentation in Polokwane, most questions were about polygamous marriages. Men did not understand the logic behind the first wife's authorisation and the court consultation or approval for such a marriage. Hence, should anyone intend to marry polygamously, the spouses must consult the high court and pay an amount of not more than R10 000. Lebogo has a separate contract specifically for polygamous marriages. He says the tribal council welcomed the option of a legal contract since it would reduce customary marriage problems, particularly as proof of the agreement can be produced. Lebogo has had the contract copyrighted and has proposed its use to the Department of Home Affairs and the customary marriage division. Part of the first stage was to test the product among friends and family members and to obtain buy-in from tribal councils and their chiefs.

Lebogo, who grew up in Limpopo, went to his community's chief as a starting point. The contract was received positively there and is likely to gather momentum through the networking process of various councils. As part of the second stage, Lebogo made a proposal to Proudly South African, which was approved, and the first sale was made. The contract is available in all the official languages, although getting a foot in the door of some of the other nations may not be as easy as it was approaching nations with cultural similarities to the Bapedi, which is Lebogo's background. "I have been involved in negotiations with a Sotho family and a Tsonga family", he says. "I have consulted with other nations and have done translations, which were accepted in all languages, except Afrikaans, where lobola isn't really paid. In those situations, English will do. There are numerous cultural factors to consider."

If he wishes to present the idea to the Zulu king, for example, Lebogo will need the contact of a respectable Zulu man who will help him to gain access to those areas. This is where the business now stands. From here, Lebogo needs a kick-start in funding and basic equipment, as well as an incubation possibility. "I have approached the Innovation Hub, a Blue IQ project, and am waiting for a response", he says. The final stages of putting the business into operation will be marketing and consulting and obtaining approval from all local provinces, chiefs and the tribal unions. Once advertising has appeared in the local newspapers and broadcast on radio and possibly television, Lebogo will have to have a call centre set up to deal with inquiries. "In many rural areas, people cannot write, so I will have to have a comprehensive call centre set-up", he says. In terms of marketing, negotiations are already under way to have liquor stores sponsor the "mouth opener". Lebogo aims to take his concept to the international market and to get ahead of any potential competition, which is inevitable. Financing a business is never easy and from Lebogo's point of view, creating a budget is not an easy task either, particularly as this product is new to the market. The problems he faces are: Is it better to take it slowly, one province at a time, or is it better to go all out, obtain a large loan, set up the call centre and market aggressively? The first option will be cheaper and less risky, but the second will ensure that competition is held off for a time.

Question

What must Lebogo do to understand his customers?

FEEDBACK

The business concept that Mpho Lebogo has created is a sound and extremely creative one. However, it appears to have complex implications from a community point of view. It is MTN's recommendation that Lebogo should not set up a call centre until his business has been firmly established. It would be easier and more cost effective to outsource this function, in the interim, if necessary. MTN also needed to segment its target audiences when it started its business 10 years ago. MTN recommends that Lebogo determine the market size for his business and the potential uptake for each of the market segments and then focus on creating customised offerings for each segment. Although the concept is extremely entrepreneurial, Lebogo is dealing with the most traditional of communities. MTN therefore recommends that he embark on a series of high-level negotiations with the respective traditional council chiefs, as well as an intensive word-of-mouth campaign.

SELF-ASSESSMENT

(1) Critically discuss the concept of customer relationship management. In your discussion, explain what the following statement means: "CRM is primarily a mindset."

(2) Does CRM place more emphasis on current or potential customers? Give reasons for your answer.

(3) Discuss the two essential building blocks of a successful CRM programme. What "materials" are used to construct these building blocks?

(4) Why is a small firm potentially in a better position to achieve customer satisfaction than a large organisation?

(5) Illustrate how technology supports customer relationship management.

(6) What types of information should be part of a customer profile?

(7) Critically discuss the techniques or sources of information that could be used to develop a customer profile.

(8) Discuss the four stages of the consumer decision-making process. Why is the first stage so vital to consumer behaviour?

(9) Discuss the four psychological influences on consumers that are highlighted in this learning unit. What is their relevance to consumer behaviour?

(10) Discuss the four sociological influences on consumers that are highlighted in this learning unit. What is their relevance to consumer behaviour?

SUMMARY

In this learning unit we looked at the way in which entrepreneurs prepare to market their products or services effectively. We discussed the essential variables in understanding customers. Customer behaviour is the cornerstone of marketing management because knowledge of the way in which customers behave ensures the development of marketing activities that are in line with their needs. In the next learning unit we will discuss product and supply chain management.

LEARNING UNIT 9

PRODUCT AND SUPPLY CHAIN MANAGEMENT

CONTENTS

INTRODUCTION

In learning unit 8 you learnt about customer decision-making (demand) and the need for entrepreneurs to make a strong commitment to customer relationship management (CRM) to ensure that new customers are drawn to their businesses and that connections with current customers are preserved. You also learnt that marketing programmes must reflect consumer behaviour concepts if CRM efforts are to sustain a business's competitive advantage. In this learning unit we will discuss the demand side of the equation further, explaining how product innovation, like the improvements made by RegimA, can lead to business growth from increased demand. You will also get a healthy dose of supply-side thinking, in that we will discuss product and supply chain management decisions, which, together, have a significant impact on the total bundle of satisfaction offered to customers. Business growth can be a wonderful thing, but supply–demand balance is critical to the success of an enterprise.

LEARNING UNIT LEARNING OUTCOMES

Upon completion of this learning unit, you should be able to

- explain the challenges associated with growth in a small firm
- explain the role of innovation in a firm's growth
- identify the stages in the product life cycle and the new product development process
- describe the components involved in building a firm's total product
- explain product strategy and the alternatives that are available to small businesses
- analyse how the legal environment affects product decisions
- explain the importance of supply chain management
- specify the major considerations in structuring a distribution channel

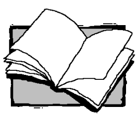
KEY CONCEPTS

- sustainable competitive advantage
- product life cycle
- brand
- brand image
- brand name
- brand mark
- trademark
- service mark
- warranty
- product strategy
- product team
- product line
- product mix
- product mix consistency
- product
- patent
- utility patent

- design patent
- plant patent
- copyright
- trade dress
- supply chain management
- distribution
- physical distribution (logistics)
- channel of distribution
- merchant middlemen
- agents/brokers
- direct channel
- indirect channel
- dual distribution
- common carriers
- contract carriers
- private carriers

OVERVIEW

In the previous learning unit you learnt that entrepreneurs need to make a strong commitment to customer relationship management (CRM). You also learnt that marketing programmes must reflect consumer behaviour concepts if CRM efforts are to sustain a firm's competitive advantage. In this learning unit we will explore the challenges associated with growth and the role of innovation in a firm's growth and then delve into product and supply chain management decisions. These factors have a remarkable impact on the total bundle of satisfaction offered to customers.



Read "Products that change lives – RegimA" in Longenecker et al (2017:438).

Study Longenecker et al (2017:406–429).

9.1 TO GROW OR NOT TO GROW

Longenecker et al (2017:408) explain the challenges associated with growth in a small business, in particular, the pressure on cash flow, difficulty obtaining external funding and demands on personnel and management style.

9.2 INNOVATION: A PATH TO GROWTH

Although innovation can be used to gain a competitive advantage, the risk of failure may increase. Longenecker et al (2017:409–412) suggest the following six rules of thumb to reduce the risk of failure:

(1) Base innovative efforts on your experience.
(2) Focus on products or services that have largely been overlooked.
(3) Be sure there is a market for the product or service you are hoping to create.
(4) Pursue innovation that customers will perceive as adding value to their lives.
(5) Focus on new ideas that will lead to more than one product or service.
(6) Raise sufficient capital to launch the product or service.

Although continued innovation is critical to sustaining a competitive advantage, other strategies can be utilised to secure a sustainable competitive advantage. Longenecker et al (2017:411) explain the competitive advantage life cycle (exhibit 15-1) and illustrate how a competitive advantage can be sustained (exhibit 15-2).

9.3 THE PRODUCT LIFE CYCLE AND NEW PRODUCT DEVELOPMENT

It is an entrepreneur's responsibility to assess at what stage in the product life cycle a product is and when to introduce new innovations in order to counteract the decline phase. The product life cycle is a summary of the sales and profit of a new product over its expected life. The product life cycle is a guide for the total product, price, promotion and distribution strategy. By studying the product life cycle, an entrepreneur can gauge when to start with new product innovation. For example, because of the introduction of digital video discs (DVDs), ordinary video cassettes are now in the mature and almost decline phase of the product life cycle. Similar examples are the long-playing record (LP) versus the compact disc (CD), the landline phone versus the cellular phone and the personal desktop computer versus the laptop.

Read exhibit 15-2, which depicts the product life cycle (Longenecker et al 2017:412).

Developing a new product requires a certain process that involves the following consecutive stages:

- stage 1: idea accumulation from many possible sources
- stage 2: business analysis – considering four key factors
- stage 3: development of the product
- stage 4: product testing to prove acceptability

9.4 BUILDING THE TOTAL PRODUCT

Building a suitable product offering over time, again in line with customer needs and beliefs, will ensure increases in market share.

The success of any product offering depends on the inclusion of the components discussed below.

9.4.1 Branding

A brand provides the means to identify a product. It can be symbolic (e.g., the three-pointed star of Mercedes-Benz) or verbal (e.g., "Aaaaaah, Grand-Pa"). Study the five rules of branding in Longenecker et al (2017:416). Make sure you can distinguish between a trademark and a service mark.

Study exhibit 15-3, which shows the components of a brand identity (Longenecker et al 2017:417).

Read the tips for logo design (Longenecker et al 2017:418).

You should be able to distinguish between the following concepts: brand, brand image, brand name, brand mark, trademark and service mark.

9.4.2 Packaging

In addition to providing safety and hygiene, packaging enhances the value of the total product offering. For example, a certain Swiss chocolate company spends more on packaging than the core product, chocolate. Many attributes need to be considered when deciding on packaging: colour (e.g., the red of Coca-Cola), safety (e.g., medicine), durability (e.g., olive oil containers) and visibility (e.g., the green cap of a Handy Andy bottle).

9.4.3 Labelling

Labels serve several useful purposes for customers. Information is the principal feature of labelling (e.g., name/brand of the product, ingredients, volume, disposal of the product and certain legal considerations, such as the statement printed on cigarette packs that smoking is harmful to one's health).

9.4.4 Warranties

A warranty is a promise to customers that a product will perform at a certain level and meet set standards. It can be in written or verbal form. The following factors need to be considered in respect of warranties:

- the cost (to replace or repair products)
- service capability (with or without specialised staff)
- competitive practices (adapt to competitors)
- customer perceptions (customers expect warranties on motor vehicles and appliances)
- legal implications (the cost of lawsuits)

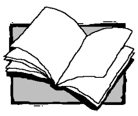
9.5 PRODUCT STRATEGY

Products include goods (which are tangible, for example, television sets) and services (which are intangible, like receiving advice from a business consultant). The marketing of these variables is not the same. Different approaches and strategies need to be developed in line with customer needs. A hair salon that renders a service will have a different offering approach than a retail outlet that sells shampoo and skin-care products.

Study the following terms and indicate the differences between them:

- product strategy
- product item
- product line
- product mix
- product mix consistency

Thinking of an example of each term will give you a better idea of its meaning.

Read exhibit 15-4, which deals with the product lines and product mix of 180s LLC (Longenecker et al 2017:421).

9.5.1 Product marketing versus service marketing

In exhibit 15-5, Longenecker et al (2017:422) compare service marketing with goods marketing.

Study Longenecker et al (2017:422–423).

9.5.2 Product strategy options

Focusing on the right market with an appropriate market offering may guarantee high sales figures. The major product strategy alternatives of a small business are divided into the following six categories:

(1) one product/one market
(2) one product/multiple markets
(3) modified product/one market
(4) modified product/multiple markets
(5) multiple products/one market
(6) multiple products/multiple markets

A small business can use any one of these strategies to increase sales of an existing product (Longenecker et al 2017:422).

9.6 The legal environment

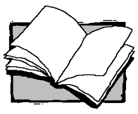
The legal environment encompasses specific laws and regulations that protect the consumer, as highlighted below.

(1) Consumer protection, which involves the following:

- labelling (especially on food products)
- product safety (to protect against risk of injury)

(2) The protection of intangible assets, which entails the following:

- trademark protection (indicated by ™)
- patent protection (an exclusive right of an inventor)
- copyright (indicated by ©)
- trade dress (any distinctive element not protected by a patent, copyright or a trademark)


Read exhibit 15-6, "Protecting marketing assets", in Longenecker et al (2017:426).

9.7 SUPPLY CHAIN MANAGEMENT

A product cannot reach its target market if its distribution is not carefully planned and executed. Until a product or service has been delivered to customers, purchasers cannot derive the benefits they seek and satisfy their needs. Therefore, for purposes of achieving maximum consumer satisfaction, a small enterprise's marketing system needs a distribution strategy to ensure that its products arrive at the proper place at the right time.

9.7.1 Intermediaries

In bringing their products to the market, small producers must often entrust some of their marketing tasks to intermediaries. For example, dairies sell their milk through cafes and supermarkets, while CD companies sell their discs through music shops such as Look & Listen or Musica discount stores and a variety of other intermediaries. Entrepreneurs therefore need to understand the underlying principles of distribution.

ACTIVITY 9.1: Marketing success (case study)

Read the case study, "National Brands: marketing success through effective distribution", in Dorrian (1998:79–86).

Company background

Next time you go into your grocery or bathroom cupboard, take a good look at the brands you keep there. There is a good chance that you will find at least one product made by this highly successful South African company. From Bakers, Willards and Flanagan's to Koffiehuis, Ciro and Ellis Brown, Five Roses and Teaspoon Tips, ProNutro and Maltabella, Bisto and Cerebos Salt to Yardley and Lenthéric fragrances, many of South Africa's best-known and most-loved brands can be found in the National Brands stable.

A member of the giant Anglovaal Group, National Brands operates in an extremely competitive environment, one in which international competition is increasingly making its presence felt. Indeed, considering the removal of trade barriers, the reduction in import tariffs, growing consumerism and greater pressure from the trade, this magical company has successfully geared itself for survival and growth by operating at an even higher level of efficiency and effectiveness. It is an example for other South African companies to follow in the face of international competition and is proof of the internationally acceptable marketing capabilities we possess.

One of the strengths of this organisation is that it has brought together a group of well-known and highly respected companies whose values included rich and reputable histories of brand-building and a tradition of consistently high product quality. A number of these companies, such as Bakers, Baumann's, Pyotts, Willards and Becketts, originated as family businesses – some as long ago as the last century – and their values form the backbone of National Brands as we know it today.

What has made National Brands the success it is, and a candidate to be called a "magical company"? First, in its determination to stay at the forefront of the markets in which it competes, National Brands developed a strategic intent that has been its guiding light in dealing with challenges that have come its way and those that lie ahead. Consider for a moment the statement of this intent and observe the importance the company places on serving its customers:

The Group is committed to building powerful value-for-money brands and delivering superior customer service to better meet the needs of consumers throughout sub-Saharan Africa.

For any organisation, the delivery of such a strategic intent to the marketplace on a consistent basis is a major challenge. For National Brands, this has meant instituting a number of changes in its operation, including restructuring the company to meet the needs of its customers and to enhance its distribution capabilities; introducing a company-wide computerised business system for managing the supply chain; and committing increased resources to brand development and support.

Marketing thinking

To illustrate the potency behind the marketing approach followed by National Brands, consider the branded foods side of its business. The company's marketing people know that the element of taste in food is often very personal to an individual consumer. For that reason, the components of taste have been carefully considered (and analysed) to provide the consumer with the most appealing option in his/her decision-making process. Factors such as flavour type and intensity, texture, mouth feel, colour, ingredient type and base product type all need to be understood in terms of flavour perception within the target market in question. This type of understanding gives company marketers the data to develop products that will appeal to the particular segments of the population.

Take, for example, the company's snack and biscuit categories. Its well-known brands include Willards and Flanagan's, and within the biscuit category, Bakers, Pyotts and Baumann's. Part of the National Brands strategy has been to create what is termed "master brands", for example, Willards, which in turn comprises sub-brands such as Crinkle Cut, Cheese Curls, Big Corn Bites, Hula Hoops, Ringz, Scoops and Tangos. Within the snack portfolio, Willards is a strong number two in the market with a market share of about 35%, while Flanagan's is a strong brand within its target market of adult premium snacking.

The company's biscuit portfolio has also been successful in developing and maintaining a dominant position within the local market, generating a good revenue stream. This position has been sustainable thanks mainly to a strategy of consistent product quality coupled with innovations to the product range such as chocolate-coated biscuit bars, mini-packs and strip packs, which have helped to extend the snacking opportunities of South Africans.

In the mixed ground coffee market, National Brands is the dominant player with a market share of approximately 85% through its Koffiehuis, Kloof and Ace brands. The marketing department has extended the Koffiehuis brand into Gold and Silver blends and coffee bags to cater for the changing needs of the mixed ground consumer. An interesting point is that at the time of writing, National Brands was the only manufacturer of coffee bags in South Africa. This particular segment accounts for about 6% of total mixed ground volumes, and sales have been increasing in recent years as new black urban consumers enter the market. Coffeelets, Koffiehuis Pronto and Koffiehuis Bags are the company's brands in the bag market.

Coffee bags were launched in the product range to provide consumers with an alternative to instant coffee. Research had indicated that the consumer, while preferring the taste of mixed ground coffee, wanted a more convenient product. Marketing targeted Coffeelets at white consumers and Koffiehuis Bags mainly at coloured consumers, while Pronto had a strong coloured profile, with the black segment growing strongly over recent years. Marketing admits that although the volumes in this sector are still relatively small, this innovation has strengthened the company's position as a leading player in the South African coffee market.

In the pure ground market, however, the brands Ciro and Kenna are good and strong. Ciro is a strong number two in the market with a share of 31%, thanks mainly to a sound distribution strategy. According to the Nielsen rankings, the brand has a weighted distribution of approximately 94%, well ahead of its next competitor. Distribution is a vital part of the marketing mix for pure ground coffees, given that the segment served is mainly the food industry, namely, hotels, restaurants, institutions, contract caterers, and so on.

In the tea market, National Brands is a leader, holding a 49% market share through brands like Five Roses, Teaspoon Tips and Trinco. However, the growing health consciousness among consumers prompted the company's marketers to take a serious look at this market. The result is that National Brands commands some 68% of this market with brands like Freshpak and 11 o'clock. As part of its product policy, National Brands has ensured 100% distribution across all trade types. Moreover, each tea brand has a selection of either leaf or teabag format and a variety of pack sizes to suit every pocket. In addition, marketers have ensured that blends differ between brands, allowing consumers the choice of purchasing to their particular taste.

Strategic distribution

National Brands is aware that distribution is vital to achieving its marketing goals. The company's belief is that it is simply not enough to provide the marketplace with brands that appeal to consumers without first ensuring that distribution is in place and that people are able to buy a product as and when they want it. In other words, the goal is to have the right brands in the right place at the right time in a cost-effective manner. This starts with accurate sales forecasting, which translates into effective production scheduling and inventory management all the way through to deployment and the physical distribution network. National Brands therefore considers its distribution from three angles:

- Firstly, the marketing people identify which brands work in which regions by store type and in which pack configurations.
- Secondly, category management in-store ensures that only those lines that are the most relevant to the consumer profile are stocked. On top of this, relationships are built with the trade to create partnerships, ensuring that value is added for both the trade customer and the final consumer.
- Thirdly, marketing is aware that timing and stock control are vital. Constant liaison and forward planning are necessary to ensure the smoothing of production demand and the availability of stock in correct quantities at the right place and at the right time. The National Brands philosophy is based on effective supply chain management. This means focusing on consumer demand and moving backwards through the supply chain all the way to raw material procurement. Distribution is therefore not only a vital link in the chain but also a key element in providing outstanding customer service.

Traditionally, National Brands has concentrated its distribution at the top end of the market, that is, the larger retailers and wholesalers. However, given the growth of convenience and forecourt stores, the marketing department has taken a new look at distribution strategy. Through the acquisition of Willards and its distribution capability, National Brands has found itself with the resources to service this growing segment. Therefore, the company realises that it has to improve the informal sector of the market and meet the various requirements linked to this market. The current segments being served include large retailers and wholesalers, the general trade, which includes smaller stores in the formal sector, and food services such as hotels, restaurants, caterers and institutions.

