BUSINESS START-UP AND ENTREPRENEURSHIP

QCF Level 4 Units

- Understanding Entrepreneurship (12 Credits)
- Enterprise Start-up (12 Credits)
- Business Plan for Enterprise Start-up (12 Credits)

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Introduction to the Study Manual

Welcome to the study manual for Business Start-up and Entrepreneurship. This is a combined manual for the three Level 4 Entrepreneurship units: Understanding Entrepreneurship (4UE), Enterprise Start-up (4ESU) and Business Plan for Enterprise Start-up (4BP), the syllabus contents of which are closely related. The fourth unit, Introduction to Marketing, has a separate recommended reading list on the Members Area of the ABE website (www.abeuk.com).

This study manual has been developed for use by students who are studying ABE qualifications in colleges and centres in some 70 countries around the world. Clearly, it would be impossible to reflect the different cultures, legal and financial systems and currencies of all of those individual countries within this manual. Therefore, for simplicity and consistency, definitions of entrepreneurship and small and medium-sized enterprises (SMEs) will be those used in the UK and European Union (EU), the currency used in financial examples will generally be British pounds (£), and the examples of legislation quoted will be based on English law. Tutors and students alike are encouraged to relate the principles of these units to their own national currencies, and to consider examples of their own national legislation.

Level 4 Diploma in Business Start-up and Entrepreneurship

The ABE Level 4 Diploma in Business Start-up and Entrepreneurship consists of four units totalling 48 Credits on the Credit framework. Whilst the examinations for these units will all be offered twice yearly, the Association of Business Executives strongly recommends that students should take the Introduction to Marketing unit and the Enterprise Start-up units before or alongside the Business Plan for Enterprise Start-up unit in order to cover the necessary knowledge and understanding required for the latter unit examination.

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It is intended that the Level 4 Business Start-up and Entrepreneurship units will provide a combination of both practical and theoretical information. The theory learned from the Understanding Entrepreneurship unit and the Introduction to Marketing unit provides the broader knowledge of entrepreneurship. When linked to the more applied knowledge of the Enterprise Start-up unit and the Business Plan for Enterprise Start-up unit, this will
provide the relevant knowledge and understanding for a student to prepare and start up a new small business, or to work as a supervisor or junior manager within a small business.

This manual has been written to assist you in your studies for the Business Start-up and Entrepreneurship Level 4 units (except Introduction to Marketing, which has a separate recommended reading list), and is designed to meet the learning outcomes listed in the syllabus for each unit. As such, it provides thorough coverage of each subject area and guides you through the various topics you will need to study and understand. However, it is not intended to “stand alone” as the only source of information in studying the units, and we have set out below some guidance on additional resources that you should use for help in preparing for the examination.

The syllabuses for each of the three units are set out on the following pages. They have been approved at Level 4 within the UK’s Qualifications and Credit Framework. You should read the three syllabuses carefully so that you are aware of the key elements of each unit – the learning outcomes and assessment criteria. The indicative content provides more detail to define the scope of the units.

Following each of the unit syllabuses is a breakdown of how the manual covers each of the learning outcomes and assessment criteria for the units.

The main study material then follows in the form of a number of chapters as shown in the contents. Each of these chapters is concerned with one topic area and takes you through all of the key elements of that area, step by step. You should work carefully through each chapter in turn, tackling any questions or activities as they occur, and ensuring that you fully understand everything that has been covered before moving on to the next chapter.

You will also find it very helpful to use the additional resources (see below) to develop your understanding of each topic area when you have completed the chapter.

Additional resources

- ABE website – www.abeuk.com. You should ensure that you refer to the Members Area of the website from time to time for advice and guidance on studying and on preparing for the examination. We shall be publishing articles which provide general guidance to all students and, where appropriate, also give specific information about particular units, including recommended reading and updates to the chapters themselves.

- Additional reading – It is important you do not rely solely on this manual to gain the information needed for the examination in these units. You should, therefore, study some other books to help develop your understanding of the topics under consideration. The main books recommended to support this manual are listed at the end of the syllabuses on the ABE website and in the reading list on the Members Area. Details of other additional reading may also be published there from time to time.

- Newspapers – You should get into the habit of reading the business section of a good quality newspaper on a regular basis to ensure that you keep up to date with any developments which may be relevant to the subjects in these units. Most of the
main international daily newspapers and weekly or monthly business journals can also be accessed via the internet.