A major strength within the National Brands marketing thrust is its ability to identify the different needs that the different markets display and to adopt a flexible approach to inventory management and fleet make-up. For example, large retailers and wholesalers require their goods to be delivered in large quantities to either a centralised warehouse or individual stores; the smaller stores in the formal market require smaller deliveries more often. Servicing the food services sector requires high service levels, as well as technical expertise. Meeting the diversity of needs cost-effectively requires careful planning through the supply chain. In addition, to implement an effective distribution strategy, National Brands matches consumer profiles and brand preferences by outlet and by region, and the need to schedule production runs in a cost-effective manner.

In today's fast-moving consumer goods (FMCG) market, an effective distribution strategy is composed of a number of critical elements, elements on which National Brands has successfully focused its efforts.

A highly efficient logistical network

An efficient logistical network includes integrated planning systems that link demand through sales, distribution, outbound logistics, manufacturing and inbound logistics; the ability to route stock to customers in the most efficient way; and the ability to maintain the lowest inventory levels to provide the required customer service levels while smoothing out manufacturing demand.

A sound distribution system

A sound distribution system requires advanced integrated information technology solutions that provide online, efficient operations and enable electronic trading with customers. It also requires a measurement system that monitors service levels and facilitates a process of continuous improvement. Good systems require a review process that is built into the infrastructure to ensure that changes in the marketplace are dealt with timeously, together with an ongoing competency development programme to address skills and to engender a service ethic.

Physical network

National Brands strives to maintain optimum physical infrastructure to reach its customer base cost-effectively.

Customer relationships and brand strength

Category management in-store ensures that only those lines that are most relevant to the consumer profile are stocked.

What makes National Brands a magical company and one from which lessons can be learnt? Its dynamic approach to brand-building resulted in nationally loved brands and a distribution strategy that ensures that those brands are accessible to the consumer where and when he/she wants them. Furthermore, the company is constantly upgrading its systems, reviewing all processes, developing competencies and ensuring the customer and the consumer receive the very best in service. In other words, focusing its resources on creating true and long-lasting consumer satisfaction and relationships has enabled this company to create marketing magic.

Questions

(1) Critically discuss the concept of effective distribution.

(2) Discuss the distribution strategy that was implemented in National Brands to achieve effective distribution.

FEEDBACK

An effective distribution system involves sourcing demand through sales, logistics and manufacturing and is characterised by low inventory levels. National Brands has an advanced integrated information technology system that streamlines the total distribution network, allowing changes in the marketplace to be dealt with timeously.

Distribution is both the physical movement of products and the establishment of intermediary relationships to guide and support such product movement. The physical movement is also called logistics, while channel distribution is the intermediary (middleman) system. Distribution activities involve both tangible (products) and intangible (services) activities. Entrepreneurs should clearly understand the function of intermediaries, given their cost-adding propensity.

Functions of intermediaries

Intermediaries perform several functions, as indicated below.

- **Breaking bulk.** Intermediaries divide large quantities of goods into smaller packaging units (e.g., a spaza shop may buy 20 dozen eggs per month and divide this amount into smaller units of half a dozen).
- **Assorting.** Intermediaries fulfil the function of assorting by mixing homogeneous lines of goods to offer assortments (e.g., Woolworths offers a variety of salads combined in one package).
- **Providing information.** Intermediaries transfer information to customers (e.g., price and product features).
- **Shifting risk.** Intermediaries take over the total risk of products, as against brokers or agents, who only represent and sell products.

9.7.2 Channels of distribution

Various options, which may involve a combination of direct, indirect and dual distribution, are available for the structuring of a distribution channel.

An entrepreneur should distinguish between the following options in respect of distribution channels:

- direct distribution (from the producer directly to the end user)
- indirect distribution (the inclusion of intermediaries)
- dual distribution (more than one channel)

Study exhibit 15.6, "Channels of distribution", in Longenecker et al (2017:427).

When entrepreneurs build a channel of distribution, they need to consider the following three factors:

(1) **Cost.** For certain products it is only logical to conclude that the greater the number of intermediaries, the higher the cost will be. In the case of other products, however, higher costs will be incurred when a direct channel (producer to end user) is used. If, for example, an entrepreneur has a business that manufactures small wooden toys (high profit but low volume and labour intensive), it may be impossible for the entrepreneur to buy his/her own transport facility and to pay a high rental for a location to reach the upper end of the market.

(2) **Coverage.** Intermediaries can increase their coverage of the market through their own distribution networks or geographical location.

(3) **Control.** Entrepreneurs should evaluate each distribution format with regard to the control of the product through the channel. If they choose an indirect channel, they need to carefully consider the reputation of the intermediaries. The marketing of the product (by an intermediary) should be in line with the product image, as stipulated by the entrepreneur. A direct channel yields a far better control option than an indirect channel.

9.7.3 The scope of physical distribution

Note the following six aspects of physical distribution (i.e., the movement of products):

(1) Transportation, which involves

- common carriers (available for hire to the general public)

- contract carriers (contracted to specific suppliers)
- private carriers (owned by the shippers of goods)

(2) Storage (warehousing)

(3) Materials handling (perishable or fragile products as opposed to solid unbreakable stock)

(4) Delivery terms, which involve

- determining who will pay the freight costs
- selecting the carriers
- bearing the risk of damage in transit
- selecting the modes of transport

(5) Logistics companies (they provide specialised trucking, packaging and warehousing services)

(6) Inventory management

SELF-ASSESSMENT

(1) How will an understanding of the product life cycle help with product strategy?
(2) Briefly discuss each stage of the process of product development.
(3) What are some of the product strategy options that are available to a small firm? Which ones are most likely to be used?
(4) Identify and discuss the three ways to increase sales of an existing product once a product strategy has been implemented.
(5) Select two product names and then evaluate each one with respect to the five rules for naming a product.
(6) Explain how the registration of a small firm's trademarks would be helpful in protecting its brand.
(7) Why do small firms need to consider indirect channels of distribution for their products? Why involve intermediaries in distribution at all?
(8) Discuss the major considerations in structuring a channel of distribution.

SUMMARY

In this learning unit you learnt that the product (goods and services) strategy and total product offering of a small business should be based on in-depth knowledge of the customer. The last part of this learning unit dealt with the role of distribution as a marketing activity and the structuring of distribution channels. In the next learning unit we will examine pricing and credit strategies.

LEARNING UNIT 10

PRICING AND CREDIT STRATEGIES

(Prescribed book: chapter 16 of Longenecker et al 2017:436–454)

CONTENTS

INTRODUCTION

Very few business owners have any formal training in how to set the prices for the products and services they sell. In many instances, their prices are based on what competitors are charging, some percentage above their costs, or what their suppliers suggest. All too often, new business owners think that their path to success is to undercut competitors' prices. In this unit we explain why that can be dangerous. Pricing and credit decisions are vital to the success of a business because they influence the relationship between the business and its customers. These decisions also directly affect both revenue and cash flows. If, for example, you find that you start with prices that are too low to cover your costs, you can expect that your customers will not be happy with price increases or restrictive credit policies. A business owner needs to set prices and design credit policies as carefully as possible to avoid the need for frequent changes.

LEARNING UNIT LEARNING OUTCOMES

Upon completion of this learning unit, you should be able to

- discuss the role of cost and demand factors in setting a price
- apply break-even analysis and mark-up pricing
- identify specific pricing strategies
- explain the benefits of credit, factors that affect credit extensions and types of credit
- describe the activities involved in managing credit

KEY CONCEPTS

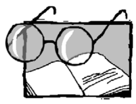
- price
- credit
- total cost
- total variable cost
- total fixed cost
- average pricing
- elasticity of demand
- elastic demand
- inelastic demand
- prestige pricing
- break-even point
- mark-up pricing
- penetration pricing strategy
- skimming price strategy
- follow-the-leader pricing strategy
- variable pricing strategy
- dynamic (personalised) pricing strategy
- price-lining strategy
- consumer credit
- trade credit

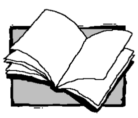
- open charge account
- instalment account
- revolving charge account
- trade credit agencies
- credit bureaux
- ageing schedule
- bad debt ratio

OVERVIEW

Once you, as an entrepreneur, understand the needs and wants of the consumers in your target market, you can develop your product or service offering accordingly. However, the fact of the matter is that a product needs to be sold at a certain price.

The price of a product or service is a measure of what you, the seller, are willing to receive in exchange for transferring ownership of your product or service. A credit system often helps to place a product or service in a more competitive position. To supplement your product strategy and to develop a total marketing strategy, you need to apply the skills involved in pricing.

Study Longenecker et al (2017:436–454).

Read "In the spotlight: Department of Coffee in Khayelitsha – spreading the joys of java: Cape Town's first township-based artisan coffee shop" in Longenecker et al (2017:437).

10.1 SETTING A PRICE

The importance of setting a price is seen in the revenue equation in business. The price of a product forms half of the total equation, where **sales X price = revenue**. A small change in price can make a considerable difference in revenue, as shown below.

Situation A

Quantity sold	X	price per unit	=	gross revenue
100 000	X	R3,00	=	R300 000,00

Situation B: A 10% decrease in price will result in the following:

Quantity sold	X	price per unit	=	gross revenue
100 000	X	R2,70	=	R270 000,00

A small change of 30 cents in price will mean R30 000,00 less in revenue!

The price of a product therefore has a dual influence on the total sales revenue: a direct impact as part of the gross revenue equation and an indirect impact on the quantity sold. Bear in mind that because of the complex nature of service pricing, this learning unit focuses primarily on product (goods) pricing.

The following elements form the basis of price determination:

10.1.1 Cost determination of pricing

Price = total cost + profit

Because price equals total cost plus profit, a careful study of cost in a business may keep the business from pricing too low. Total cost has three components, as shown below (refer to exhibit 16-1 in Longenecker et al 2012:475).

Total cost = cost of goods sold + selling cost + overhead cost

Total cost = total variable cost + total fixed cost

The concept "average pricing" is used when the behaviour of variable cost and fixed cost is treated equally. Average pricing is calculated by means of the total cost divided by the quantity sold over a certain period, as illustrated in exhibits 16-2 and 16-3 in Longenecker et al (2017:440; 442). The authors explain why average pricing is a dangerous practice.

Read "Living the dream – entrepreneurial experiences: have you had your brick for the day?" in Longenecker et al (2017:443).

10.1.2 How customer demand affects pricing

A cost analysis enables one to calculate the minimum prices of products. The following two demand influences need to be considered in pricing because they determine the actual price of a product:

(1) **Elasticity of demand.** Elasticity of demand is the degree to which changes in price affect the quantity of products purchased by customers. An **elastic demand** situation occurs when demand fundamentally changes according to changes in the price of a product (e.g., computer products). An **inelastic demand** situation occurs when there are no fundamental changes in the quantities purchased because of price changes (e.g., salt).

(2) **Pricing a business's competitive advantage.** A product that satisfies unmet needs will be in demand (e.g., a totally or revolutionary new product that meets a need that was neglected by entrepreneurs in the past will be in high demand). Most products are different, but similar products can be marketed differently (e.g., compare the marketing strategies of KFC and Nando's). The term "prestige pricing" is used to indicate the differentiation and uniqueness reflected in a high price.

ACTIVITY 10.1: Pricing (case study)

Instructions

Read the case study below and then answer the questions that follow.

Waco Composites, Ltd

Price cutting by a competitor leads to a new strategy

A few years ago, Wayne Hampton found himself jerked into a price war. Waco Composites I, Ltd, in Waco, Texas, which was founded by Hampton, manufactures bulletproof panels used in hospital emergency rooms, banks, guardhouses, police stations, residential safe rooms – anywhere there's a potential security threat.

In 1999, one of Hampton's more established competitors saw the three-year-old Waco Composites as a serious threat and suddenly cut his panel prices to $13 per square foot from $15. "He was trying to starve me to death", Hampton says. Losing orders, Hampton matched the cuts – and gross profit margins fell to 18% from 28%.

A few months later, the competitor baited Hampton by slashing prices again, moving to $10,50 per square foot. Hampton knew he had two choices: follow suit and see profits sink even lower, or find a way to differentiate his company. He picked the second option and began to introduce initiatives to enhance both product value and Waco Composites' image in the industry.

Fireproofing

Up to then, Waco Composites' fiberglass panels were no different from those of competitors, which made them a commodity item. Believing that fire-retardant panels would benefit his customers, Hampton hired an engineer who developed a new manufacturing process that earned Waco Composites' panels a one-hour fire rating from the American Society for Testing and Materials. What's more, this process added only pennies to company costs.

Faster shipping

In contrast to the industry norm of a product arriving within three to six weeks, Waco Composites began to ship its goods within 24 hours of receiving an order. This enabled customers to order at the last minute, keeping payables off their books longer.

Friendly, professional service

Customers told Hampton that competitors were perceived as unfriendly – even rude at times – and slow to provide quotes. Hampton quickly implemented formal policies to highlight his company's image of being friendly, fast and professional. For example:

- Calls are taken by real people – usually on the second ring – not an automated system.

- All price quotes are provided within an hour, compared to the several days sometimes taken by competitors.
- No profanity or slang is allowed in conversations with customers.

Some of these changes are about perceived value rather than tangible value. But that doesn't matter – Hampton says: "Perception is everything. It's as important as real value in the mind of the customer. And, unlike competitors' pricing, your company's perceived value is something that you have control over."

Source: http://www.fasttrac.org/article.cfm?ID=244 (accessed: 26 August 2004)

Questions

(1) What type of elasticity of demand does this product face? Explain your answer.

(2) What is your evaluation of the competitive advantage strategy mapped out by Waco Composites? What other ideas could help the firm gain a competitive advantage?

(3) Do you believe the strategy being used to create a competitive advantage – without pricing as a major component – will work in the specific industry? Give reasons for your answer.

(4) Do you think it would be feasible for Hampton to implement a variable pricing strategy? Give reasons for your answer.

FEEDBACK

(1) Hampton's product is much like the example of certain products in the personal computer industry; the products are alike in that a decrease in price will draw customers to the product with the lowest price. This means that the demand Hampton faces for his product is highly elastic – demand changes significantly when the price of a product is decreased. Hence customers see many available substitutes – such as the product of Hampton's competitor.

(2) Waco Composites' competitive advantage strategy is an excellent idea and seemingly the only strategy in the light of the low profit margins related to matching its competitor's prices. However, Hampton should not base his competitive strategy on one factor only. He has improved and distinguished his product, and

his total product offering has been enhanced with improved shipping and professional service.

Additional efforts to gain a competitive advantage could focus on developing an even more distinctive brand image and offering promotions that create an association with the product. The development of more innovative but related products could also allow the company to continue its efforts to gain a competitive advantage.

(3) There is nothing to suggest that the strategy will not work. Even if Hampton were able to cut costs to make the business price competitive, this would not necessarily be the best option. This is an industry with relatively few manufacturers. It is also characterised by low levels of product knowledge – hence it is a good candidate for prestige pricing.

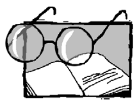
(4) Yes, this is an ideal situation in which to use a variable pricing strategy. Lower prices can be offered for various reasons, including a customer's knowledge and bargaining strength. The "uniform price" will probably not be widely promoted and, therefore, provides an opportunity for both upward and downward adjustments.

10.2 APPLYING A PRICING SYSTEM

In order to develop a pricing system, an entrepreneur should understand break-even analysis and mark-up pricing.

10.2.1 Break-even analysis

Cost break-even analysis is used to determine the quantity point at which a product will generate enough revenue to start showing a profit.

Study the charts in exhibit 16-4, "Break-even graphs for pricing", in Longenecker et al (2017:444).

Graphs are used in these charts to indicate the break-even point. However, the algebraic method can also be used to calculate the break-even point in quantity and rand (R) value, as indicated below.

Q	= number of units manufactured and sold
FC	= total fixed cost
V	= variable cost per unit
P	= selling price per unit
Qb	= break-even quantity
PQb	= break-even in rand (R) value

Break-even quantity:

$$Qb = \frac{FC}{P - V}$$

Break-even point in rand (R) value:

$$PQb = \frac{P\,(FC)}{P - V}$$

ACTIVITY 10.2: Break-even point

Indaba CC, a small publishing business in Pretoria, conducted a feasibility study regarding the publication and distribution of a new magazine. The following information is available:

Fixed cost per edition:

Development cost	R15 000,00
Setup cost	R27 500,00
Selling and advertising cost	R 7 500,00
Total fixed cost:	**R50 000,00**

Variable cost (per edition):

Printing and binding cost	R6,65
Administrative cost	R1,50
Sales commission	R0,55

Royalties per edit	R3,30
Discount to bookstores	R5,50
Total variable cost:	**R17,50**
Proposed selling price:	**R27,50**

Question

Calculate the break-even point in

(1) units
(2) money value (R)

FEEDBACK

(1) The break-even quantity:

$$Qb = \frac{FC}{P - V}$$

$$= \frac{50\ 000}{27{,}50 - 17{,}50}$$

$$= 5\ 000 \text{ units}$$

(2) The break-even point in rand:

$$PQb = \frac{P\ (FC)}{P - V}$$

$$= \frac{27{,}50\ (50\ 000)}{27{,}50 - 17{,}50}$$

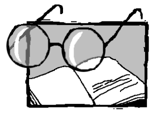
$$= R137\ 500{,}00$$

The above activity illustrates a simplistic method to determine the point at which a profit will be made. The break-even point forms a starting point for price determination on a mark-up basis.

10.2.2 Mark-up pricing

There is a difference between the mark-up on cost and the mark-up on selling price. A farmer who sells chickens incurs certain costs (e.g., food, medicine, labour and energy costs) in raising chickens to the stage where they are in a selling condition. The farmer calculates the break-even cost and then adds a mark-up. The chickens are sold to an intermediary (e.g., Chicken Licken). The retailer calculates his/her mark-up percentage on the selling price of the end product. The selling price also incorporates market demand. The following variables need to be included:

- operating expenses (e.g., raw materials, rent, labour, insurance, advertising and energy)
- price reduction (e.g., employee discounts or competitions)
- desired profit



Study exhibit 16-4, "Break-even graph adjusted for estimated demand", in Longenecker et al (2017:444).

Profitable selling starts with a proper mark-up to establish a satisfactory selling price. Longenecker et al (2017) provide the two formulas that are commonly used for mark-up calculations (p 445) and the formulas that are used to convert mark-up as a percentage of selling price and mark-up as a percentage of cost (p 445).

10.3 SELECTING A PRICING STRATEGY

Many small businesses make the mistake of basing all their prices on the break-even method only. Price determination should also include characteristics and variables in the market environment. An entrepreneur should therefore combine his/her pricing strategy with the total business strategy. The following six pricing strategies can be used.

(1) **Penetration pricing.** This strategy is normally adopted when new competitors enter the same market. A lower price than normal is followed to create the impression among competitors that the strategy is based on long-term expectations.
(2) **Skimming pricing.** This strategy is normally associated with unique or prestige products. A higher price than normal is asked. The strategy is based purely on customer perceptions.

(3) **Follow-the-leader pricing.** This strategy is evident in a highly competitive environment. The prices of the major competitor form the basis of pricing. This strategy is especially noticeable during the Christmas holidays.
(4) **Variable pricing.** Price concessions are made to different types of buyers. High-volume buyers receive a lower price than buyers who purchase single units at a time.
(5) **Price lining.** A price-lining strategy is adopted when a business has a range of distinct prices. In the motor retail sector, for instance, customers pay different prices for specific models (e.g., the cost of 1 300 models may be between R50 000 and R70 000; the cost of 1 600 models between R70 000 and R100 000; and the cost of 2 litre models more than R100 000).
(6) **Pricing at what the market will bear.** The global business environment has created a situation in which increasingly more competitive strategies have evolved. This specific strategy can only be adopted when there are no or few competitors in the same market. Only entrepreneurs with revolutionary new products, unique services or monopolistic businesses can apply it. The Quickshop retailing outlet is a case in point. The traditional street corner café is usually only open until 20:00 or 21:00. Quickshop stores (combined with garages), however, operate on a 24-hour ("24/7") basis for the utmost convenience of a specific market. The prices of many products are much higher in a Quickshop store than in a supermarket (e.g., Spar).

A final note on pricing strategies

In certain situations, government laws should be taken into consideration for the setting of prices.

10.4 OFFERING CREDIT

10.4.1 Benefits of credit

The benefits of offering credit to customers are explained in Longenecker et al (2017:447). Entrepreneurs should consider the four factors that affect selling on credit before they offer customers this option (see Longenecker et al 2017:447).

10.4.2. Factors that affect selling on credit

The following four factors relate to an entrepreneur's decision to extend credit to customers:

(1) the type of business (durable versus perishable goods)
(2) the competitor's credit policies
(3) the customers' income level
(4) the availability of working capital

10.4.3 Types of credit

Entrepreneurs can extend the following types of credit to customers:

(1) **Consumer credit.** This type of credit is extended to final consumers and includes the following:

- open charge accounts (with an indefinite repayment period)
- instalment accounts (for larger purchases such as cars)
- revolving charge accounts (instalment accounts with a credit limit)

(2) **Credit cards.** Note the following examples:

- bank credit cards (e.g., Visa, Mastercard)
- entertainment credit cards (e.g., Diners Club)
- retailer credit cards (e.g., Edgars card)

(3) **Trade credit.** See Longenecker et al (2017:450) for a discussion of this type of credit.

10.5 MANAGING THE CREDIT PROCESS

The following are some of the major considerations in developing and operating a comprehensive credit management programme for a small business (Longenecker et al 2017:450–454):

10.5.1 Evaluation of credit applicants

Entrepreneurs need to evaluate all customers who apply for credit before granting it.

The following four credit questions can be used to evaluate applicants:

(1) Can the buyer pay as promised?
(2) Will the buyer pay?
(3) If so, when will the buyer pay?
(4) If not, can the buyer be forced to pay?

The traditional five Cs of credit can be used as a tool to evaluate the questions asked:

(1) **character** (honesty)
(2) **capital** (cash and assets)
(3) **capacity** (financial planning)
(4) **conditions** (business cycles and changes)
(5) **collateral** (security)

10.5.2 Sources of credit information

Where would an entrepreneur obtain credit information regarding an applicant? Note the following sources:

- the customer's credit history
- a business's financial statements
- data supplied by outsiders (e.g., other sellers)
- the customer's banking institution
- trade credit agencies
- credit bureaux (online bureaux such as Campbells)

10.5.3 Ageing of accounts receivable

By using an ageing schedule, entrepreneurs can identify debtors who delay payment. The data can be used to forecast cash flow. Entrepreneurs should provide debtors with timely information on their debit balance because this will help to streamline the payment of accounts. Entrepreneurs should try to collect the monies owed by late payments before handing them over to an attorney.

Read exhibit 16-5, "Hypothetical aging schedule for accounts receivable", in Longenecker et al (2017:452).

10.5.4 Billing and collection procedures

A small business should establish formal procedures for billing and collecting from debtors.

10.5.5 Credit regulation

It is essential that small businesses comply with all the relevant credit regulations.

SELF-ASSESSMENT

(1) Why does average pricing sometimes result in a pricing mistake?

(2) Explain the importance of total fixed and variable costs in the pricing decision.

(3) Using an example, explain how the concept of elasticity of demand relates to prestige pricing.

(4) If a firm has fixed costs of R100 000 and variable costs per unit of R1, what is the break-even point in units, assuming a selling price of R5 per unit?

(5) What is the difference between a penetration pricing strategy and a skimming pricing strategy? Under what circumstances would each be used?

(6) If a small business conducts its break-even analysis properly and finds the break-even volume to be 10 000 at a price of R10, should it price its product at R10? Give reasons for your answer.

(7) What are the major benefits of credit for buyers? What are the major benefits of credit for sellers?

(8) In what way does an open charge account differ from a revolving charge account?

(9) What does "2/10 net 30" mean? Does it pay to accept discounts when they are offered?

(10) What is the major purpose of ageing accounts receivable? At what point in credit management should this activity be performed? Give reasons for your answer.

SUMMARY

This learning unit dealt with a key issue in small business management, namely, the pricing strategy, as well as break-even analysis and the role it plays in price structuring. The different price strategies were explained in a small business context. Small businesses generally have to deal with difficult cash-flow situations. The credit policy of a business should therefore be adapted and managed according to its specific needs. The next learning unit focuses on promotional planning in a small business.

LEARNING UNIT 11

PROMOTIONAL PLANNING
(Prescribed book: chapter 17 in Longenecker et al 2017:458–482)

CONTENTS

INTRODUCTION

Promotion consists of marketing communications that inform potential customers about a business and its product or service and that try to persuade them to buy or use that product or service. Small businesses use promotion in varying degrees. In this learning unit we will discuss promotion on the internet and social media, as well as valuable traditional methods, including personal selling, advertising and sales promotion tools.

LEARNING UNIT LEARNING OUTCOMES

Upon completion of this learning unit, you should be able to

- describe the communication process and the factors that determine a promotional mix
- explain methods of determining the appropriate level of promotional expenditure
- describe personal selling activities
- identify advertising options for a small business
- discuss the use of sales promotion tools

KEY CONCEPTS

- promotion
- promotional mix
- personal selling
- prospecting
- advertising
- product advertising
- institutional advertising
- banner ads
- pop-up ads
- e-mail promotion
- web sponsorship
- linkage
- sales promotion
- publicity

OVERVIEW

The target market of a business consists of potential customers and is influenced by competitive forces. In terms of time and space, customers are removed from entrepreneurs or their sources of supply. Therefore, customers cannot keep abreast of the thousands of products or services on the market that are alternatives to particular products or services. New products, services and outlets appear daily, together with changes to existing products – of which consumers are probably unaware. Clearly, therefore, entrepreneurs need to communicate with their target market. In marketing terminology this communication is known as promotion.

Promotion consists of marketing communications that inform, persuade and remind consumers of the product or service that an entrepreneur is offering. Large as well as small businesses use the various forms of promotion (advertising, personal selling, sales promotion and publicity) to varying degrees. A given business will apply different forms of promotion or marketing communication in proportions that enable the entrepreneur to communicate effectively with the target audience (market).

Promotion is a complex communication activity that many entrepreneurs fail to utilise effectively.

Study chapter 17 in Longenecker et al (2017:458–482).

Read "In the spotlight: You Know What Campaign/Not the World Cup Campaign" in Longenecker et al (2017:459).

11.1 THE COMMUNICATION PROCESS IN PROMOTION

The promotion of all products (old and new) is based on communication, which is a two-way process involving a sender (a business) and a receiver (a target market). Promotion is therefore a communication process whereby information about a product is sent to a potential or existing customer via various media channels.

Study Longenecker et al (2017:460–461).

Various promotional techniques exist for a small business, and a combination of these techniques is referred to as a promotional mix. An entrepreneur may, for example, decide to promote his/her new product by means of personal selling and an advertisement in the local paper or on a radio station or even a website. The selection of a promotional mix is influenced by the following three major factors:

(1) **Geographical nature of the market (broad versus focused).** An entrepreneur who exports peanuts to Japan would not advertise the product in the *Sowetan*, which is a local newspaper. He/she would rather advertise it on his/her website or promote it by means of personal selling in Japan.
(2) **The size of the promotional budget.** Certain forms of promotion may not be selected because the costs involved are high. The cost of television advertising is generally higher than the cost of radio advertising.
(3) **Product characteristics to be promoted.** Characteristics such as technical qualities (e.g., a personal computer or a motor car, which involves personal selling) will determine the appropriate promotional techniques.

11.2 DETERMINING THE PROMOTIONAL BUDGET

There is no specific or set percentage of turnover that should be spent on the promotional mix of a business. However, the approaches highlighted below serve as guidelines.

11.2.1 Allocating a percentage of sales

Allocating a percentage of sales to promotion (e.g., 30% of turnover) is a simple method and is suitable for an existing business with historical figures. The disadvantage of this method, however, is that when sales decline, less money is spent on promotion, which does not always solve the problem of determining an effective promotional budget.

11.2.2 Deciding how much can be spared

This is undoubtedly the most popular guideline in promotional expenditure. Every cent that is left after all expenses have been paid is sourced to promotional activities. This method is not necessarily the best because the business stage in which a business finds itself requires different approaches to promotion (e.g., a totally new product requires broad and effective exposure to the target market, which is normally quite expensive).

11.2.3 Spending as much as the competition does

This method can be used to short-run the efforts of competitors, depending on their size. A young entrepreneur who is planning to enter the cereal market will never be able to spend as much money on promotion as, say, Kellogg's.

11.2.4 Determining how much is needed for specific results

This is the preferred approach to promotional expenditure. This method is based on a proper market analysis and all existing or new alternatives that are available as promotional channels. A small spaza shop based in Mamelodi, Pretoria, would definitely not develop an expensive website to promote its products. A visible advertisement board in front of the shop would be more than adequate.

ACTIVITY 11.1: Promotional planning

One of your fellow students has developed a new microwave freezer known as the Chill Ready. The core product is not the standard freezer, but an appliance that freezes food in the same time that a microwave oven heats food.

Using the four-step method (see exhibit 17-2 in Petty et al 2012:501) for determining a promotional budget, prepare a suitable budget for promoting her new product.

FEEDBACK

The Chill Ready is a totally new product on the market. The newness of the product means that no market exposure is yet present. The product therefore requires a larger promotional expense than an existing product. In your answer you should consider the following aspects:

- allocation of promotional expense as a percentage of sales
- savings regarding promotional tasks
- competitive promotional strategies and expenditure
- expenditure that is in line with effective market exposure strategies

11.3 PERSONAL SELLING IN A SMALL FIRM

Personal selling is defined in Longenecker et al (2017:468). The primary objective of personal selling should be the long-term retention of customers. There are numerous examples of salespeople who push customers into agreements without any concern for future resale or growth in word-of-mouth marketing. High ethical standards in this regard ensure positive relationships with customers. The following principles serve as guidelines for entrepreneurs in respect of personal selling:

11.3.1 The importance of product knowledge

A salesperson's knowledge of a product can make a big difference in focusing a customer's attention on the product. Demonstrating the advantages, technical characteristics and various uses of the product and pointing out its limitations normally make a difference in closing a sale.

11.3.2 The sales presentation

The presentation of a product to a customer forms the foundation of personal selling in a telephone conversation or a face-to-face situation. The following methods should be used:

(1) **Using prospecting techniques.** This involves a systematic process of continually seeking out new customers.

(2) **Practising the sales presentation.** Longenecker et al (2017:469) categorise customers' objections into six categories and make several suggestions about ways to deal with valid objections from customers.

(3) **Making the sales presentation.** A salesperson should not use the standard technique of presenting a product. He/she should present the product in line with customer needs. Twenty per cent of all salespersons secure 80 per cent of all sales. The use of sales gimmicks or special sales techniques may work but should not annoy potential customers.

11.3.3 Cost control in personal selling

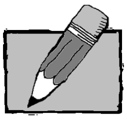
Entrepreneurs should manage salespeople in such a way that effective costing principles apply. For instance, a salesperson's travelling and accommodation expenses can easily become unnecessary expenses.

11.3.4 The compensation programme for salespeople

Salespeople are remunerated in two ways, namely, non-financially (e.g., personal recognition) and financially (e.g., commission or salaries).

11.4 ADVERTISING PRACTICES FOR SMALL FIRMS

Advertising as a promotional method is explained in Longenecker et al (2017:473–475).



ACTIVITY 11.2: Advertising

Instructions

Read the case study below and then answer the question that follows.

ScrubaDub internet site promotes car wash

Dot.com firms aren't the only ones to benefit from the internet. A traditional brick-and-mortar business can use this technology to promote and improve its operations.

Consider ScrubaDub, a full-service car wash offering fuel and car detailing founded in 1986 by Marshall Paisner in Natick, Massachusetts. The company operates 10 outlets in the north-eastern USA. Many companies don't know their customers but Marshall's sons Bob and Dan Paisner, who now run the company, have developed a cutting-edge operation through their savvy of operation.

When customers join ScrubaDub's Car Care Club, they are given windshield-mounted barcodes. As soon as a car pulls into a ScrubaDub location, the barcode is scanned, and a computer screen at the car's location, linked to a central database via the internet, flashes the customer's identity and other information so that attendants can greet the driver by name and recommend specific services. Accounting information is also exchanged among locations via the internet every hour. "Using the internet to update our database has saved us hundreds of hours", says Bob.

The company website, which gets about 100 hits per day from both current and potential customers, is used to promote the business. Visitors to the site can learn about the Car Care Club, ScrubaDub services and prices, how to buy coupon books and how to find ScrubaDub locations; they can even play an online game to win a free car wash.

Bob, the CEO, also wants to use the web to deliver promotional information to customers while they are getting their cars washed. ScrubaDub currently uses satellites to beam ads to monitors on each gas pump, but Bob has plans to use the internet instead for these transmissions because it will permit more control through the main office. Bob says: "This technology can accelerate our growth and make new locations more productive".

Question

In what way did the internet promote the small business's advertising strategy?

FEEDBACK

The case study shows that the internet is not limited to corporate gain only. Small businesses (like ScrubaDub) can benefit by advertising on the internet and therefore look much larger than they really are. Market exposure is also ensured by the huge number of internet users. However, it is essential to dispel the myth that if one sets up a website, customers will immediately start flocking to one's shop. A web address needs to be advertised in order to attract interest.

11.4.1 Advertising objectives

The objectives of advertising are to

- inform customers about a product (characteristics and price)
- persuade potential customers to purchase a product
- remind customers to purchase a product (e.g., Verimark's advertising is constantly reminding customers about product benefits)

11.4.2 Types of advertising

Entrepreneurs can use the following two types of advertising:

(1) **Product advertising.** In product advertising, the primary focus is on product benefits and uses (e.g., specials on all Nokia cell phones).

(2) **Institutional advertising.** In institutional advertising, the primary focus is on promoting a business and its image (e.g., Vodacom's corporate image advertising).

11.4.3 Obtaining assistance with advertising

Small businesses rely on other people's experience to create their promotional messages. They can make use of the services of advertising agencies, suppliers, trade associations and advertising media in this regard.

11.4.4 Frequency of advertising

Advertising generally involves high costs. An entrepreneur should therefore emphasise cost-effectiveness in relation to exposure. A decision in this regard would involve, say, frequent exposure (e.g., a small advertisement on the morning show of 947 every Tuesday and Friday) or a noncontinuous or once-off advertisement (e.g., a full-page advertisement in striking colours in the *Sunday Times* to introduce a new product).

11.4.5 Where to advertise

An entrepreneur's budget in a small business context is usually somewhat limited. Advertising should therefore be effective in the sense of reaching and attracting the correct customer. It makes no sense to advertise on a national radio station if, geographically speaking, one is selling a localised product (e.g., selling fish in a small coastal town).

Study exhibit 17-4, "Advantages and disadvantages of major advertising media", in Longenecker et al (2017:475).

11.4.6 Web advertising

Three critical start-up tasks are related to the success of a corporate website. These tasks are

(1) creating and registering a site name
(2) building a user-friendly site
(3) promoting the site

The basic methods of web advertising are as follows:

- banner ads and pop-ups
- direct e-mail promotion
- reciprocal advertising and hyperlinks
- blogs

11.5 SALES PROMOTION TOOLS

Sales promotion tools are described in Longenecker et al (2017:476). The following method/tools can be utilised:


Read Longenecker et al (2017:476–478).

11.5.1 Specialties

Specialties include calendars, pens, ties, coffee mugs, shirts and free tickets to entertainment events. The business logo and contact details of a business are normally printed on a specialty. Specialties can be customised and personal and may induce relationship marketing.

11.5.2 Trade show exhibits

Trade shows afford entrepreneurs the opportunity to introduce their products directly to customers. Customers have the opportunity to experience the products before buying them (e.g., new gym equipment). Helpful tips on trade shows are given on pages 476–477 in Longenecker et al (2017).

11.5.3 Publicity

Publicity normally involves free exposure by the media and has high visibility. Not all forms of publicity are free, for instance, sponsorship of a sports event.

11.5.4 When to use sales promotion

Sales promotion strategies can be applied in any facet of a firm's supply chain. Suppliers can stimulate the promotion of their products by a wholesaler; wholesalers can do the same with the retailing sector. Small manufacturers can use sales promotion to stimulate channel members, retailers and wholesalers to market their products. Wholesalers can use sales promotion to induce retailers and, in a similar way, to lure customers into buying products.

ACTIVITY 11.3: Promotion strategies

Instructions

Analyse the case study below and answer the questions that follow.

Solid Gold Health Products for Pets

Prospering through creative promotion

Sissy Harrington-McGill, a certified nutritionist, has always loved dogs, especially Great Danes. In 1974 she combined her passion for animals with her expertise in nutrition and launched Solid Gold Health Products for Pets. That year, McGill bought a champion Great Dane in Germany, where she discovered something unexpected: German Danes could live two to six years longer than their American counterparts. Attributing this to nutrition, she brought home samples of German dog food to be analysed. The ingredients of the German dog food confirmed her hypothesis and motivated her to seek a licence to sell the food in the United States. She started by manufacturing three tons of dog food and warehousing the food in her garage. Soon her garage held 30 tons of dog food, and by 1984 she finally moved her business out of her house.

Clearly, McGill's business did not explode overnight – after all, it took her 10 years to get out of the garage. Her company continues to grow incrementally, however, as a result of her targeted promotional strategy.

Questions

(1) What promotional methods has Sissy used to build her business? Be specific. Once you have listed the ways in which she promotes her business, classify them according to the categories discussed in this learning unit, namely, personal selling, advertising and sales promotion.

(2) Describe the role that Sissy's knowledge and expertise play in her promotional activities.

(3) The objectives of advertising are to inform, persuade or remind consumers about the existence or superiority of a firm's product or service. What function best describes the goal of Sissy's advertising? Give reasons for your answer. What type of advertising does Sissy use (product or institutional), or does she use something completely different?

(4) Sissy owns a small retail shop that sells her products. The shop also offers a "do-it-yourself" dog-washing facility. Does this facility constitute a service or a promotional activity? Explain your answer.

(5) What ways of preparing a promotional budget could Solid Gold consider?

FEEDBACK

(1) **Personal selling.** Sissy's trip to England to meet with Philips Yeast and Buster Lloyd Jones is an example of personal selling. When company representatives work the booth at dog shows or pay visits to veterinarians, they are also engaging in personal selling.

Advertising. Sissy places detailed advertisements in dog enthusiast magazines. Advertisements in programmes at dog shows also constitute advertising.

Sales promotion. The sales promotion tools mentioned in the learning unit are publicity, trade show exhibits and specialties. The articles that Sissy writes and publishes are a form of publicity. Solid Gold also exhibits at trade and dog shows.

(2) For Sissy, product knowledge extends from the actual product to its promotion. Her degrees in nutrition can be regarded as the impetus for founding Solid Gold Health Products for Pets, and nutrition is the core of all the company's promotional messages. For example, instead of using visual devices for the company's advertising, Sissy chooses a unique format that shares a great deal of information about nutrition with consumers. Her advertisements are more like the articles she publishes without copyright so that local kennel clubs can reprint and circulate them freely. Sissy's emphasis on sharing her expertise makes her a well-known and reliable source of information on dog nutrition, which then extends to her brand – dog owners trust her products because she is an authority on nutrition.

(3) Advertising seeks to sell by informing, persuading or reminding customers of the existence or superiority of a firm's product or service. Sissy's advertising is unique because she focuses intently on the informational aspect of her advertising. As she says in the video: "Our advertising – these are articles. And if you take the two minutes to read the article, you'll learn something. And people like to learn things." By teaching consumers about animal nutrition and then showing how Solid Gold products are the most nutritious alternative for their pets, Sissy's advertisements are first informative and then persuasive. Product advertising focuses on making potential customers aware of a particular product or service. Institutional advertising is designed to enhance a firm's image. In many ways, Sissy's advertising is a hybrid of the two. Although she is advertising her products, she is, in fact, doing far more. She uses her advertising to position her company as an authority on animal nutrition, which enhances the company's image (institutional advertising), but also talks about how the company's products fulfil the nutritional needs of dogs and cats, which makes potential customers aware of her products (product advertising).

(4) Students' answers to this question will vary. The dog-washing facility is only available as part of the company's retail operation. If the company were to charge a fee for its use, it would be a product. However, offering free dog washing on a particular day of the week (or with purchases over a certain amount) or taking the dog-washing apparatus to trade shows could be considered a promotional activity. Solid Gold could also use such a unique service to generate publicity about its

store and food products.