- Your college tutor – If you are studying through a college, you should use your tutors to help with any areas of the syllabus with which you are having difficulty. That is what they are there for! Do not be afraid to approach your tutors for this unit to seek clarification on any issue, as they want you to succeed in your studies.

- Your own personal experience – The ABE examinations are not just about learning lots of facts, concepts and ideas from the study manual and other books. They are also about how these are applied in the real world, and you should always think how the topics under consideration relate to your own work and to the situation in your workplace and others with which you are familiar. Using your own experiences in this way should help to develop your understanding by appreciating the practical application and significance of what you read, and make your studies relevant to your personal development at work.

And finally …

We hope you enjoy your studies and find them useful, not just for preparing for the examination, but also in understanding the modern world of business and enterprise, and in developing your own job role. We wish you every success in your studies for the ABE Level 4 Diploma in Business Start-up and Entrepreneurship.

The Association of Business Executives

January 2013

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Unit Specification – Understanding Entrepreneurship

Unit Title: Understanding Entrepreneurship

Guided Learning Hours: 100

Level: Level 4

Number of Credits: 12

Learning Outcome 1

The learner will: Understand the concepts of entrepreneurship and enterprise, and the characteristics that differentiate the various types of entrepreneurs and business owners, and the importance of entrepreneurs and SMEs to the economy.

Assessment Criteria

The learner can:

1.1 Define and explain the terms: entrepreneurship, entrepreneurs, enterprise and owner-managers.

1.1.1 Define and explain the meanings of entrepreneurship and enterprise and the various forms these can take.

1.1.2 Identify the differences between entrepreneurs, serial entrepreneurs, intrapreneurs and owner-managers – growth objectives, ability to identify opportunities, attitude to innovation and risk, strategic vision.

1.2 Explain and discuss the importance of entrepreneurship and small businesses to the economy.

1.2.1 Explain the role and characteristics of micro-, small and medium-sized businesses in the economy in terms of relative size, turnover, number of employees, value of turnover, role in national economies, etc, using the EU (or alternative) definitions of these businesses.

1.2.2 Explain the importance of business start-ups and small firms to the economy – sources of innovative products and services, generating new employment opportunities, wealth creation and revenue from taxation of profits.
1.3 Identify and explain the key differences between small businesses and large corporations.  

1.3.1 Explain the differences and relevance of those differences between small and large firms in terms of:
- structure and management
- organisational culture
- financial complexity and access to funding
- skills requirements
- attitude to staff training and development
- the ability to manage red-tape and legal compliance
- the ability of small firms to be flexible and respond rapidly to market demand.

Learning Outcome 2

The learner will: Understand characteristics and motivations that influence the way entrepreneurs operate, and the specific skills they use to succeed.

Assessment Criteria

The learner can:

2.1 Identify the range of skills typically exhibited by successful entrepreneurs.

2.1.1 Describe the combination of entrepreneurship skills that typify entrepreneurs or differentiate them from other business managers – opportunity-spotting, developing networks, strategic vision, product commercialisation, ability to harness resources, tenacity, etc.

2.1.2 Describe several examples of successful international entrepreneurs to illustrate how the skills are employed, for example: Richard Branson (Virgin), Bill Gates (Microsoft), James Dyson (Dyson), Anita Roddick (The Body Shop), Michael Dell (Dell), Alan Sugar (Amstrad), Duncan Bannatyne (Dragons’ Den), Mo Ibrahim ( Celtel), Wale Tinubu (Oando Plc).

2.2 Explain and discuss key arguments and interpretations relating to entrepreneurial personality and characteristics.

2.2.1 The key arguments.
- Are entrepreneurial skills inborn in certain people? (The “made or born” argument.)
- Can entrepreneurship be taught or learned? Is it a transferable management skill?
- Does growing up in an entrepreneurial environment influence the potential to be entrepreneurial?

2.2.2 Characteristic traits of owner-managers.
• The need for achievement.
• The need for independence.
• The locus of control (believe you can exercise control over your environment).
• The ability to live with uncertainty and take measured risks.

2.2.3 Characteristic traits of entrepreneurs.
• Opportunistic.
• Innovative.
• Self-confident.
• Proactive and self-motivated.
• Visionary with flair.
• Willingness to take far greater risks and live with greater uncertainty.

2.2.4 Entrepreneurial motives.
• Push (necessity-based) motives vs pull (opportunity-based) motives.
• Personal/lifestyle motives – desire to prove personal ability or achievement/make a mark/create personal wealth/gain social recognition or prestige/create a legacy for family future/competitive instincts.
• Desire to develop and grow a strong and profitable business or business empire.
• Desire to minimise unbalanced risk/dislike of imposed authority/desire to prove oneself.

2.3 Explain and discuss the concept of the need for family support to ensure survival of a new business.

Learning Outcome 3

The learner will: Understand the various barriers faced by entrepreneurs when starting a new business or when growing an existing small business.

Assessment Criteria

The learner can:

3.1 Identify and explain the barriers to

3.1.1 Describe and explain the various barriers that entrepreneurs may experience when starting a new
business start-up. business, including:

- Barriers relating to the entrepreneur’s own skills, knowledge and abilities, competence and confidence to successfully establish a new business.
- Sales and marketing problems, including issues of researching and understanding markets.
- Financial problems, including identifying and accessing appropriate forms of finance for start-up, and the need for possible security against borrowing.
- Resource implications for the business, including both staff and physical resources.
- Identifying essential issues of statutory and legal compliance, or registrations needed to operate the business.

3.1.2 Describe and explain the options an entrepreneur might have to overcome these barriers.

3.2 Identify and explain the barriers to growing an existing small business.

3.2.1 Describe and explain the various barriers that entrepreneurs may experience when expanding a small business, including:

- barriers relating to the entrepreneur’s own financial position, renewed exposure to financial risk, or the need to give up some personal control in order to delegate to and trust new functional managers
- barriers to market entry, including the size of the market, problems of market penetration, numbers and relative strength of competitors, and costs of achieving market share
- financial problems, including identifying and accessing appropriate forms of finance to fund each stage of the growth, especially for innovative/high-tech businesses
- resource implications for the business, including expansion of both staff and physical resources
- organisational issues relating to the impact that growth strategies may have on the existing staff and the culture within the business.

3.3 Identify and explain the 3.3.1 Explain the meaning and the key features of enterprise cultures and how an organisation can
importance of creating an innovative or enterprising culture to support small business growth. benefit from creating such a culture.

3.3.2 Describe the ways in which an entrepreneur might seek to create an enterprising culture within a business, including:

- encouraging suggestions from staff for new ideas or innovations
- allowing time and resources for staff to work on new ideas
- creating a positive, supportive and blame-free environment in which staff feel valued
- accepting failure as an acceptable risk, as a normal part of the process and without any blame
- building innovation targets into the staff appraisal process
- acknowledging or rewarding successful ideas.

Learning Outcome 4

The learner will: Understand the entrepreneurial motivations and influences that will affect the ways in which a small business might develop and grow.

Assessment Criteria

The learner can:

4.1 Define the traditional concept of the business life cycle and its inherent weaknesses in explaining how businesses develop.

4.1.1 Explain the five-stage linear business life-cycle model and why it is unsatisfactory in the context of options for growth and development of small businesses.

4.1.2 Describe and explain the various growth and development options that a small firm might follow, including:

- failure to survive the start-up stage, and voluntary or involuntary closure
- achievement of break-even and profitable trading levels and continuation as a lifestyle business without subsequent growth
- continuation as a family business via succession planning
- achievement of break-even and profitable trading levels and continuation to grow to maturity and decline
- achievement of break-even and profitable trading levels and continuation to grow further
• trade sale/merger/acquisition by another company, or a pre-defined exit strategy
• stock market flotation
• continued expansion and success.

4.2 Explain and discuss how the entrepreneur’s own objectives and motivations will change at each stage of business development.

4.2.1 Explain how the personal objectives, business priorities and decision-making processes of entrepreneurs change as they progress from start-up to relative stability and subsequent growth.

4.2.2 Explain the importance of strategic thinking to the development of growth strategies in small firms – as a factor that differentiates growth-firms from lifestyle businesses.

4.3 Explain and discuss the importance of succession planning in small firms.

4.3.1 Explain the purpose and process of succession planning in business, and in particular in family firms.

4.3.2 Explain and describe the problems that can occur relating to succession planning in small firms.

4.4 Explain and discuss the importance of exit strategies for entrepreneurs.

4.4.1 Explain what is meant by exit strategies and why it may be important for an entrepreneur to identify exit options in the early stages of planning a new business.