(5) Four ways of preparing a promotional budget are identified in this learning unit. Firstly, some businesses simply allocate a percentage of sales to promotion. If Solid Gold were to use this method, the sales manager, Manny Rosillo, would reserve a set portion of the expected sales for a given fiscal year to be used for promotional activities. A second way businesses prepare a promotional budget is to decide how much money can be spared. This method is the most popular among small businesses, which typically think of promotions only after all other expenses have been covered. A third method is spending what it takes to meet the promotional activities of the competition. If Solid Gold were to use this method, it might run into difficulty because its market includes some large players such as Iams (owned by Procter & Gamble), Eukanuba and Hill's Science Diet. These large competitors have deep pockets and wider distribution than the smaller companies like Solid Gold that also operate in the organic and specialty pet food market. The last method of setting a promotional budget involves determining what it will take to do the job. This method requires comprehensive analysis of the market and the firm's goals. Although nothing in the case study indicates how much money Sissy spends on promotion, there are a few clues that her budget is not that high. Even though Solid Gold has full-page advertisements in four-colour glossy magazines, the company only submits two-colour (i.e., black and white) advertising copy. Since the advertisements are text heavy and include minimal (if any) graphics and no photos, they are inexpensive to produce. The most expensive part of Sissy's promotional plan is salespeople’s attendance of dog and trade shows. Travel expenses for salespeople, shipping expenses for the booth and even printing expenses for flyers and other brochures, which Sissy highlighted as being part and parcel of dog shows, all add up to make this type of promotion an expensive venture. Based on the types of promotion that Sissy uses and the company's $7,5 million in annual sales, it is safe to assume that Sissy either determines what it will take to do the job or sets aside a portion of annual sales for her promotional methods. Because Sissy is regular about her promotional activities, it is unlikely that she simply uses whatever money is left after satisfying other items in the expense budget.

SELF-ASSESSMENT

(1) Describe the communication process and the factors that determine a firm’s promotional mix.
(2) Explain the methods of determining the appropriate level of promotional expenditure.
(3) Describe personal selling activities.
(4) Identify advertising options for a small business.
(5) Discuss the use of sales promotion tools.

SUMMARY

This learning unit dealt with sales promotion, focusing on how entrepreneurs can present their products to their target market. The learning unit also dealt with promotion in a communication context and different methods of determining a firm’s promotional expenditure. Advertising and personal selling techniques were described as the more popular tools of sales promotion.

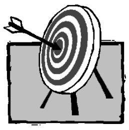
TOPIC SUMMARY

The ways in which a small business venture should market its products, services or processes were explained in topic 2. The success of any business depends primarily on its approach towards customers. Customer loyalty should be cultivated through quality customer service. A business's product strategy should be in line with customer needs and expectations. The aspects involved in determining the pricing and credit strategies of a business were discussed in learning unit 10. The topic concluded with a discussion of the promotional strategy of a small business. Effective promotional actions attract customers to a business with the aid of relevant product or service information. Topic 3 focuses on managing growth in a small business.

TOPIC 3: MANAGING GROWTH IN A SMALL BUSINESS

AIM

The aim of topic 3 is to promote an understanding of the managerial functions in a small business context. You will learn how to manage a small business venture by applying professional management principles. You will learn more about the human resource management function, which encompasses all the factors involved in attracting the right personnel and retaining their services by creating the ideal working conditions. Quality is a basic requirement for an entrepreneur's business processes. Therefore, you will learn about the operational strategies that are needed to facilitate a total quality management system in a business. You will also learn about the value and implementation of risk management.



LEARNING OUTCOMES

Upon completion of this topic, you should be able to

- describe the role of professional management and leadership in a growing small business
- discuss human resource management in a small business environment with regard to attracting and retaining the services of employees
- manage the operational function of a small business in a quality assurance context
- manage a company's assets effectively
- elaborate on risk management in small companies

TOPIC CONTENT

This topic consists of five learning units, as shown below.

Learning unit	
12	Professional management and leadership
13	Human resource management
14	Operations management
15	Managing a firm's assets
16	Risk management

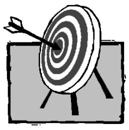
LEARNING UNIT 12

PROFESSIONAL MANAGEMENT AND LEADERSHIP
(Prescribed book: chapter 19 of Longenecker et al 2017)

CONTENTS

INTRODUCTION

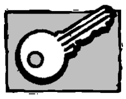
Unless you plan to remain a one-person business forever, you are sure to encounter leadership and management problems. When they occur, you must find ways to integrate the efforts of employees and to give new direction to the business. This is absolutely necessary if production employees, salespeople, administrative staff and other personnel are to work together effectively. Even long-established businesses need vigorous leadership if they are to avoid stagnation or failure. This learning unit examines the leadership challenges confronting entrepreneurs and the managerial activities that are required as businesses mature and grow.



LEARNING UNIT LEARNING OUTCOMES

Upon completion of this learning unit, you should be able to

- discuss an entrepreneur's leadership role
- discuss the distinctive characteristics of small business management
- identify the managerial tasks of entrepreneurs
- offer solutions to problems related to personal time management
- explain the various types of outside management assistance



KEY CONCEPTS

- empowerment
- work teams
- professional manager
- long-range plan (strategic plan)
- short-range plan
- budget
- chain of command
- line organisation
- line-and-staff organisation
- span of control
- delegation of authority
- negotiation
- small business development centres (SBDCs)
- networking

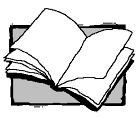
OVERVIEW

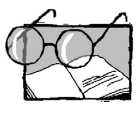
Entrepreneurs who have already entered the market can only succeed if they are able to manage their new ventures successfully. Conventional wisdom states that if you are a successful entrepreneur, you are probably a poor manager because you lack management skills and experience.

A small business venture's successful entry into the market does not guarantee long-term success. South Africa's small business sector has an extremely high failure rate. One of the main reasons for this is that entrepreneurs seem to lack the knowledge and skills required to manage a business. A reason why poor management is characteristic of such a large percentage of small businesses is that entrepreneurs tend to focus on their new ventures instead of sustained management. The problem is usually aggravated by a shortage of resources and an inability to appoint competent management talent.

Launching a new venture and then managing rapid growth means that an entrepreneur has to adapt to a new situation. The key to achieving longer-term sustained growth and profitability is an entrepreneur's ability to develop competencies as a manager. The aim of topic 3 is to give you, an emerging entrepreneur, an overview of the management competencies that you will need to ensure the successful establishment and sustained growth of a venture.

A new small business experiences constant change in its organisation and management needs as it moves from the launching stage to the point where it can employ a full staff of professional managers. Many ventures begin with entrepreneurial drive and are successfully launched, but problems emerge when the entrepreneurial driving force alone is not sufficient to keep the growing and seemingly successful ventures on track. Entrepreneurs who realise this will appoint professional managers or contract the necessary management talent timeously. Understanding how a business grows and what to do when it reaches maturity will give you the necessary background for the topics dealing with the management of a small business.

 Read "In the video spotlight: leadership and management – PSG Group" in Longenecker et al (2017:510).

 Study Longenecker et al (2017:510–531).

12.1 SMALL BUSINESS LEADERSHIP

In an attempt to understand the concept of leadership, it is often equated with management. Leadership is, in fact, not the same as management – it complements entrepreneurs' management abilities.

12.1.1 What is leadership?

Leadership is about giving direction. Leaders show the road that should be travelled. True leaders are only leaders if they have followers. They have to face uncertainties and help their followers to make sense of insecurities.

12.1.2 The leadership qualities of business founders

Longenecker et al (2017:552) explain the main qualities of leaders.

12.1.3 What makes a leader effective?

Study the descriptions of leaders in Longenecker et al (2017:511) and relate them to the way in which leadership manifests in small versus large organisations.

12.1.4 Leadership styles

Leaders use different styles of leadership. Longenecker et al (2017:512) explain six different leadership styles. Leadership is all about the empowerment of followers. Leaders are successful if they create more leaders who will take their vision further.

12.1.5 A leader shapes an organisation's culture

An entrepreneur should deliberately shape the culture of his/her company, which can greatly influence the way in which business is conducted in the company and how it performs.

12.2 THE SMALL FIRM MANAGEMENT PROCESS

Business enterprises, even small ones, do not function independently. They need to be managed. The successful and growing small business soon becomes too large for the entrepreneur to manage on his/her own. A small business will fail if it is not properly managed.

12.2.1 From founder to professional manager

Small business management differs from normal corporate management. Initially, an entrepreneur will manage his/her business until it reaches the point where he/she can appoint professional managers (see the definition of a professional manager in Longenecker et al 2017:515). The challenge of a new venture is to apply professional management principles from the moment the business opens.

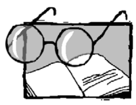
The founders of new ventures are normally creative, innovative and risk-taking individuals who thrive on continuous opportunity identification. These individuals tend to neglect professional management practices. The ability of an entrepreneur to progress from being a start-up owner to fulfilling the role of a professional manager is critical for the growth of a business venture.

Weaknesses in small business management in South Africa are normally found in the financial management function (cash-flow management) and marketing management.

The basic constraints in any small business are limited cash and staff and a general lack of basic business skills.

12.2.2 Firm growth and managerial practices

The management of growth in a small business context is a difficult task.

Study exhibit 19-1, "The organisational stages of small business growth", in Longenecker et al (2017:517). Note that each consecutive stage has different and more complex management demands, and a weakness in managing a stage may spell failure.

**ACTIVITY 12.1: Leadership style**

Instructions

Analyse the case study below and then answer the questions that follow.

Douglas Electrical Supply, Inc

A management consultant examines an entrepreneurial firm

Jim Essinger is a management consultant and training specialist from St Louis who specialises in continuous process improvement and total quality management. Every month, he goes to Springfield, Illinois, and provides three days of training to employees of a privately owned electrical wholesaler-distributor, Douglas Electrical Supply, Inc.

Most of the employees attending the fourth session are from the Springfield branch and have either gone back to the office or to their favourite restaurants during the lunch break. Jim has noticed that one of the class members is alone in the coffee shop of the hotel where the training sessions are conducted and he invites the young man to join him for lunch. The nervousness of his young companion is apparent to Jim, and he decides to ask a few questions.

Jim: Tony, you seem a little distracted; is there something wrong with your lunch?

Tony: Oh, it's not that, Jim. I … I'm having a problem at work, and it kind of relates to the training you are doing with us.

Jim: Really? Tell me about it.

Tony: Well, as you might know, I drive a van for the company, delivering electrical products and materials to our customers.

Jim: You work at the Quincy branch, right?

Tony: Yes. I drive about 250 miles a day, all over western Illinois, making my deliveries.

Jim: I see.

Tony: About seven weeks ago, I was making a big delivery at Western Illinois University in Macomb. A lady pulled out in front of me, and I had to brake hard and swerve to miss her!

Jim: You didn't hit her?

Tony: No! She just drove off. I don't think she ever saw me. Anyway, I had a full load of boxes, pipe, conduit, and a big reel of wire. The load shifted and came crashing forward. Some of it hit me hard in the back and on the back of my head.

Jim: Were you injured?

Tony: I'm not sure if I was ever unconscious, but I was stunned. Some people stopped and helped me get out of the van. I was really dizzy and couldn't get my bearings. Eventually, they called an ambulance. The paramedics took me to the hospital, and the doctors kept me for two days while they ran some tests.

Jim: Did you have a concussion?

Tony: Yes, I had some cuts and a slight concussion. My wife was really upset, and she made me stay home for the rest of the week. We have two little kids under four, and she wants me to quit and get a safer job.

Jim: She wants you to quit?

Tony: Yes! Sooner or later, all of the drivers get hit or have close calls. When you have a full load, those loads can shift and do a lot of damage. When I get in the van lately, especially when I have pipe or big reels of wire, I'm frightened. My wife is scared for me. I don't want to be killed or paralysed or something!

Jim: I can understand your concern, Tony. What can the company do to protect you? Can you put in some headache racks or heavy-gauge metal partitions in the van that would keep the load from hitting you if it shifts?

Tony: That's exactly what I was thinking! I've been talking with some of the other drivers during our TQM sessions. We've learnt that we can get heavy-gauge partitions that would keep us safe built for about $350 per vehicle.

Jim: Good! Have you talked to management about making the modifications?

Tony: Yes, I had all the information and talked to my boss in Quincy, Al Riess. However, he hardly seemed to listen to me. When I pressed the issue, he said the company had nearly 30 vans, counting the ones in Chicago and northern Illinois, and that the company could not afford to spend $10 000 for headache racks, partitions or anything else! Al finally said that I was just being paranoid, that I should drive more carefully and that I should definitely stop talking to the other drivers if I valued my job.

Jim: You mean he threatened you?

Tony: You could say that. He said to keep my mouth shut and just drive … or else!

Jim: Tony, is there someone else you could talk to about this problem? It would seem to me that one injury lawsuit would certainly cost the company more than the modifications you're proposing.

Tony: Well, there's the problem! You know how expensive the TQM training is …

and all of us "little people" were actually excited about TQM and continuous process improvement when the owners and you first talked to us. We believed management was changing and was really interested in our ideas and suggestions. We thought maybe they cared about us after all.

Jim: Well, I believe the owners do want to change the culture and improve the operations.

Tony: Maybe it's different in Chicago and northern Illinois, Jim, but the guys in Peoria and Springfield are like military types and are really into control. I think they're authoritarians – is that the right term?

Jim: Yes, authoritarians, autocrats … .

Tony: Al Riess, my boss, is the son-in-law of Bob Spaulding, who heads our division. As you probably know, Bob has a real bad temper and nobody crosses him twice, if you know what I mean. Bob is particularly sensitive about Al – because everyone knows Al doesn't have much ability and we're losing money at the Quincy branch.

Jim: Okay, I see your problem with going to Bob. Is there a safety officer or anyone at headquarters who could logically be brought into this situation?

Tony: I don't know! The owners seem to have a lot of confidence in Bob and give him a free hand in the management of our division. No, I don't see much hope of change. It makes the TQM training pretty hollow and kind of a crock! No offense, Jim!

Jim: No, I see what you mean, Tony.

Tony: See, I have eight years invested in this company! I used to like my job and driving the van. But, now, I'm afraid, my wife is afraid … .

Jim: Sure, I can understand where you're coming from! Let me ask you a question. How many van drivers are there in the entire company?

Tony: I'm not absolutely sure. There are 17 drivers in our division, and I believe 13 to 15 drivers in the north. About 30 vans and drivers would be close to the correct numbers.

Jim: Are any of the drivers in a union?

Tony: None of us in this area, but all of the truck and van drivers in the north are Teamsters.

Jim: Aha! Have any of you ever talked to those drivers about this safety issue?

Tony: Oh, I see where you're coming from … .

Jim: Hang on! That might be your fallback position, but you won't necessarily be protected if you're regarded as a troublemaker. Let me think about ways I might be able to intercede in a functional way.

Tony: Gee, that would be great if you could. I mean, we like our jobs, but we've got to be safe and we've got to be heard when it is a matter of life and death!

Questions

(1) Describe and evaluate the leadership style that is followed in Douglas Electrical Supply.

(2) What are the apparent values and assumptions of management in this business?

FEEDBACK

(1) This case study reflects one person's evaluation of a company's leadership and management. One can assume that this perception is seriously flawed. Corporate leadership in the company appears to be deficient – certainly at local level – and is evidently tolerated by the CEO. There is no evident vision of the future or values that would encourage employees to "buy into" the company's goals. In terms of the leadership styles cited by Daniel Goleman in the text, the local boss is using a coercive style and even threatening the employee. Certainly, this style is dramatically different from that of a so-called affiliative and coaching leader. In short, the picture here reflects abysmally deficient leadership.

(2) The following statements reflect the values of management:

- Employees are a means to the end.
- Employees must be driven rather than led.
- Money is more important than safety.
- Do not rock the boat.
- People are expendable.

12.3 MANAGERIAL RESPONSIBILITIES OF ENTREPRENEURS

The specific management functions of a small business manager are briefly discussed below.

12.3.1 Planning activities

There is nothing as true as the saying: "When you fail to plan, you plan to fail". A business plan is the initial planning blueprint of a business. However, drawing up a business plan is not the end of planning. Continuous planning is essential, hence the need for formal planning. The process of thinking business issues through improves productivity. A business plan can guide decisions, thus ensuring that small business managers work towards the same goal. In addition, evidence of planning increases credibility with bankers, suppliers and other outsiders.

Types of plans include long-range or strategic plans (five to ten years) and short-range plans (one day to one year), which include budgets.

Entrepreneurs should carefully consider and determine the amount of time that will be spent on planning and to what extent employees can participate in the process.

12.3.2 Creating an organisational structure

Creating an organisational structure allows an entrepreneur to define the relationships between the activities in his/her business. The following three aspects should be considered in this regard:

(1) **Unplanned structure.** The manager of a small business should create a structure that defines the relationship between employees and managers. The initial structure of a small business is normally unplanned. To start with, the entrepreneur will probably manage all the functions. Later on, a new employee might be appointed to fulfil the three management tasks of administration, finance and marketing. This is part of the natural evolution in the structure of a business. It is essential to put an effective structure in place as the business grows. If this does not happen, a chaotic chain of command, characterised by human conflict, may result.

(2) **Chain of command.** The chain of command in a business is the official vertical line of communication that is part of the organisational structure. Typically, small businesses start with a line organisation in which each employee reports to one supervisor (see exhibit 19-2 in Petty et al 2012:563). A line-and-staff organisation structure includes staff specialists who assist managers (human resource or public relations managers).

(3) **Span of control.** The span of control in a business relates to the number of subordinates supervised by one manager. The following factors determine the optimal size of control: the type of work, energy, personality and abilities.

12.3.3 Delegating authority

Petty et al (2012:564–565) explain the implications of an entrepreneur's inability or unwillingness to delegate authority, on the one hand, and the unexpected problems that an entrepreneur may run into when taking the "delegation plunge", on the other. The authors explain that the delegation process has two dimensions, namely, quantity and quality. With regard to the latter, they distinguish between "gofer" delegation and "stewardship" delegation.

12.3.4 Controlling operations

Control entails keeping track of all operations in a business. Targets and standards are two basic components of the control process. A quality control process is an example of a control process (e.g., the quality of a product, functionality and packaging). The corrective actions that are needed (e.g., the replacement or repair of packaging) will depend on the type of business, problem or operation. Study exhibit 19-3, "Stages of the control process", in Longenecker et al (2017:522). The following three stages of control are identified:

(1) the input stage – preventive control
(2) the process stage – concurrent control
(3) the output stage – corrective control

12.3.5 Communicating

Longenecker et al (2017:523) emphasise the importance of two-way communication for effective communication and explain the approach that should be adopted during communication. They describe seven practical tools and techniques for enhancing two-way communication. Apart from engaging in interpersonal communication, employees have to make presentations to a number of different stakeholders, such as customers, suppliers and bankers. Exhibit 19-4 provides a few "presentation tips" (Longenecker et al 2017:524).

12.3.6 Negotiating

Professional managers continuously find themselves in situations where they need negotiation skills. Negotiations occur daily between suppliers, customers, bankers, estate agents and providers of business services. Negotiation is a two-way communication process aimed at resolving differences in needs, goals or ideas. A competent negotiator is someone who can create a win-win situation for all parties involved.

12.4 PERSONAL TIME MANAGEMENT

To a small business owner, time is a scarce resource on which numerous demands are made.

12.4.1 The problem of time pressure

Many entrepreneurs will tell you that they worked seven days a week, 24 hours a day to set up their businesses. Effective time management increases productivity and even profit. Time pressure is best explained by means of the following activity:

ACTIVITY 12.2: Managing growth in a small business

Instructions

Read the case study below and then answer the questions that follow.

An entrepreneur who launched a new business a few years ago finds himself in a situation where he is spending 16 hours a day running from one appointment to the next, negotiating with customers, looking for new business and checking up as much as possible on employees. He knows that selling is his strong point, but his general managerial responsibilities are extremely time-consuming and interfere with his sales efforts. He even has to sleep at the office two nights a week just to keep abreast of things.

Despite his hard work, he knows that his employees are disorganised and are experiencing many problems. However, he simply does not have the time to formulate personnel policies or even draw up job descriptions for his six employees. One employee takes advantage of the lack of supervision by sometimes not showing up for work. Invoices are sent to customers late and delivery schedules are sometimes missed. Fortunately, the business is profitable despite all these problems.

Questions

(1) Is this business founder's problem one of time management or general managerial ability? Would it be feasible to engage the services of a management consultant to help solve the business's problems?
(2) If you were asked to improve this business's management system, what would be your first steps and initial goal?

FEEDBACK

(1) A lack of general management skills appears to be the main problem here. Other businesses run successfully with less frantic administrative activities. The situation appears ideal for analysis by a well-qualified management consultant. The entrepreneur is aware of the problem and concerned about solving it. However, he apparently lacks the knowledge to deal with it. Enlisting the services of a qualified consultant would certainly ease the situation.

(2) The first steps would be to interview key members of the company, to examine the organisational structure and responsibilities, to evaluate the qualifications of key personnel, to look for gaps in staffing and to study the entrepreneur's administrative style. An initial goal might be to eliminate the owner's need to sleep in the office at night and to limit his 16-hour day to a more modest 12 to 14 hours.