4.4.2 Describe some of the exit strategy options available to entrepreneurs (or investors in small firms), including:
• trade sale to another company
• sale of the company equity to an external investor to facilitate future growth
• sale to a management buy-out
• closure of the business and sale of assets.

Learning Outcome 5

The learner will: Understand the concepts of innovation and creativity, their importance to the economy, and the roles that both play in entrepreneurship and business development.

Assessment Criteria Indicative Content

The learner can:
5.1 Define and explain the terms innovation and creativity.

5.1.1 Define the meaning of innovation and creativity and explain how they interrelate.

5.1.2 Describe the different aspects of innovation that comprise the innovation spectrum and explain the importance of breakthrough innovations in creating competitive advantage for businesses.

5.2 Explain and discuss the importance of encouraging technological innovation and high-growth-potential enterprises.

5.2.1 Explain the importance of high-tech and high-growth firms as contributors to economic wealth and the creation of new employment opportunities.

5.2.2 Explain the different requirements that high-growth and high-tech enterprises have compared with conventional lifestyle businesses – specialist management teams, support for research and development (R&D), staged funding for growth.

5.2.3 Explain why high-tech businesses often need to access several stages of funding in order to grow – e.g.

- R&D funds
- proof of concept funding
- pre-market product development and patenting
- market launch
- seed funding for growth
- venture capital for expansion etc.

5.2.4 Explain how business incubation and support programmes can improve the potential for high-growth and high-tech start-ups to succeed and grow.

5.3 Explain the importance of protecting intellectual property (IP) for innovations.

5.3.1 Describe the main types of property rights protection.

- Patents.
- Patent licensing.
- Copyrights.
- Trade marks.
- Brand names.
- Industrial and commercial secrets.

5.3.2 Explain some of the limitations of intellectual property rights (IPR) protection and why some entrepreneurs adopt a straight-to-market strategy.

- Concern that competitors may copy a patent application.
- Expensive, time consuming and requires
specialist legal expertise.
- Even 20 years’ protection may be insufficient to generate a satisfactory return on R&D costs. Patents (and copyrights etc) are only meaningful if they can be successfully defended.

Learning Outcome 6

The learner will: Understand the political and economic issues facing entrepreneurs and government support agencies, and identify the range of business support processes that governments may offer to encourage and support entrepreneurial development.

Assessment Criteria

Indicative Content

The learner can:

6.1 Define and explain the political and economic factors that can influence the success of small enterprises.
6.1.1 Describe and explain some of the political and economic issues that impact on the operations of small businesses.
- The conflicting need for regulatory controls and the disproportionate impact this has on the resources of small firms.
- The tendency of governments to regard small enterprises as the solution to economic downturns, whilst simultaneously cutting back on support services for those businesses when they are most needed.
- The lack of continuity of business support caused by changes in national and regional government.
- The lack of coherent funding support, e.g. for start-up grants, market research, and skills training.
- The lack of affordable finance and loans for small firms due to the reluctance of commercial banks to lend to them.

6.2 Explain and discuss ways in which new and early stage enterprises can be encouraged and supported.
6.2.1 Identify and explain ways in which governments can create the right environment and fiscal conditions to encourage the development and growth of new enterprises.
- Availability of business support expertise.
- Access to loans and investment funding.
- Enterprise-friendly taxation policies.
- Tax incentives to encourage risk investment.
- Start-up loans and grants for innovation
development.
• Encouraging collaboration with academic research.
• Encouraging development partnerships with larger businesses.
• Supporting international market access and export trade development.

6.2.2 Identify and explain the main types of business support agencies used by small firms, e.g:
• chambers of commerce
• local enterprise agencies and partnerships
• economic development agencies (public or private sector)
• inward investment agencies
• international trade agencies and overseas embassies
• export documentation and export credit services
• private commercial banks.

6.3 Define and explain the issues relating to individuals and small enterprises that operate in the grey economy.

6.3.1 Describe the potential attractions and pitfalls of operating illegal part-time or full-time business activities without being registered as a business – avoidance of paying taxes or complying with legal regulations etc.

6.3.2 Describe and explain the problems faced by governments with illegal or unregistered individuals and small firms operating in the grey economy – lack of regulation and control, risk of unsafe or dangerous practices, loss of taxation to the economy, no recompense for unsatisfied customers, etc.