12.4.2 Time savers for busy managers

Small business managers need to assess possible time savers and determine exactly what functions are wasting their time. On completion of such an analysis, managers should prioritise all the variables and then formulate an efficient work plan. Procrastination is a common problem in small businesses. Time management and self-discipline can help to resolve the problem. Longenecker et al (2017:526) list eight time wasters.

12.5 OUTSIDE MANAGEMENT ASSISTANCE

Various types of outside management assistance are available to managers.

12.5.1 The need for outside assistance

A solution to the basic problem of ineffective small business management might be to enlist help from outside. There are various options in this regard.

12.5.2 Sources of management assistance

The following external sources of management assistance are available:

(1) **Business incubators.** These are organisations that offer entrepreneurs shared infrastructure such as office space, secretarial services and managerial support. Follow the links below to visit the websites of two South African incubators.
http://www.csir.co.za/m&mtek/MSMMEDC/smme-main.html
http://www.csir.co.za/biochemtek/bioincubator.html

(2) **Educational institutions.** Many colleges and universities have student consulting teams who provide assistance to small businesses. These teams are made up of graduate students who work with small business owners under the direction of faculty members.

(3) **Service Corps of Retired Executives (SCORE).** This group operates in the USA. Unfortunately, South Africa does not have anything similar. SCORE is an organisation of retired business executives who serve as volunteer consultants.

(4) **Small business development centres (SBDCs).** In South Africa, Business

Partners is an organisation that focuses on the development of small businesses. It has several centres from which it operates (www.businesspartners.co.za).

(5) **Management consultants.** Many management consultants operate in the entrepreneurship and small business environment. Longenecker et al (2017:529) discuss some of the reasons why entrepreneurs need outside management assistance.

(6) **Small business networks.** Networking is the process of developing and engaging in mutually beneficial relationships.

(7) **Other business and professional services.** Such services may be provided by banks, accountants, attorneys, insurance agents, suppliers, trade associations and chambers of commerce.

(8) **US Small Business Administration (SBA).** In the USA, this is the first place small business owners go for assistance.

SELF-ASSESSMENT

(1) Describe the role of professional management and leadership in a growing small business.
(2) Discuss the operational function of a small business in a quality assurance context.
(3) Discuss how would you effectively manage a company's assets.
(4) Elaborate on the risk management process in a small business.

SUMMARY

In this learning unit we explored the competencies required of entrepreneurs to manage small business ventures effectively and efficiently. Small business management differs from the management of larger operations because of small firms' limited size and initial survival strategies. We also examined the management functions of planning, leading, organising and control and focused specifically on time management. The learning unit concluded with an explanation of the need for outside management assistance because of entrepreneurs' general lack of business management skills. Learning unit 13 deals with the role of human resource management in a small business venture.

LEARNING UNIT 13

HUMAN RESOURCE MANAGEMENT
(Prescribed book: chapter 20 of Longenecker et al 2017)

CONTENTS

INTRODUCTION

Although the human resource management (HRM) practices of small businesses should be well planned and professional, research has shown that this often is not the case. If you are concerned that you may not know enough to hire suitable employees for your start-up or business expansion, this learning unit will help you by presenting HRM practices that work best for entrepreneurial companies.

LEARNING UNIT LEARNING OUTCOMES

Upon completion of this learning unit, you should be able to

- explain the importance of employee recruitment and to list sources that could be useful in finding suitable job applicants
- identify the steps to follow in evaluating job applicants

- describe the role of training and development in respect of managerial and nonmanagerial employees in a small business
- explain the various types of compensation plans, including incentive plans
- discuss some of the special issues related to human resource management

KEY CONCEPTS

- headhunter
- workforce diversity
- job specification
- behavioural interview
- validity
- reliability
- job descriptions and job specifications
- job instruction training
- fringe benefits
- employee leasing

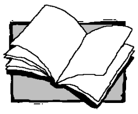
OVERVIEW

The following six basic components are needed to operate an enterprise successfully:

(1) people
(2) materials
(3) machinery
(4) management
(5) markets
(6) money

If any of these components are not managed professionally or utilised optimally, an enterprise runs the risk of failing or ultimately closing down. People are the most complex, dynamic and active of all the components or resources. None of the other components have these characteristics. Because everything in an enterprise is ultimately done by people, it is easy to see why an enterprise's people or employees are the key component in its functioning – hence the importance of this learning unit.

Large enterprises usually have a separate human resource department to deal with employee matters. In small businesses, the owners/employers often have to cope with this function personally. Appointing and retaining the right staff is vital because every person in a small business affects general work performance and productivity. Employees should, therefore, always be regarded as valuable business resources.


Read the following case study in Longenecker et al 2017 (2017:538): "In the spotlight: STM Human Resource Consultants".


Study Longenecker et al (2017:539–568).

13.1 RECRUITING PERSONNEL

Employees represent a business's most valuable assets. A business should therefore attract and employ people of the right quality to achieve its overall business objectives.

13.1.1 The need for quality employees

The employment of people is generally expensive. Therefore, business owners need to carefully assess the need for employees and decide whether they will, in fact, improve business performance and ensure success. An entrepreneur could argue that for every rand invested in an employee, there should be three rand more as a return on investment. Because the human resource factor ultimately has an impact on a business's profit structure, the recruitment of quality employees is vital.

13.1.2 The lure of entrepreneurial firms

How can small businesses compete for employees? Smaller enterprises have the following advantages:

- freedom and flexibility versus the bureaucracy of a corporate enterprise
- compensation packages
- the flexibility of working schedules
- creative challenges

- diversified experience
- satisfaction in knowing efforts make a difference to the company

13.1.3 Sources of employees

Where or how can an entrepreneur find people of the right quality? The following sources or methods of recruitment are available:

- "help-wanted" advertising
- walk-ins (the unemployed walking from door to door)
- schools
- public employment offices
- private employment agencies
- executive search firms
- employee referrals
- internet recruiting
- temporary help agencies (e.g., at universities or universities of technology, as well as staffing specialists like Kelly)

13.1.4 Diversity in the workforce

The South African situation should be mentioned here because of the complex diversity of the country's work environment. The following Acts should be analysed before any form of recruitment can take place:

- the Labour Relations Act 66 of 1995
- the Basic Conditions of Employment Act 75 of 1997
- the Employment Equity Act 55 of 1998
- the Skills Development Act 97 of 1998
- the Skills Development Levies Act 9 of 1999

The government's long-term plan for employment equity is to ensure that the workforce represents the country's demographic composition. Consequently, entrepreneurs are faced with the challenge of adapting to and accepting the benefits of diversity.

13.1.5 Job descriptions and job specifications

The compilation of job descriptions is undoubtedly one of the most neglected areas in small businesses today. So many entrepreneurs employ people simply to free themselves from time management constraints. The problem with that approach is that legislation protects employees against the traditional "hire-and-fire" practices. A proper disciplinary procedure, which may be time-consuming, should be followed before an employee can be dismissed. The human resource function should be a well-planned action and be part of the overall business strategy of an enterprise. A job description is a definition of a job with regard to the duties to be performed. A job specification, on the other hand, defines the human element of a job – in other words, the skills that a person would need in order to perform the job successfully. Job descriptions and job specifications are part and parcel of the job analysis process.

13.2 EVALUATING PROSPECTS AND SELECTING EMPLOYEES

Once the job analysis process has been finalised, the recruitment process can start. The following steps, discussed in detail in Longenecker et al (2017:548–553), should be followed to evaluate and select the right kind of employee:

- Step 1: using application forms
- Step 2: interviewing the applicant
- Step 3: checking the applicant's references and other background information
- Step 4: testing the applicant
- Step 5: requiring physical examinations

All five steps in the selection process should be in line with South African labour legislation.

13.3 TRAINING AND DEVELOPING EMPLOYEES

The training and development process starts the moment an employee is recruited. Any training process needs to help an employee to perform and achieve set objectives in the workplace.

13.3.1 Basic components of training and development

Employee training refers to planned efforts to help workers master the knowledge, skills and behaviour that they need in order to perform the duties for which they were hired. Management development is more focused on preparing employees for future roles in business and places an emphasis on the formal education, job experience, relationship formation and assessment necessary to achieve long-term career goals and to fulfil managerial potential.

13.3.2 Orientation for new personnel

The first few days for a new incumbent are normally highly confusing. It is the management team's responsibility to regard this initial phase as part of the development process.

13.3.3 Training to improve quality

Training programmes can be designed to improve the quality of work delivered.

ACTIVITY 13.1: Human resource problems

Instructions

Read the case study below and answer the questions that follow.

Gibson Mortuary

Human resource problems in a small family business

Gibson Mortuary was founded in 1929 and has become one of the best-known funeral homes in Tacoma, Washington. One of its most persistent problems over the years has been the recruitment and retention of qualified personnel.

Background of the business

Gibson Mortuary is a family business headed by Ethel Gibson, who owns 51% of the stock. As an active executive in the business, Ethel is recognised as a community leader. She has served in various civic endeavours, been elected to the city council and served one term as mayor.

The mortuary has built a reputation as one of the finest funeral homes in the state. The quality of its service over the years has been such that it continues to serve families over several generations. While large corporations have bought up many mortuaries in recent years, Gibson Mortuary continues to remain competitive as an independent family firm – a "family serving families". Funeral homes in general have recently become the target of public criticism, and books such as *The American way of death* reflect adversely on this type of business. Nevertheless, Gibson Mortuary has withstood this threat by its determined, consistent effort to provide the best possible customer service. In its most recent year, it conducted 375 funerals, which places it in the top 9% of all funeral homes in the nation when measured in terms of volume of business.

Ethel's son, Max Gibson, entered the business after completing military service and became general manager of the firm. He is a licensed funeral director and embalmer. Both mother and son are active in the day-to-day management of the firm.

Recruitment and retention problem

Perhaps the most difficult problem that Gibson Mortuary faces is the recruitment and retention of qualified personnel. The image of the industry has made it difficult to attract the right calibre of young people as employees. Many individuals are repelled by the idea of working for an organisation in which they must face the fact of death daily. In addition, the challenges raised by social critics reflect poorly on the industry and convey to many people the impression that funeral homes are profiting from the misery of those who are bereaved.

One source of employees is walk-in applicants. Also, Gibson Mortuary works through local sales representatives who often know of people who might be considering a change in their careers.

As a small business, Gibson Mortuary presents fewer total opportunities than a larger company or even a funeral home chain. The fact that it is a family business also suggests to prospective employees that top management will remain in the family. It is apparent to all that the two top management spots are family positions. However, Ethel and Max (who is 49 years old) are the only family members employed, so there is some hope for the future for nonfamily employees.

Training problem

Gibson Mortuary uses two licensed embalmers – Max and another individual. The pressure of other managerial work has made it difficult for Max to devote sufficient time to this type of work.

Any individual interested in becoming a licensed embalmer has to attend Mortuary College (mortuary science programmes are part of some community college programmes) and serve a two-year apprenticeship. The apprenticeship can be served either prior to or after the college training. Gibson Mortuary advises most individuals to take the apprenticeship prior to the college training so that they can evaluate their own aptitude for this type of career.

Gibson Mortuary prefers its personnel to be competent in all phases of the business. The work involves not only embalming but also making funeral arrangements with families and conducting funerals and burials. However, some part-time employees only assist in conducting funerals and do not perform preparatory work.

Personal qualifications for employment

All employees who meet the public and have any part in the funeral services need to be able to interact with other people in a friendly and relaxed but dignified manner. The personalities of some individuals are much better suited to this than those of others. Ethel describes one of the problem personalities she had to deal with as follows:

"In the first place, he didn't really look the part for our community here. He was short and stocky, too heavy for his height. His vest was too short, and he wore a big cowboy buckle! Can't see that going over big in a mortuary! He wanted to stand at the door and greet people as they came in. We do furnish suits, so we tried to polish off some of the rough edges.

But he was still too aggressive. He became upset with me because I wouldn't get him any business cards immediately. One day I had to send him to the printer, and he came back and said, 'While I was there, I just told them to make some cards for me. I'll pay for them myself.' I said to him, 'Willis, you go right back there and cancel that order! When you are eligible for cards, I'll have them printed for you.' We couldn't have him at that point scattering his cards with our name all over town."

Another young applicant made an impressive appearance but lacked polish. His grammar was so poor that he lacked the minimal skills necessary for any significant contact with the public.

Two characteristics of employment that discourage some applicants are the irregular hours and the constant interruptions that are part of the life of a funeral director. A funeral director might start to do one thing and then find it necessary to switch over to another, more urgent matter. Also, some night and weekend duty in the work schedule is required.

Solving the human resource problems

Although Gibson Mortuary has not completely solved its need for qualified personnel, the business is working at it. While waiting for the right person to come along, Gibson Mortuary started another apprenticeship prior to any college training. In addition, it is following up on a former apprentice who worked during summer vacations while attending mortuary college. The business also employs a part-time minister as an extra driver. In these ways, Gibson Mortuary is getting along, but it still hopes to do a better job in personnel staffing.

Source: Personal communication (the names have been changed to protect the individuals concerned)

Questions

(1) Evaluate the human resource problems this firm is facing. What problems appear to be the most serious?
(2) How could Gibson Mortuary be more aggressive in recruitment? How could the firm make itself more attractive to prospective employees?
(3) Does the fact that Gibson Mortuary is a family firm create a significant problem in recruitment? How could the firm overcome any problem that may exist in this regard?
(4) Assuming you are the right age to consider employment with Gibson Mortuary,

what would be your main question or problem as a prospective employee? What, if anything, could the Gibsons do to deal with that type of question or problem?

FEEDBACK

(1) The general problem is the lack of a pool of qualified applicants. This is caused by a number of specific factors. One factor is the nature of the industry. The business deals with death, and many potential applicants find such an atmosphere unattractive. (Question (4) reflects a sample of student attitudes on this point.) In addition, social critics have strongly criticised the industry in such books as *The American way of death*. Another factor is the size of the mortuary. As in the case of all small firms, the number of advancement opportunities is limited. In addition, the fact that this is a family business means that top management positions, at least for the present, are assigned to family members, thus reducing the potential for advancement. Finally, the irregular hours and interruptions in this type of work create a pattern of employment that many people would find unattractive.

The seriousness of these factors is difficult to evaluate. No doubt, individuals will have different opinions on their relative importance. You could try to rank these and possibly other factors in some way. The idea of working with the dead could well be the primary deterrent.

(2) The first question is: "How aggressive is Gibson Mortuary at present in searching for qualified applicants?" The recorded facts create the impression that management are concerned about the problem of recruitment but are not aggressively pursuing the matter. You may have imaginative suggestions on how an aggressive programme might work. Mortuary colleges would seem to be a likely source of applicants. The case provides no information on enrolments at such colleges or their location relative to Gibson Mortuary.

What steps could be taken to build a strong relationship with potential applicants from mortuary colleges? To make a career in the mortuary industry attractive to applicants, the firm would need to emphasise positive factors. The opportunities for service could be stressed when talking to prospective employees. Personnel in this industry deal with bereaved people who are appreciative of the kind of service rendered. In addition, management could highlight the income generated in the mortuary industry and the opportunities for entrepreneurship for people who gain experience in this field. Also, applicants would be attracted to employers who use career development planning and periodic performance reviews.

(3) The fact that Gibson Mortuary is a family firm does create a problem in recruitment. It is the same problem that all small family firms face. Most applicants prefer to work for firms in which all positions are potentially available to them. The fact that family members occupy key positions means that these jobs are not available to other qualified personnel.

To overcome problems in this regard, the manager should make it clear that good performance will be recognised and rewarded. The manager could also point out the potential for advancement that does exist in the firm. The fact that a family member currently fills the top management position should not mean that all opportunities for advancement are completely closed. In fact, a well-developed programme for career advancement might be the most attractive aspect of an effective recruitment programme. A well-developed career plan would provide a schedule for training and periodic evaluation. The manager could also suggest to applicants the possibility of eventually starting their own business or perhaps acquiring an ownership interest in Gibson Mortuary.

(4) Your responses should be tabulated in order to give a picture of the factors that are critical to young people. Once the problem areas have been identified, feasible solutions for each should be discussed. Personalising the question in this way will help you understand some of the crucial issues and to see some of the possibilities and frustrations involved in solving them. Some factors are obviously difficult to resolve. For example, it will be hard to change the thinking of people who are strongly repelled by the thought of working in a mortuary.

13.3.4 On-the-job training

Job descriptions and job specifications serve as a basis for the identification of training needs. Changes in a job description over time (e.g., changes in technology) may necessitate extra training and development. Job instruction training is a form of training for nonmanagerial employees that involves instructing an employee physically in how to complete a job effectively (e.g., operating a heavy-duty machine or crane). Refer to exhibit 20.2 in Longenecker et al (2017:555).

13.3.5 From training to implementation

The goal of training is to teach employees new knowledge, skills and behaviours that will lead to improved job performance. Only 10–40% of training provided is ever applied on the job. If you want a better return on training and development spending, you must encourage people to use the training they have received. Haary J Martin suggests the following programme features for training and development:

- Put it on paper.
- Measure results.
- Get peers to help.
- Involve supportive superiors.
- Provide access to experts.

13.3.6 The development of managerial and professional employees

The need for managerial training in a small business environment is always present, especially during the growth phase. The following aspects need to be taken into account for purposes of establishing a management training programme:

- the need for development
- a plan for development
- a timetable for development
- employee counselling (one-to-one interviews with employees to analyse their progress and training needs)

Longenecker et al (2017:555) depict the steps in job instruction training in exhibit 20-2.

13.4 COMPENSATION AND INCENTIVES FOR EMPLOYEES

Even though some theories on motivation indicate that money is not the primary driving force behind employees' performance, the fact is that remuneration is still and will always be a determining factor in business. A small business should therefore ensure that its salaries and wages are competitive and motivational. The structuring of remuneration packages also merits special attention.

13.4.1 Wage and salary levels

As a rule, small businesses have to pay competitive wages in order to attract well-qualified personnel. Paying above minimum wages for the lowest-level employees may result in several benefits for a business.

13.4.2 Financial incentives

Incentives are introduced into the business sector to motivate employees to increase their productivity (e.g., financial remuneration excluding salaries or wages). Performance-based compensation plans should be carefully designed. The following guidelines apply in this regard:

- Set attainable goals.
- Include employees in the planning of financial incentives.
- Keep updating the goals.

13.4.3 Stock incentives

Some small businesses award shares to their employees. This option is called an employee stock ownership plan (ESOP). The main purpose of such a plan is to increase productivity and a feeling of security.

13.4.4 Employee benefits

By law, small businesses are obliged to pay their employees the following benefits:

- unemployment insurance
- workmen's compensation

Other benefits may include

- a retirement plan
- study assistance

- housing
- a motor allowance
- parking
- subsidised meals
- medical aid

13.5 SPECIAL ISSUES IN HUMAN RESOURCE MANAGEMENT

The human resource management environment is constantly changing. The following issues are currently relevant:

13.5.1 Co-employment

Entrepreneurs can choose to outsource part of the burden of managing employees through an arrangement known as co-employment. About 700 co-employment companies, also known as professional employer organisations, operate in all 50 states of the USA and assist small businesses with their human resource management needs.

13.5.2 Legal protection of employees

The South African legal system protects employees by means of the following Acts:

- the Labour Relations Act 66 of 1995
- the Basic Conditions of Employment Act 75 of 1997
- the Employment Equity Act 55 of 1998
- the Skills Development Act 97 of 1998
- the Skills Development Levies Act 9 of 1999

13.5.3 Labour unions

Labour unions are formed to protect member employees individually and collectively against any form of unfair labour practice. Unions normally do not target small businesses, but it is beneficial for an entrepreneur to keep an open line of communication with all unions in his/her industry to prevent union action proactively.

13.5.4 Formalising employer–employee relationships

The initial phases of small business management normally entail informal employer–employee relationships. This informal style of communication and relationships needs to change as a business grows. Proper personnel policies and procedures need to be in place to formalise the workplace for increased productivity.

13.5.5 The need for a human resource manager

The appointment of a human resource manager becomes necessary at some point as a company continues to add employees. Petty et al (2012:605) identify seven conditions that favour the appointment of a human resource manager in a small business.

SELF-ASSESSMENT

(1) Explain the importance of employee recruitment and list sources that could be useful in finding suitable applicants.
(2) Identify the steps to follow in evaluating job applicants.
(3) Describe the role of training and development in respect of managerial and nonmanagerial employees in a small business.
(4) Explain the various types of compensation plans, including incentive plans.
(5) Discuss some of the special issues related to human resource management.

SUMMARY

This learning unit dealt with the human resource factor in a small business context. The whole process of hiring an employee starts with a job analysis, comprising a job description and a job specification. The job analysis serves as a basis for recruitment, as well as training and development. New recruits should complete an orientation programme. Effective training interventions will ensure increased work performance. Adequate remuneration systems should be in place because of their motivational value. Bear in mind that this learning unit should be studied in the South African context only. Learning unit 14 focuses on operations management.

LEARNING UNIT 14

OPERATIONS MANAGEMENT

(Prescribed book: chapter 21 Longenecker et al 2017)

CONTENTS

INTRODUCTION

Effective operations management is all about understanding the individual activities involved in a company's creation of goods and services and the way they fit together in an orderly sequence and then managing these activities with efficiency in mind. Entrepreneurs who work to improve their operations will find that their companies are better able to withstand the escalating pressures of the competitive marketplace. This learning unit focuses on best practices for operations management that can be adopted by small businesses. Whether they are used in a manufacturing business or service-based company, these practices can drive profit and improve the competitive edge of a small business.

LEARNING UNIT LEARNING OUTCOMES

Upon completion of this learning unit, you should be able to

- critically discuss ways in which operations can enhance a small business's competitiveness
- explain the nature of the operations process in respect of products and services
- identify ways to control inventory and to minimise inventory costs
- recognise the contributions of operations management to product and service quality
- discuss the importance of purchasing and the nature of key purchasing policies
- explain lean production and synchronous management and their importance to operations management in small firms

KEY CONCEPTS

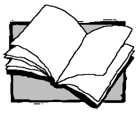
- operations process
- total quality management (TQM)
- organisational culture
- quality
- continuous quality improvement
- benchmarking
- quality circle
- inspection
- inspection standard
- bottleneck
- attribute inspection
- variable inspection
- acceptance sampling
- statistical process control
- control chart

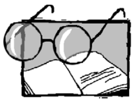
- ISO 9000
- operations management
- job shops
- project manufacturing
- repetitive manufacturing
- batch manufacturing
- preventive maintenance
- corrective maintenance
- productivity
- re-engineering
- time and motion studies
- purchasing
- make-or-buy decision
- outsourcing
- strategic alliance
- economic order quantity (EOQ)
- ABC method
- just-in-time (JIT) inventory system
- physical inventory system
- cycle counting
- perpetual inventory system
- synchronous management
- lean production

OVERVIEW

Since the lifting of sanctions and import protection duties, the South African business environment has become more competitive. It can be expected to become even more competitive because an increasing number of overseas enterprises are considering South Africa as a market for their products and services. In addition, there is a looming worldwide recession, and some enterprises may dump their products on the South African market. To survive in such an environment, South African enterprises will have to place greater emphasis on the quality of both products and services in order to secure customers.

In this learning unit we will discuss the elements of total quality management (TQM), the various types of manufacturing operations and ways to improve productivity.

 Read "In the spotlight: Ignatius: smarter – stronger – faster" in Longenecker et al (2017:570).

 Study Longenecker et al 2017 (2017:570–598).

14.1 COMPETING WITH OPERATIONS

Operations refers to the process that is followed to create and deliver a good or service. These days, companies vary considerably in the way they compete for customers, and the planning and management of operations almost always play a major role. Operations management refers to the planning and control of a conversion process that includes bringing together inputs (such as raw materials, equipment and labour) and turning them into outputs (products and services) that customers want.

14.2 THE OPERATIONS PROCESS

The operational side of a business (manufacturing) is concerned with the transformation of raw materials into a final product in line with customer demand.

14.2.1 The nature of the operations process

All types of businesses have operations or work flow to be managed. For example, in higher education, the inputs are students, a university and books and the outputs are graduates. The production processes form part of operations management. During the operations process, inputs are converted into outputs, as illustrated in exhibit 21-1 (Longenecker et al 2012:614).

14.2.2 Managing operations in a service business

The operations of companies that provide services differ from those that provide products in a number of ways. In a service business,

- productivity is easier to measure
- quality is easier to control
- employees have extensive interaction with customers
- services are created and delivered on demand

14.2.3 Types of manufacturing operations

There are five basic types of manufacturing operations:

(1) **Job shops.** These are manufacturing units with intermittent operations, short runs and general-purpose machines.
(2) **Project manufacturing.** This type of manufacturing operation is designed to produce unique but similar products, often in an outdoor setting.
(3) **Repetitive manufacturing.** This type of operation involves long, uninterrupted production runs and the use of specialised equipment.
(4) **Continuous manufacturing.** This is a form of repetitive manufacturing with output that more closely resembles a product stream than individual products.
(5) **Flexible manufacturing.** This type of operation usually involves the use of computer-controlled equipment that can turn out products in smaller or more flexible quantities.

14.2.4 Capacity considerations

A small company's capacity to serve or produce goods or services is a critical factor since it puts a ceiling on the firm's ability to meet demand and to match competitors. It may also determine start-up costs and usually represents a long-term commitment.

14.2.5 Planning and scheduling

Time is always a factor in the eyes of the customer. The purpose of operations planning and scheduling is to meet delivery dates, to achieve efficiency and to eliminate bottlenecks or work stoppages. The operations process is more complicated in a service business than in manufacturing because the arrival of customers, say, in a nail bar triggers service opportunities. The scheduling of appointments may even out the fluctuating demand for a service (e.g., scheduling vehicle repairs).

14.3 INVENTORY MANAGEMENT AND OPERATIONS

Inventory may represent a major current asset investment, hence the importance of inventory management.

14.3.1 Objectives of inventory management

The objectives of inventory management are to have the right goods in the right place at the right time and at the right price.

Study exhibit 21-2, "Service level and balance sheet considerations", in Longenecker et al (2017:576).

14.3.2 Inventory cost control

Various methods of inventory management can be used. Study the methods discussed in Longenecker et al (2017:577–579). Approaches to inventory management that can be adopted are as follows:

- **Economic order quantity (EOQ).** This method involves maintaining optimal inventory, that is, the level that minimises stockouts and eliminates excess inventory.
- **Statistical inventory control.** This method involves statistically determining the appropriate amount of inventory to carry and is easier to use.
- **ABC inventory analysis.** This system involves classifying inventory items on the basis of their relative value.
- **Just-in-time (JIT) inventory.** This method is a way of reducing inventory levels to an absolute minimum.

14.3.3 Inventory record-keeping systems

Record-keeping saves long-term costs. There are four different methods of keeping a record of inventory, as highlighted below.

(1) **Physical inventory system.** A physical inventory system involves counting the

actual items on hand.

(2) **Cycle counting.** This method involves counting different segments of inventory at different times during the year.

(3) **Perpetual inventory system.** A perpetual inventory system works on the basis of ongoing/continuous record-keeping.

(4) **Two-bin inventory system.** For each item in inventory, the business sets up two containers, each holding enough items to cover lead time.

14.4 OPERATIONS MANAGEMENT AND QUALITY

A strong commitment to the achievement of quality will be to the benefit of a small business.

14.4.1 Quality as a competitive tool

The operations process is defined as all the activities concerned with the production of goods and services. Because of customer needs, the role of quality has increased over time. This applies to both large manufacturing companies and small businesses. The emphasis is therefore on quality that can be achieved in the operations process.

See Longenecker et al (2017:580) for a definition of quality. All businesses should focus on TQM to ensure TQM emphasises commitment, focus and an all-encompassing effort involving everyone in a firm. TQM is becoming increasingly necessary in South Africa because of competitive pressures, including increasing international business activities. Successful quality management incorporates the three elements discussed below.

14.4.2 The customer focus of quality management

All operational activities in a business should be in line with customers' needs. The following two factors should be considered:

(1) **Retail is detail.** The following guidelines apply:

- Operating details can make or break a business, especially in the food service industry.
- Customer expectations vary according to the product or service.

(2) **Customer feedback.** The following guidelines apply:

- Entrepreneurs should listen attentively to customers.
- Marketing research methods may be useful in this respect.

14.4.3 The seven basic "quality tools"

(1) A **cause-and-effect diagram** is useful for identifying potential causes and effects of problems and sorting them into categories.
(2) A **check sheet** provides a structured, prepared form for collecting and analysing data.
(3) A **control chart** transforms data into graphs that can be used to determine if a process errs in some predictable and correctable way.
(4) A **histogram** is the most commonly used graph for showing how often each value occurs in a set of data.
(5) A **Pareto chart** is a bar graph that reveals which causes of a problem are significant, separating the "vital few" from the "useful many".
(6) A **scatter diagram** A scatter diagram graphs paired numerical data, with one variable on each axis, to look for a relationship between them.
(7) A **flow chart** visually represents the series of steps required to complete an operation.

14.4.4 Quality assurance using inspection versus poka-yoke

Inspection is the traditional method of maintaining product quality. Inspection involves examining a part or a product to determine whether or not it is acceptable. For effective quality control, the inspector must be honest, objective and capable of resisting pressure from shop personnel to pass borderline cases. Although quality inspection processes are helpful, poka-yoke is a more proactive approach to quality management. The aim of poka-yoke is to mistake-proof a firm's operations, thus avoiding problems and waste before they can occur.

14.4.5 Statistical methods of quality control

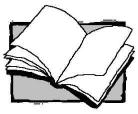
Statistical methods of quality control are effective, less expensive and easier to control (see the definitions in Longenecker et al 2017:595) but require technical expertise.

Note the following methods:

- **Acceptance sampling.** This method involves the use of a random representative portion of products to determine the acceptability of an entire lot.
- **Attributes.** Attributes are product or service parameters that can be counted as being either present or absent.
- **Variables.** Variables are measured parameters that fall on a continuum, such as weight or length.

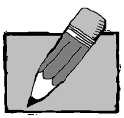
14.4.6 International certification for quality management

ISO 9000 is the standard that governs the international certification of a firm's quality management procedures.

 You can find the specifications of ISO 9000 at www.iso.ch.

14.4.7 Quality management in service businesses

Quality is as critical in the service sector as it is in the manufacturing sector. However, because services tend to be intangible, it is far more difficult to measure them. For example, how do you measure the quality level of the service provided by a hair salon? The customers' perception would be the main variable in measuring quality standards.

 **ACTIVITY 14.1: Quality management**

Instructions

Read the case study below and then answer the question that follows.

The quality of a product or service should meet the desires and expectations of a firm's customers. Obviously, the appropriate quality level depends on the kind of customers, the type of business and the business strategy.

In the trenches: better versus cheaper

When Texas was hit by a recession in the mid 1980s, Carmelo Mauro, who runs Carmelo's Italian restaurants in Houston and Austin, elected to go against the trend.

Rather than lowering prices, he decided to compete on quality, increasing the number of menu items, using costlier ingredients and raising prices!

"In no way could I compete with the large Italian-American pizza chains and their $3,99 buffets", Mauro says. "I marketed quality to attract a specific clientele, the only one who could afford to eat out anymore and did not want to eat at a mass-volume restaurant."

Carmelo's is now recognised as a restaurant of exceptional quality. It was chosen by the National Pizza and Pasta Association as its 1993 "pasta maker of the year". By emphasising superior quality, Mauro was able to attract customers who enjoyed the food and atmosphere associated with fine dining.

Question

Does a low-price strategy always increase customer loyalty? Motivate your answer by referring to the case study.

FEEDBACK

Carmelo's strategy of increased quality, with an accompanying high price, increased customer loyalty.

14.5 PURCHASING POLICIES AND PRACTICES

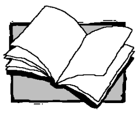
The purchasing function is defined as the process of obtaining materials, equipment and services from outside suppliers.

14.5.1 The importance of purchasing

The quality of a product is affected by the quality of the raw materials that are used to manufacture it. Profitability is boosted when purchasing ensures timely delivery. If purchasing secures the best prices, cost savings are achieved. The importance of purchasing varies according to the type of business.

Many firms are confronted with make-or-buy decisions. Such decisions are important for small manufacturing companies that have the option of making or buying components or parts for products they produce. The decision to make or buy should be based on long-run cost and profit optimisation because it may be expensive to reverse.

A business owner may opt to purchase products or services that are outside the firm's area of specialisation – this is called outsourcing. A business owner can also decide to use more than one supplier when purchasing components or parts for products this is called diversification of supply. In addition, a business owner can increase his/her buying power by joining cooperative purchasing organisations.


Read "Living the dream: entrepreneurial experiences – saving face and saving money" in Longenecker et al (2017:591).

14.5.2 Measuring supplier performance

Five attributes should be considered in assessing a supplier's performance:

(1) reliability
(2) responsiveness
(3) flexibility
(4) cost
(5) assets efficiency

14.5.3 Building good relationships with suppliers

To implement a policy of fair play and to cultivate good relations with suppliers, a small business should try to observe the following purchasing practices:

- Pay bills promptly.
- Give sales representatives a timely and courteous hearing.
- Minimise the abrupt cancellation of orders merely to gain a temporary advantage.

- Avoid attempts to browbeat a supplier into special concessions or unusual discounts.
- Cooperate with suppliers by making suggestions on product improvements and/or cost reductions, wherever possible.
- Provide courteous, reasonable explanations when rejecting bids and make fair adjustments in the case of disputes.

14.5.4 Forming strategic alliances

Some small firms find it advantageous to develop strategic alliances with suppliers. This form of partnership enables the buying and selling firms to work much more closely together than is customary in a simple contractual arrangement.

14.5.5 Forecasting supply needs

Forecasting gives a business owner insight into where the business is headed and the level of resources, from personnel to capital funding, that will be required. Forecasting techniques project what will happen based on what happened the previous year, the previous week or an average of several previous periods.

14.5.6 Using information systems

Nowadays, small firms have greatly improved operational efficiency owing to the use of computers, new software and internet links with suppliers and customers.

14.6 LEAN PRODUCTION AND SYNCHRONOUS MANAGEMENT

14.6.1 Lean production

Lean production is an approach that emphasises efficiency through the elimination of waste. Most companies are adopting the principles of lean production. Lean production is fundamentally reshaping the way operations are planned and managed. Lean production makes the elimination of waste a top priority. Consider the following:

- Defects are costly because they have to be repaired or scrapped.
- Excess products that are the result of overproduction must be stored and might never be sold.
- Transportation can be minimised by locating operations close to suppliers and

customers.

- Waiting can be wasteful because resources are idle.
- Inventory in excess of the minimum required is unproductive and costly.
- Motion, whether in respect of products, people or machinery, can be wasteful.
- Processing itself is wasteful if it is not productive.

14.6.2 Synchronous management

Synchronous management is an approach that involves recognising the interdependence of assets and activities in a firm and managing them to optimise the entire firm's performance. It is based on the presumption that the goal of an organisation, as well as the definition of performance that flows from it, is known and influences all decision-making.


Study the common methods of dealing with bottlenecks and constraints in exhibit 21-3 in Longenecker et al (2017:594).


ACTIVITY 14.2: Operations management

Instructions

Read the following case study and answer the questions that follow.

Texas Nameplate Company

Leveraging the quality process

The National Institute of Standards and Technology sends out hundreds and thousands of applications for the Malcolm Baldrige National Quality Award, but merely reading over the criteria was enough to scare off all but 60 companies in 2004, and only eight of those were small businesses with fewer than 500 employees. Similar statistics confronted Dale Crownover, owner of Texas Nameplate Company (TNC), when he applied. But he had been on the path to quality improvement long before he decided to throw his hat in the ring.

Texas Nameplate Company provides the identifying labels for all types of products, from appliances and computers to military equipment. Nameplates are stamped or etched before being sent to the company's customers, located in all 50 states and 12 foreign countries. Before Crownover took over the business from his father, TNC was a very different company. Morale was low, there were no benefits, turnover was very high and the pay was extremely low. There were always new faces on the production line. The defective part rate was crippling. The company was spending $20 000 a month, or 10% of sales, on bad work. Workers would just make 50% more than they needed to be sure that they had enough good parts to cover a customer's order. And it wasn't just a single type of nonconformance: nameplates were cut incorrectly or missing information, holes were cut the wrong diameter or put in the wrong place and the overall dimensions were wrong. TNC had a lot of employees, but there didn't seem to be enough time to train them, particularly at the rate new employees were being brought on board. When Crownover became president in 1991, those problems were compounded by lawsuits from the city of Dallas over wastewater discharges and from the Equal Employment Opportunity Commission (EEOC). The quality of the company's output reflected an arid organisational culture.

Shortly after taking control, Crownover had a meeting with TNC's biggest customer, General Dynamics (now Lockheed Martin). General Dynamics was implementing a vendor certification programme in statistical process control (SPC), and TNC would need to be certified to remain a vendor, their long relationship notwithstanding. Crownover, however, thought he knew his business and threw any correspondence related to the quality certification programme in the trash. Inevitably, TNC was cut off for not complying with the SPC directive. Crownover swallowed his pride and asked for a second chance. He submitted a half-page document on TNC's quality process to General Dynamics. The version General Dynamics approved three months later covered 45 pages.

Within two years of implementing an agreed-on quality programme, the company had made such a turnaround that Crownover celebrated a Zero Defects Day with his employees. In the following four years, the company nearly doubled its market share, doubled its sales growth, decreased employee turnover by 82%, cut its product cycle time by 61%, reduced its nonconformance by a third, nearly doubled the amount of product it manufactured per hour and increased profits and decreased cost of sales each by 9%.

SPC was only the beginning of TNC's commitment to total quality management, however. TNC went on to be ISO 9002 certified (now ISO 9001:2000), a certification granted by the International Organization for Standardization. TNC also applied for and won the Texas Quality Award and the prestigious Baldrige National Quality Award. Crownover continues to push forward by restructuring TNC as a lean manufacturing operation, using kanban production techniques for regular customers, and achieving ISO 14000 certification. To no one's surprise, Crownover applied for a second Baldrige in 2004, when he was again eligible to do so.

Questions

(1) What kind of manufacturing operation is Texas Nameplate Company?
(2) What is the role of quality in productivity measures?
(3) How productive was Texas Nameplate Company before it implemented quality control standards and processes?
(4) Rewrite the productivity formula (p 449) to account for quality levels.
(5) According to Crownover, what are the effects of productivity and quality on pricing?
(6) Explain the changes that Texas Nameplate Company underwent in respect of inventory control. How did the company manage to make this shift?
(7) Referring to both the video and the case study, describe the cultural change that took place in Texas Nameplate Company as a result of changes in its operational practices.

FEEDBACK

(1) The prescribed book discusses three types of manufacturing operations. Job shops are companies that do short production runs to produce small quantities of unique items. Repetitive manufacturing involves long production runs that produce large quantities of standardised products. Batch manufacturing is an intermediate between the two in variety and volume of product. According to these definitions, Texas Nameplate Company is best described as a job shop. Even though the

company makes one product (nameplates), a variety of nameplates are produced. Since nameplates contain serial numbers and other product information, each nameplate is unique. Machinists do not produce, say, 100 identical nameplates and then switch to produce another 100 different but identical nameplates.

(2) Quality has to do with the features of a product or service that enable it to satisfy customers' needs. Productivity is the efficiency with which inputs are transformed into outputs. According to these definitions, productivity can be understood, in a limited fashion, as the rate at which something happens. For example, how quickly can you make a product? Before the implementation of statistical process control, Texas Nameplate Company was able to maintain an acceptable rate of production, but the quality was marginal. Workers would produce 50% more product than required so that they would have enough quality nameplates to fill an order. Although workers were producing, they were not productive. Looking more carefully at the definition of productivity, you can see how quality is incorporated into the word "efficiency". Think about efficiency as doing a job with the minimum of time, effort and waste. Before the implementation of control processes, employees of Texas Nameplate Company generated a lot of scrap (waste): the company was spending $20 000 a month, or 10% of sales, on bad work! And by running 50% over on each job, workers were wasting time and money producing defective products. The conventional formula for productivity accounts for productivity in many ways. For example, the more labour hours are spent producing defective parts, reworking (fixing) defective parts or meeting to discuss how to solve problems regarding defective parts, the greater the labour variable. Since labour is an input, an increase in it causes a decrease in productivity. Likewise, running scrap wastes raw material. Companies have to buy more raw material than needed to cover a scrap product. As raw material purchases increase (in this case, because of scrap), productivity decreases. Running 50% more parts to cover poor quality results in a 50% increase in the amount of energy required to produce an order. The same is true for the cost of equipment: the longer an order stays on a machine, the higher the machine-hour cost of manufacturing the products to fill that order will be. Even though the productivity formula does not explicitly factor in scrap (defective products), poor quality levels affect the input levels in such a way that productivity declines. Bear in mind,

though, that high quality does not necessarily translate into high productivity. For example, if it takes workers a long time to manufacture a high-quality product such as a luxury yacht, by definition, they are not highly productive. To reconcile this discrepancy, one needs to realise that different industries have different productivity standards. For example, productivity at McDonald's is measured differently from productivity at, say, a five-star restaurant.

(3) In the video, Crownover says that many companies use the demand for high quality as a rationale for price increases. To him, this is faulty logic. He says: "I still think a lot of companies, to this day, have price increases because they do not look internally at what their price of nonconformance is. What you throw away, somebody has to pay for." This indicates that Crownover believes that increases in quality can result in increased profitability at level prices. As the internal price of nonconformance (bad parts) decreases, profit margins increase at the current pricing level. Companies with high nonconformance levels must charge higher prices to maintain a certain profit margin since they are throwing away so much capital in the way of labour resources, raw material resources, and so forth.

(4) Now that Texas Nameplate Company's defect rate has greatly decreased, it no longer has to hold (or create) large amounts of inventory to meet customers' needs. At one point, the upstairs section was 75% full of extra nameplates! By implementing statistical process control, Texas Nameplate Company was able to restructure itself as a lean manufacturing operation. It now offers kanban production techniques to its regular customers. In other words, Texas Nameplate Company is able to help its customers reduce inventory levels to the absolute minimum.

(5) Before Texas Nameplate Company began its quality programme in earnest, it had crippling scrap costs, inadequately trained employees and several legal problems relating to wastewater discharges and employment practices. Within two years of implementing the total quality programme, company employees were able to celebrate a Zero Defects Day. Savings from reduced scrap were redirected to employee training. Crownover remarks: "We were going to spend money doing something ... . But what we were doing was spending money on defect parts. So, let's curtail our defect parts, save that money, and let's train our people." Investing

in employees has reaped its own rewards. Workers are now more proactive about satisfying the customer and identifying potential problems before they go out the door. They are also more involved in devising simplified processes that increase productivity. An example mentioned in the video is of a woman who reorganised the way the company stores film. In the past, it could take 20 to 30 minutes to find a film. Following the re-engineering of the film department, it takes less than 15 seconds to find a film. The woman has been with the company for more than 30 years, which means that for the bulk of her employment, she was content to follow the old way. The culture shift that occurred as a result of Texas Nameplate Company's pursuit of a total quality management and continuous improvement inspired this long-time employee to rethink her job and to find a way to make it more productive for her and the company. In addition, the company is no longer faced with legal battles over environmental and employment issues. In fact, it has devised a method to recycle the acids it uses to etch nameplates, thus nearly eliminating the 10 000 gallons of wastewater it produces every day.

SELF-ASSESSMENT

(1) Discuss the customer focus of quality management.

(2) Define "TQM".

(3) A small manufacturer is sceptical about the usefulness of statistical quality control charts and sampling plans. Would the traditional methods suffice? Do you think 100% inspection by the final inspectors could eliminate all defective products? Give reasons for your answer.

(4) List some of the distinctive features of the operations process of service firms.

(5) The customer demand for services is generally not uniform during a day, week or other period of time. What strategies could a service firm use to better match its capacity to render services with the customer demand for services?

(6) Define "re-engineering" and explain its purpose.

(7) Doing something quickly and doing it well are often incompatible. In what way can quality improvement contribute to productivity improvement?

(8) What conditions make purchasing a particularly vital function in a small business? Would the owner-manager of a small firm be able to safely delegate

purchasing authority to a subordinate? Explain.

(9) Under what conditions should a small manufacturer either make component parts or buy them from other manufacturers?

(10) Explain the basic concept underlying the calculation of an economic order quantity.

SUMMARY

This learning unit examined the fundamentals of operations management and discussed the role of TQM as applied in the small business environment. Entrepreneurs need to be aware of the way in which the operations process can increase or decrease productivity. Purchasing management is part of the inbound side of a business and influences profitability directly. Entrepreneurs therefore need to manage the operations process with a balanced emphasis on customer needs and profitability. The next learning unit deals with managing a firm's assets.

LEARNING UNIT 15

MANAGING A FIRM'S ASSETS
(Prescribed book: chapter 22 of Longenecker et al 2017)

CONTENTS

INTRODUCTION

Debt collection is a never-ending challenge. In fact, most novice entrepreneurs are shocked by the amount of time and energy they must commit to debt collection. Controlling all of a business's assets requires the same commitment from management as collecting debt. This learning unit deals with this important issue.

LEARNING UNIT LEARNING OUTCOMES

Upon completion of this learning unit, you should be able to

- describe the working capital cycle of a small business
- identify the main issues in managing a firm's cash flows
- explain the key issues in managing accounts receivable
- discuss the key issues in managing inventory
- manage accounts payable
- give examples of the types of capital budgeting decisions small business owners have to make
- describe the techniques commonly used in making capital budgeting decisions

KEY CONCEPTS

- working capital management
- working capital cycle
- cash conversion period
- cash budget
- lock box
- pledged accounts receivable
- capital budgeting analysis
- accounting return on investment technique
- payback period technique
- discounted cash flow (DCF) technique
- net present value (NPV)
- internal rate of return (IRR)

OVERVIEW

Working capital management involves monitoring the flow of cash into and out of a business, that is, managing short-term assets (current assets) and short-term sources of financing (current liabilities). It includes overseeing inventory, accounts receivable and accounts payable to maintain the liquidity and profitability of a business. The key issue in working capital management is to ensure that a business does not run out of cash.

A small business owner needs to devote most of his/her time to managing working capital, which means managing all of the firm's short- and long-term assets effectively.

Study Longenecker et al (2017:600–625).

15.1 THE WORKING CAPITAL CYCLE

Working capital management is defined as the management of current assets and current liabilities. The working capital cycle refers to the flow of a business's resources through the cash, accounts receivable and inventory accounts. A key goal of working capital management is to reduce the risk of running out of cash.

Study the five stages of the working capital cycle in combination with exhibit 22-1 in Longenecker et al (2017:601–602).

15.1.1 The timing and size of working capital investments

Longenecker et al (2017) discuss the chronological sequence of a hypothetical working capital cycle on pages 602 and 603 and illustrate the working capital timeline in exhibit 22-2 on page 602.

15.1.2 Examples of working capital management

Examples of working capital management are illustrated graphically in exhibit 22-3

(Longenecker et al 2017:604). The examples include detailed calculations.

15.2 MANAGING CASH FLOWS

Cash is the blood of every small business. Without cash, a business will not grow or even survive, for that matter. Cash inflow and outflow are explained in exhibit 22-4 in Longenecker et al (2017:609). Small business owners need to distinguish between revenue and cash receipts. Many small business owners make the classic mistake of regarding the two things as synonymous, which invariably results in a shortage of cash on hand. Small business owners also need to understand the difference between cash flow and net profit. Extending credit to customers leads to the uneven timing of sales revenue and cash receipts. Some cash receipts (e.g., bank loans) are not and can never be revenue.

Entrepreneurs should distinguish between net cash flow and net profit. The differences are as follows:

- Net cash flow means the difference between cash inflows and outflows.
- Net profit is the difference between revenue (income) and expenses.

Growth can soak up cash faster than it is generated from profits. The growth trap is particularly acute for small businesses. Think about an expanding/growing landscaping business. After receiving larger contracts, the entrepreneur buys new vehicles, expands his labour force and invests in technologically advanced equipment. His business is such that he relies on contracts. These contracts are normally not based on retainer business activities but more on ad hoc business. This could mean a once-off income injection after three months, but wages and instalments need to be paid monthly during the three-month period.

15.3 MANAGING ACCOUNTS RECEIVABLE

A critical part of managing cash is a small business's ability to collect accounts receivable quickly.

15.3.1 How accounts receivable affect cash

Selling on credit creates receivables and delays the receipt of cash (e.g., for 30, 60, 90 or 120 days). The subsequent collection of receivables produces cash receipts. The growth of receivables therefore soaks up cash.

15.3.2 The life cycle of accounts receivable

The life cycle begins with a cash sale. Longenecker et al (2017:610–611) discuss examples of credit management practices that may have a positive effect on a business's cash flow.

15.3.3 Accounts receivable financing

Pledged accounts receivable may serve as collateral at some banks. One option is to sell the accounts receivable to a financial institution (e.g., factoring). Accounts receivable have the basic advantage of giving a business that lacks working capital an immediate cash injection. However, the cost of this form of financing is relatively high.

15.4 MANAGING INVENTORY

Inventory management is based on the supply of and demand for a product. This management task is difficult in the sense that these two factors (supply and demand) are normally not controlled by management but severely influenced by external factors.

15.4.1 Reducing inventory to free cash

The type of business, whether it is a service or manufacturing unit, determines the level of inventory needed. The emphasis should be on the optimal minimisation of inventory to decrease inventory carrying costs.

15.4.2 Monitoring inventory

Inventory management starts with the identification of the content of inventory and the time span of the inventory carried. The latest information technology undoubtedly facilitates the whole process.

15.4.3 Controlling stockpiles

Large quantities of inventory are normally purchased in small businesses because of

- unrealistic demand forecasts
- an attempt to satisfy the total market's demand
- price consciousness

Entrepreneurs should therefore try to manage inventory in a balanced and cost-effective way.

15.5 MANAGING ACCOUNTS PAYABLE

An understanding of the interrelationship between cash flow management and accounts payable will help entrepreneurs to manage the latter. Note the following two elements that form the basis of the management of accounts:

(1) negotiation – postponing the payment of creditors in emergency situations
(2) timing – delaying repayment for as long as possible (see exhibit 22-5 in Longenecker et al 2017:615)

15.6 CAPITAL BUDGETING

Capital budgeting analysis is defined as a process that assists managers with long-term investment decisions. Such decisions may involve the construction of a new building or the introduction of a new product.

15.6.1 Capital budgeting techniques

The following capital budgeting techniques can help an entrepreneur to make sound investment decisions:

- **Accounting return on investment.** This technique is used to determine how many rands in average profits are generated per rand of average investment. Study the formula in Longenecker et al (2017:619).
- **Payback period.** This technique is used to determine how long it will take to recover an original investment. Study the formula in Longenecker et al (2017:619).
- **Discounted cash flow.** This technique is used to determine how the present value of future benefits from an investment compares with the investment outlay. You need to fully understand the meaning of the terms "net present value" and "internal rate of return", as explained in Longenecker et al (2017:620).

15.6.2 Capital budgeting analysis in small firms

Only a few small businesses really focus on doing a proper capital budgeting analysis. Instinct and intuition are the two inaccurate variables in a capital budgeting analysis. The following reasons are advanced to explain why small businesses generally neglect theoretically sound financial management methods:

- Nonfinancial factors play a role, which means that a business's financial management is directly part of the entrepreneur's personal financial management.
- Liquidity problems are present because of survival strategies.
- Short-term cash flow difficulties are obstacles in long-term financial forecasting.
- Keeping track of the finances of a small business is far more difficult than handling the finances of a publicly held company.
- Net present value calculations are sometimes impractical when an entrepreneur is working on small projects.
- A lack of financial management skills is normally a problem in small businesses.

Entrepreneurs should realise that every business decision has a long-term financial impact. An educated financial decision, based on the above-mentioned techniques, will decrease the levels of general business risk.

Read Longenecker et al (2017:621–622).

ACTIVITY 15.1: Working capital

Instructions

Study the case study below and answer the questions that follow.

Barton Sales and Service

Managing a firm's working capital

The owners of Barton Sales and Service ("Barton"), based in Little Rock, Arkansas, are John and Joyce Barton. John serves as general manager and Joyce as office manager. The firm sells General Electric, Carrier and York air-conditioning and heating systems to both commercial and residential customers and services these and other types of systems. Although the business has operated successfully since the Bartons purchased it in 1996, it continues to experience problems in respect of working capital.

Barton's financial structure

The firm has been profitable under the Bartons' ownership. Profits for 2003 were the highest for any year to date. Exhibit C22-1 shows the income statement for Barton Sales and Service for that year.

The balance sheet as of 31 December 2003 for Barton Sales and Service is shown in Exhibit C22-2. Note that the firm's equity was somewhat less than its total debt. However, $10 737 of the firm's liabilities was a long-term note payable to a stockholder. This note was issued at the time the Bartons purchased the business, with payments going to the former owner.

Barton's cash balance

A minimum cash balance is necessary in any business because of the uneven nature of cash inflows and outflows. John explained that they need a substantial amount in order to "feel comfortable". He believed that it might be possible to reduce the present balance by $5 000 to $10 000, but he stated that it gave them some "breathing room".

Barton's accounts receivable

The trade accounts receivable at the end of 2003 were $56 753, but at some times during the year the accounts receivable were twice this amount. These accounts were not aged, so the firm had no specific knowledge of the number of overdue accounts. However, the firm had never experienced any significant loss from bad debts. The accounts receivable were, therefore, thought to be good accounts of a relatively recent nature.

Customers were given 30 days from the date of an invoice to pay the net amount. No cash discounts were offered. If payment was not received during the first 30 days, a second statement was mailed to the customer and monthly carrying charges of 1/10 of 1% were added. The state usury law prohibited higher carrying charges.

On small residential jobs, the firm tried to collect from customers when work was completed. When a service representative finished repairing an air-conditioning system, for example, he/she presented a bill to the customer and attempted to obtain payment at that time. However, this was not always possible. On major items such as unit changeouts – which often ran as high as $2 500 – billing was almost always necessary.

On new construction projects, the firm sometimes received partial payments prior to completion, which helped to minimise the amount tied up in receivables.

Barton's inventory

Inventory accounted for a substantial portion of the firm's working capital. It consisted of the various heating and air-conditioning units, parts and supplies used in the business.

The Bartons had no guidelines or industry standards to use in evaluating their overall inventory levels. They believed that there might be some excessive inventory, but, in the absence of a standard, this was basically an opinion. When pressed to estimate the amount that might be eliminated by careful control, John pegged it at 15%.

The firm used an annual physical inventory that coincided with the end of its fiscal year. Since the inventory level was known for only one time in the year, the income statement could be prepared on an annual basis only. There was no way of knowing how much of the inventory had been used at other points and, therefore, there was no way to calculate profits. As a result, the Bartons lacked quarterly or monthly income statements to assist them in managing the business.

Barton Sales and Service was considering changing from a physical inventory system to a perpetual inventory system, which would enable John to know the inventory levels of all items at all times. An inventory total could easily be computed for use in preparing statements. Shifting to a perpetual inventory system meant that proper file equipment would have to be purchased, but the Bartons believed that that cost was not large enough to constitute a major barrier. A greater expense would be involved in the maintenance of the system – entering all incoming materials and all withdrawals. The Bartons estimated that this task would necessitate the work of one person on a half-time or three-fourths-time basis.

Barton's note payable to the bank

Bank borrowing was the most costly form of credit. Barton Sales and Service paid the going rate, slightly above prime, and owed $17 600 on a 90-day renewable note. Usually, some of the principal was paid when the note was renewed. The total borrowing could probably be increased if necessary. There was no obvious pressure from the bank to reduce borrowing to zero. The amount borrowed during the year typically ranged from $10 000 to $25 000.

The Bartons had never explored the limits that the bank might impose on borrowing, and there was no clearly specified line of credit. When additional funds were required, Joyce simply dropped by the bank, spoke with a bank officer and signed a note for the appropriate amount.

Barton's trade accounts payable

A significant amount of Barton's working capital came from its trade accounts payable. Although accounts payable at the end of 2003 were $38 585, the total payable varied over time and might be double this amount at another point in the year. Barton obtained from various dealers such supplies as expansion valves, copper tubing, sheet metal, electrical wire and electrical conduit. Some suppliers offered a discount for cash (2/10 net 30), but Joyce felt that establishing credit was more important than saving a few dollars by taking a cash discount. By giving up the cash discount, the firm obtained the use of the money for 30 days. Although the Bartons could stretch the payment dates to 45 or even 60 days before being "put on COD", they found it unpleasant to delay payment by more than 45 days because suppliers would begin calling and applying pressure for payment.

Their major suppliers (Carrier, General Electric and York) used different terms of payment. Some large products could be obtained from Carrier on an arrangement known as "floor planning", meaning that the manufacturer would ship the products without requiring immediate payment. The Bartons made payment only when the products were sold. If still unsold after 90 days, the products had to be returned or paid for. (The products were shipped back on a company truck, so no expense was incurred in returning unsold items.) On items that were not floor-planned but were purchased from Carrier, Barton paid the net amount by the 10th of the month or was charged 18% interest on late payments.

Shipments from General Electric required payment at the bank soon after receipt of the products. If cash was not available at the time, further borrowing from the bank became necessary.

Purchases from York required net payment without discount within 30 days. However, if payment was not made within 30 days, interest at 18% per annum was added.

Can good profits become better?

Although Barton Sales and Service had earned a good profit in 2003, the Bartons wondered whether they were realising the greatest possible profit. Slowness in the construction industry was affecting their business somewhat. They wanted to be sure they were meeting the challenging times as prudently as possible.

Exhibit C22-1: Barton Sales and Service Income Statement for the Year Ending 31 December 2003

Sales revenue	$727 679
Cost of goods sold	466 562
Gross profit	$261 117
Selling, general and administrative expenses (including officers' salaries)	189 031
Earnings before taxes	$ 72 086
Income tax	17 546
Net income	$ 54 540

Exhibit C22-2: Balance Sheet for Barton Sales and Service for 31 December 2003

Assets	
Current assets:	
Cash	$ 28 789
Trade accounts receivable	56 753
Inventory	89 562

Prepaid expenses	4 415
Total current assets	$179 519
Loans to stockholders	41 832
Autos, trucks and equipment, at cost, less accumulated depreciation of $36 841	24 985
Other assets: goodwill	16 500
TOTAL ASSETS	$262 836
Debt (liabilities) and equity	
Current debt:	
Current maturities of long-term notes payable	$ 26 403
Trade accounts payable	38 585
Accrued payroll taxes	2 173
Income tax payable	13 818
Other accrued expenses	4 001
Total current debt	$ 84 980
Long-term notes payable	51 231
Total stockholders' equity	126 625
TOTAL DEBT AND EQUITY	$262 836

*Current and long-term portions of notes payable:

	Current	Long term	Total
10% note payable, secured by pickup, due in monthly instalments of $200, including interest	$ 1 827	$ 1 367	$ 3 194
10% note payable, secured by equipment, due in monthly instalments of $180, including interest	5 840	584	
6% note payable, secured by inventory and equipment, due in monthly instalments of $678, including interest	6 392	39 127	45 519
9% note payable to stockholder	0	$10 737	$10 737
12% note payable to bank in 30 days	17 600	17 600	

	$26 403	$51 231	$77 634

Questions

(1) Should the firm reduce or expand its bank borrowing?

(2) How could Barton Sales and Service improve its working capital situation?

FEEDBACK

(1) Bank borrowing is costly during periods of high interest rates. Profits can be improved by reducing borrowing, assuming that operations are not adversely affected by it. If Barton's bank borrowing could be reduced by holding the cash balance at a lower level, by removing excess inventory and by speeding up the collection of receivables, the firm would benefit. Nonetheless, the firm should not pass up profitable opportunities merely for the sake of reducing borrowing.

(2) Barton should reduce the cash balance to the minimum necessary for effective operation because idle cash is costly. It should adopt a more efficient form of inventory control that will reduce the inventory level and thereby reduce carrying cost. The accelerated collection of receivables would improve the working capital situation. In addition, to the extent that buying could be concentrated with suppliers that offer the most generous financing terms, the firm could minimise the costs associated with payables and inventory.

SELF-ASSESSMENT

(1) Working capital cycle
- (a) List the stages of the working capital cycle that directly affect cash and those that do not.
- (b) What determines the length of a firm's cash conversion period?

(2) Cash
- (a) Give examples of cash receipts that are not sales revenue.
- (b) Explain how expenses and cash disbursements during a month may be

different.

(3) In what way can a seller speed up the collection of accounts receivable? Give examples that may apply to various stages of the life cycle of receivables.

(4) Suppose that a small firm could successfully shift to a just-in-time inventory system, which means that inventory is received as it is needed. How would this affect the firm's working capital management?

(5) Explain the difference between working capital management and capital budgeting.

(6) Compare the different techniques that can be used in capital budgeting analysis.

(7) What does net present value measure?

(8) Define "internal rate of return".

(9) Return on investment and payback period

(a) Find the accounting return on investment for a project that costs R10 000, that will not have a salvage value and that has expected annual after-tax profits of R1 000.

(b) Determine the payback period for a capital investment that costs R40 000 and that has the following after-tax profits (the project outlay of R40 000 will be depreciated on a straight-line basis to a zero salvage value):

Year	After-tax profits
1	R4 000
2	R5 000
3	R6 000
4	R6 500
5	R6 500
6	R6 000
7	R5 000

(10) Why would owners of small firms not be inclined to use net present value or internal rate of return measurements?

SUMMARY

This learning unit dealt with the fundamental aspects of managing the assets of a small business. Working capital cycle management has to do with the way in which current assets and current liabilities should be managed. The critical financial management issue in a small business is the management of cash flow. This learning unit emphasised the fact that entrepreneurs need to understand the management of cash in a small business context. Accounts receivable, accounts payable and inventory form part of asset management, with specific emphasis on the effect they have on a firm's cash situation. The learning unit concluded with a discussion of capital budgeting and why entrepreneurs neglect capital budgeting analysis. The next learning unit deals with risk management.

LEARNING UNIT 16

RISK MANAGEMENT
(Prescribed book: chapter 23 of Longenecker et al 2017)

CONTENTS

INTRODUCTION

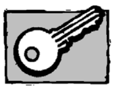
We live in a world of uncertainty. Therefore, understanding risk is of vital importance in almost all dimensions of life. Entrepreneurs have to consider risk in all business decisions they make.

Benjamin Franklin once said: "[I]n this world nothing can be said to be certain, except death and taxes." Small business owners might extend this adage to include business risk. Learning unit 1 touched on the moderate risk-taking propensities of entrepreneurs and their desire to exert some control over the perilous situations in which they find themselves by minimising business risks as much as possible. This learning unit explores how this can be done.

LEARNING UNIT LEARNING OUTCOMES

Upon completion of this learning unit, you should be able to

- define the concept of risk and explain its two dimensions
- identify the basic types of risk
- explain the steps in the risk management process and analyse how risk management can be used in small companies
- explain the basic principles used in evaluating an insurance programme
- explain the common types of business insurance coverage



KEY CONCEPTS

- risk
- market risk
- pure risk
- risk management
- real property
- personal property
- replacement value of property
- actual cash value (ACV)
- peril
- direct loss
- workers' compensation legislation
- tort
- reasonable (prudent) person
- standard
- compensatory damages
- economic damages
- noneconomic damages
- punitive damages

- proximate cause
- personnel risks
- risk management
- risk control
- loss prevention
- loss avoidance
- loss reduction
- risk financing
- risk transfer
- risk retention
- self-insurance
- business owner's policy
- named-peril approach
- all-risk approach
- insurance to value
- co-insurance provision
- business interruption coverage
- commercial general liability coverage
- medical payments coverage
- key person insurance
- disability insurance

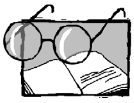
OVERVIEW

Various factors influence uncertainty in a business

All enterprises function in a dynamic environment. Internal and external factors that influence the environment give rise to uncertainty about a venture's future course. This uncertainty increases when one endeavours to plan for the future. In general, planning commercial activities one month into the future is less uncertain than planning activities that must take place in five years' time.

Uncertainty about the future manifests itself to an entrepreneur as the risk that the financial results or profits attained may deviate from what was anticipated. The greater the uncertainty, the greater the likelihood of a deviation from expected profits and the greater the risk for a business owner. We can therefore define risk as the possibility that actual results will deviate from desired results. The principle that usually applies in the business world is that if risk increases, the possible desired return also increases. An investor wishes to be compensated for increased risk and uncertainty.

Read "In the spotlight: South African business must wise up to cybercrime threat" in Longenecker et al (2017:627).

Study Longenecker et al (2017:627–646).

16.1 WHAT IS BUSINESS RISK?

Risk is a condition in which there is a possibility of an adverse deviation from a desired outcome that is expected or hoped for. Business risk is then the possibility of losses associated with the assets and earning potential of a firm (Longenecker et al 2017: 627). An entrepreneur is a moderate risk-taker and therefore responsible for managing all the risk possibilities in his/her business. There are two kinds of risk, as explained below.

(1) Market risk is the uncertainty associated with an investment decision.
(2) Pure risk is a form of risk in which there is only the possibility of a loss or no loss; there is no possible gain. This is the only insurable risk.

16.2 BASIC TYPES OF PURE RISK

The basic types of pure risk are as follows:

16.2.1 Property risks

There are two general types of property – real property and personal property. The value of property can be determined by calculating its replacement value or actual cash value. Commercial property insurance typically values property loss at the actual cash value of the damaged property and takes two primary features, namely, perils and losses into account (discussed in detail in Longenecker et al 2017:628).

16.2.2 Liability risks

The following are types of legal liability that may arise from business activities (Longenecker et al 2017:629-633):

- statutory liability (e.g., workers' compensation liability)
- contractual liability
- tort liability

16.2.3 Personnel risks

Personnel risks are risks that directly affect employees, such as

- premature death
- poor health
- insufficient retirement income

16.3 RISK MANAGEMENT

Risk management consists of all efforts to preserve a business's assets and earning power. Exhibit 23-1 (Longenecker et al 2017:635) indicates many of the risks that a business faces on the road to success.

16.3.1 The process of risk management

Developing and implementing a risk management programme in a business involves the following five steps:

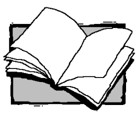
- Step 1: Identify and understand risks (e.g., damage at a plant).
- Step 2: Evaluate risks in terms of their size and probability of loss.
- Step 3: Select methods to manage risk through risk control and risk financing.
- Step 4: Implement the decision.
- Step 5: Evaluate and review the risk management programme.

16.3.2 Risk management and a small business

Risk management in a small business means that the owner must actively and continuously manage risk. Risk differs in several ways in large and small businesses. Take the example of an entrepreneur who offers garden services. His core business assets consist of a vehicle, a lawn mower, a weed eater and small garden equipment. He has no insurance on his vehicle because of cash-flow constraints. What would happen if the vehicle with all the equipment were stolen? You are right – all business activities would cease.

A prudent small business owner will take the time to identify the different types of risk that his/her firm faces and find ways to cope with them, using either one of the following methods:

(1) **Risk control** involves minimising losses through prevention, avoidance and/or reduction.
(2) **Risk financing** focuses on making funds available for losses. This involves transferring or retaining risk.


Read "Living the dream: using technology – ten security tips for a small business" in Longenecker et al (2017:637).

16.4 BASIC PRINCIPLES OF A SOUND INSURANCE PROGRAMME

Insurance is one of the primary ways of transferring business risk. Because of cash-flow constraints, small businesses usually have insufficient insurance. All entrepreneurs should be aware of the basic principles of a sound insurance programme.

Three basic principles should be followed in evaluating an insurance programme:

(1) Identify the business risk to be insured (e.g., a motor vehicle).
(2) Secure insurance coverage for all major potential losses.
(3) Consider the feasibility and affordability of insuring smaller potential losses.

The requirements for obtaining insurance are as follows: the risk must be calculable; the risk must be high (e.g., the crime rate in Gauteng, South Africa); the insured property must have a commercial value; and the policyholder must have insurable interest in the property or person insured.

16.5 Common types of insurance

The following are common types of business insurance, as discussed in some detail by Longenecker et al (2017:638–643):

16.5.1 Property and casual insurance

This category includes

- property insurance
- commercial general liability insurance
- automobile insurance
- workers' compensation insurance
- crime insurance
- package policies
- miscellaneous policies

16.5.2 Life and health insurance

This category includes

- health insurance
- key person life insurance
- disability insurance

ACTIVITY 16.1: Risk management

Instructions

Read the case study below and answer the question that follows.

Fox Manufacturing Inc

Responding to a disaster

The end of the workday on 12 May was like any other – or so Dale Fox thought when he closed up shop for the night. But 12 hours later, an electrical fire had destroyed Fox Manufacturing Inc's only plant, in Albuquerque, New Mexico. The damage exceeded $1,5 million.

"It was the largest fire New Mexico had seen in years. About 37 fire trucks were at the scene trying to put out the fire. We made local and national news", recalls Fox, president of the family-owned manufacturer and retailer of southwestern-style and contemporary furniture. The fire was especially devastating since all orders from the company's three showrooms were sent to the plant. Normally, the furniture was built and delivered 10 to 12 weeks later.

Such a disaster could force many companies out of business. But just eight weeks after the fire, the first piece of furniture rolled off the Fox assembly line in a brand-new plant in a new building. The company even managed to increase sales that year. And now, just three years later, the company has emerged stronger than ever. Annual sales average between $3,5 million and $5 million.

How did Fox Manufacturing manage to rise from the ashes? It forged an aggressive recovery plan that focused not only on rebuilding the business but also using the untapped skills of employees and an intensive customer relations campaign. Indeed, with more than $1 million in unfilled orders at the time of the fire, Fox offered extra services to retain its customer base. Dale Fox also took advantage of his close relationships with his financial and legal experts to help manage the thicket of legal and insurance problems that arose after the fire.

Rising from the ashes

Recovering from this disaster, as well as getting the company up and running again, was a particularly gruelling experience for Fox and his employees. Having to complete the monumental task in just eight weeks added to the pressure. "We had no choice", says Fox. "Because we had more than $1 million in orders, we had to get back in production quickly so we wouldn't lose that business."

Fox found himself working up to 20 hours a day, seven days a week. One of his first tasks was finding a new building to house his manufacturing facility. Remodelling the old site – and the requisite tasks of clearing debris, rebuilding and settling claims with the insurance company – would take too long and hold up the production of new furniture. At the same time, however, he had to quickly replace all the manufacturing equipment lost in the fire. He decided to hit the road, attending auctions and other sales across the country in search of manufacturing equipment, including sanders, glue machines, moulding machines and table saws. Unfortunately, all the company's hand-drawn furniture designs and cushion patterns also perished in the fire and had to be redrawn because no backup copies existed.

Tapping employee talent

Although Fox initially laid off most of his hourly workers, he put the company's 15 supervisors to work building new work tables that would be needed once manufacturing resumed. They did the work at an empty facility loaned to Fox by a friend. At the same time, the company's draftsmen – working in a rented garage – started redrawing the furniture designs, this time using a computer. (It took nearly a year to redraw all the designs lost in the fire.) To check frame configurations and measurements, they had to tear apart showroom furniture. A handful of hourly employees also started tearing apart cushions to redraw the patterns.

When Fox found the new building – the former home of a beer distributor – two weeks after the fire, he started rehiring the 65-plus hourly employees to help with the remodelling. Fox knew what construction skill – carpentry, plumbing, metalworking or painting – each had to offer because the day he laid them off he had them fill out a form listing such skills. "If I had gone through the process of having contractors bid on the work, we never would have reopened as fast as we did. Plus, our employees needed the work to feed their families", says Fox.

Within five weeks of the fire, Fox had rehired most employees. The employees, who were paid the same hourly rate they earned before the fire, proved to be competent and cooperative. Like Fox, they often worked up to 20 hours a day because they were aware of their boss's ambitious timetable for reopening.

Staying in close contact with customers

Fox's salespeople started calling customers the day of the fire to explain what had happened and to assure them that the company planned to bounce back quickly. Just days later, Fox's two sons called the same customers to reinforce that message and to let them know that the Fox family appreciated their patience. In subsequent weeks, customers received three or four more calls or letters that updated them on the company's progress. Fox even rented billboard space in Albuquerque to advertise that the company planned to be manufacturing furniture again soon.

"If we hadn't kept in such close contact with our customers, we probably would have lost 50% of the orders", Fox says. But Fox's strategy paid off handsomely; the company lost less than 3% of its pre-fire orders. That's an amazingly low percentage, especially since some customers had to wait up to 36 weeks for delivery instead of the usual 10 to 12 weeks.

Customers had good reason to be patient: when they placed their orders, they were required to pay a 25% to 33% deposit. After the fire, as a goodwill gesture, the company agreed to pay them 1% per month on the deposited money until their orders were filled. To calculate his customers' interest, Fox started from the order date, not the fire date. And rather than simply deduct the interest from the final amount due, Fox wrote each customer a check so they could see exactly how much money they had earned.

Because Fox also kept his suppliers informed, most of them continued filling the company's orders after the fire and told Fox not to worry about paying until his operation was in full swing again. " Factories were the only people we had any problem with", says Fox. "Once they found out about the fire, they wanted money that wasn't even due yet."

Relying heavily on professional expertise

During a normal year, Fox pays his chartered public accountant (CPA) and lawyer to handle such tasks as tax planning and consulting on leases, insurance and operations. Together, their bills run about $25 000 to $30 000. The year of the fire, however, Fox Manufacturing's accounting bill topped $50 000; the legal bill was over $75 000. As far as Fox is concerned, it was money well spent: "Without their help, I couldn't have gotten back in business as quickly as I did."

Fox called his CPA and his lawyer as soon as he got news of the Saturday-morning fire. While the firefighters battled the blaze, the three met with key management employees to develop a comeback plan. During subsequent weeks, Fox's accountant and lawyer assumed so much responsibility for valuing lost assets and haggling with the insurance company that he felt comfortable leaving the city to travel around the country buying manufacturing equipment.

One early decision was to apply for a $1 million loan to buy the new building. The CPA put together all the paperwork necessary for the bank to approve the application – such as a financial analysis, a cash-flow statement and profit projections. The CPA also played a key role in helping Fox's in-house accountant determine the value of the inventory, machinery and work in progress destroyed in the fire, which totalled about $800 000.

The CPA's involvement lent credibility to the numbers that were generated and quelled any concerns or doubts that the insurance companies had. "It was very important to have an outside CPA firm verify the numbers. If we had tried to throw some numbers together ourselves, we could have been in over our heads in arguments with insurance companies", Fox says.

Even so, settling insurance claims was difficult, and that's where Fox's lawyer earned his money. For example, what the insurance company thought it would cost to replace the old plant was less than half of what Fox claimed. One figure over which they disagreed was the cost of replacing the electrical wiring. The insurance company estimated that it would cost $30 000; Fox and his lawyer insisted it would cost $120 000. The lawyer had a local electrician, familiar with the Fox plant, verify that Fox's estimate was accurate. The insurance company finally settled the claim at Fox's value.

"Dealing with the insurance company was a constant battle. There are a lot of things they won't tell you unless you bring it up", Fox warns. Indeed, it was his lawyer, not the insurance company, who pointed out that Fox was entitled to $25 000 for the cost of cleaning away debris and $2 000 to replace shrubbery that was destroyed.

And, even after they settled the claim on Fox's business-interruption insurance, it took much longer than expected to get the final $750 000 payment. Fox finally had to call his insurance company with an ultimatum: "If I didn't get the check, I told them my lawyer and I were going to Santa Fe the next day to file a formal complaint with the insurance commissioner. I got the check."

Painfully aware that another disaster could strike at any time, Fox now takes risk management to a justified extreme. He doesn't leave anything to chance and takes numerous safety precautions that will make it easier for the company to rebound should it be dealt a similar setback again. What happened to Fox Manufacturing can happen to any company – other companies would do well to follow Dale Fox's lead.

Source: Nichols (1993:55–60) (Adapted, with the publisher's permission, from *Small Business Reports*, March 1993. American Management Association, New York. All rights reserved.)

Question

Discuss basic risk (disaster) precautions that Fox could have taken to minimise the loss incurred and the consequences of the disaster.

FEEDBACK

The following comments from the case source answer the above question:

Expect the unexpected

Fox could have been spared some of these hassles if he had followed some basic disaster precautions. Few companies do, however. Companies tend to wait until a disaster strikes once to prepare for the next one. With that in mind, Fox recommends that companies save themselves possible grief by taking the following precautions without delay:

- Store important documents in a safe place. Documents like product designs and accounting records should be kept somewhere they can't easily be destroyed. As an additional precaution, it's a good idea to keep backup copies of documents off premises (e.g., at home).

Unfortunately, Fox had kept all of the company's hand-drawn furniture designs in a simple metal cabinet with a fireproof door. The night before the fire, someone left the cabinet door open. "I didn't notice the door was left open because the cabinet was in the back of the plant", recalls Fox.

Fox now stores furniture designs on a computer disk, which is placed in a fireproof safe. The disk is taken off premises once a week and replaced. Cushion patterns drawn on paper also are stored in the safe; before, they were just left lying around the upholstery department.

As a matter of policy, the safe is never left unlocked. If someone accidentally leaves it open, the mistake won't go unnoticed because the safe is near the front door. "Since you have to go past the safe to turn on the burglar alarm as you leave, you would notice if it was open", Fox says.

Luckily, even before the fire, Fox had been taking backup copies of accounting records off premises. Therefore, his accountants could rebuild all of the financial documents lost in the fire – such as invoices and the work-in-process files.

- Make sure your insurance coverage is adequate. Read the fine print in your policy and meet with your agent to get any questions answered. When settling with his insurance company on contents, Fox discovered that his agent hadn't explained his policy clearly. He thought the policy would pay for the replacement value of his equipment, plus all the other contents, up to $400 000. As it turned out, the value of the equipment was included in the $400 000 that would be paid on contents. Had he realised that, he would have bought more coverage than he did. "Because of this, we ended up losing about $400 000", he says.

  According to Fox, business-interruption insurance – which is paid out when a company's business comes to a temporary halt – is an absolute necessity. This insurance paid for some vital remodelling to his new building and allowed him to keep key managers on the payroll after the fire.

Every year, Fox sits down with his accountant to evaluate the company's coverage. He is particularly careful to increase his contents insurance if the amount of his inventory increases or the price of raw materials goes up dramatically.

- Establish a solid relationship with your banker. No doubt you'll need quick cash after disaster strikes. "Most businesses don't go to their banks until they need a loan, which is the worst time", says Fox. Fortunately, Fox had been in the practice of calling his loan officer every couple of weeks, just to let him know how business was doing. (Fox has done business with the same bank since the mid 1970s.)

  Maintaining such close contact paid off in spades: Fox's request for a $1 million building loan was approved just four days after he found the building he wanted to buy. "Getting a loan that fast in 1990 was unheard of", Fox says. But even before he found a new plant location, key executives at the bank told him there would be no problem securing a loan. And knowing that enabled him to give the seller a $50 000 non-refundable deposit so that he could start making changes in the building right away, such as putting up new walls and painting the interior. "We couldn't wait until the loan was approved to start working on the building; we wanted to get back in business as quickly as we could," says Fox.

- Draw up a written succession plan. Should you lose your life in a disaster, a formal succession plan will guarantee a smooth transition and leave no doubt as to who is in charge of the business. "Many small business owners don't do this because they're afraid they'll offend one of their children", says Fox.

  Before the fire, Fox and his wife, Luana, had discussed a plan with their accountant and lawyer and their two sons who are active in the business. But nothing was put in writing until after the fire. "Now everybody knows for certain what's going to happen; there's nothing for anybody to assume", Fox says. "It's all down in black and white, so there is no reason for hard feelings later."

The company comeback

When disaster strikes, small business owners can throw in the towel or come out fighting. Dale Fox chose the latter and, as a result, his business emerged from a disaster even stronger than before. Making a successful comeback requires an aggressive and quick response – and a fair share of perspiration.

SELF-ASSESSMENT

(1) Define "risk" and then distinguish between pure risk and market risk. What are the basic ways of managing risk in a business?

(2) What are the different types of risk that a business may encounter?

(3) Describe the different sources of legal liability.

(4) If you were shopping in a small retail store and somehow sustained an injury such as a broken arm, under what circumstances would you sue the store? Explain.

(5) Can a small firm safely assume that business risks will never turn into losses that are extensive enough to bankrupt it? Give reasons for your answer.

(6) When is it logical for a small business to utilise self-insurance?

(7) Why might a small business owner decide not to purchase business insurance?

(8) Under what conditions would purchasing life insurance on a business executive constitute little protection for a business? When is such life insurance helpful?

(9) Describe a business owner's policy (BOP). List the advantages of this type of policy and explain what types of insurance coverage are available in respect of a BOP.

(10) What is the purpose of a co-insurance provision and how does it work?

SUMMARY

This learning unit dealt with risk and explained how entrepreneurs can manage it. All South African entrepreneurs, no matter where they reside in the country, face severe risk possibilities. South Africa is especially known for its high crime levels. Entrepreneurs should acknowledge the different types of risk and understand the methods and options in respect of hedging themselves against risk.

TOPIC SUMMARY

This topic focused on the basic managerial tasks that entrepreneurs need to perform when they start a business. As a rule, entrepreneurs lack general managerial skills. Learning unit 12 explored the development of professional management principles in a small business. Learning unit 13 dealt with the methods that entrepreneurs can apply to manage the human resource factor effectively. As explained in learning unit 13, high-quality products and processes ensure customer satisfaction. The TQM approach helps to make this happen. Learning unit 16 focused on risk management in a small business.