Assessment:
Assessment of this Unit will be by a three-hour examination.

Recommended Reading:
Please refer to the Qualifications section and the Members Area of the ABE website (www.abeuk.com) for lists of recommended reading books.
## Coverage of the Understanding Entrepreneurship Syllabus by the Manual

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| 1. Understand the concepts of entrepreneurship and enterprise, and the characteristics that differentiate the various types of entrepreneurs and business owners, and the importance of entrepreneurs and SMEs to the economy | 1.1 Define and explain the terms: entrepreneurship, entrepreneurs, enterprise and owner-managers  
1.2 Explain and discuss the importance of entrepreneurship and small businesses to the economy  
1.3 Identify and explain the key differences between small businesses and large corporations | 1, 4 |
| 2. Understand characteristics and motivations that influence the way entrepreneurs operate, and the specific skills they use to succeed | 2.1 Identify the range of skills typically exhibited by successful entrepreneurs  
2.2 Explain and discuss key arguments and interpretations relating to entrepreneurial personality and characteristics  
2.3 Explain and discuss the concept of the need for family support to ensure survival of a new business | 2, 6 |
| 3. Understand the various barriers faced by entrepreneurs when starting a new business or when growing an existing small business | 3.1 Identify and explain the barriers to business start-up  
3.2 Identify and explain the barriers to growing an existing small business  
3.3 Identify and explain the importance of creating an innovative or enterprising culture to support small business growth | 3, 4 |
| 4. Understand the entrepreneurial motivations and influences that will affect the ways in which a small business might develop and grow | 4.1 Define the traditional concept of the business life cycle and its inherent weaknesses in explaining how businesses develop  
4.2 Explain and discuss how the entrepreneur’s own objectives and motivations will change at each stage of | 3, 2, 3 |
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<td>4.4 Explain and discuss the importance of exit strategies for entrepreneurs</td>
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<tr>
<td>5. Understand the concepts of innovation and creativity, their importance to the economy, and the roles that both play in entrepreneurship and business development</td>
<td>4</td>
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<tr>
<td>5.1 Define and explain the terms innovation and creativity</td>
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<td>5.2 Explain and discuss the importance of encouraging technological innovation and high-growth-potential enterprises</td>
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<td>5.3 Explain the importance of protecting intellectual property (IP) for innovations</td>
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<tr>
<td>6. Understand the political and economic issues facing entrepreneurs and government support agencies, and identify the range of business support processes that governments may offer to encourage and support entrepreneurial development</td>
<td>1, 3, 4</td>
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<tr>
<td>6.1 Define and explain the political and economic factors that can influence the success of small enterprises</td>
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<tr>
<td>6.2 Explain and discuss ways in which new and early stage enterprises can be encouraged and supported</td>
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<tr>
<td>6.3 Define and explain the issues relating to individuals and small enterprises that operate in the grey economy</td>
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Unit Specification – Enterprise Start-up

Unit Title: Enterprise Start-up

Guided Learning Hours: 100

Level: Level 4

Number of Credits: 12

Learning Outcome 1

The learner will: Understand that creativity is a central component of true entrepreneurial activity; what makes an individual creative; the barriers to creativity and the creative process.

Assessment Criteria  Indicative Content

The learner can:

1.1 Explain the importance of creativity to the entrepreneur.

1.1.1 Understand that creativity is important in coming up with new ways of doing things.
- The need for entrepreneurs to focus on creating commercial opportunities leading to new products/services.
- Be aware that out of every 11 ideas only one will be successful (Page 1993).
- The more ideas generated, the more chance of success.

1.2 Explain how creativity can be stimulated.

1.2.1 Understand how the two sides of the brain operate in different ways.
- Understand that the left side of the brain tends to be rational/logical or vertical thinking and the right side tends to be more creative and lateral thinking.
- Understand that both sides of the brain are used but there is a need to encourage the development of the right side to encourage creativity.
- Creativity can be encouraged with training.

1.3 Explain the

1.3.1 Understand and explain the main barriers to
barriers to creativity. creativity.
• Explain that being creative often takes individuals out of their comfort zone.
• Be aware that many people find change threatening.
• Von Oech (1998) identifies ten blocks to individual creativity.
• Realising that these blocks exist can be the first step in dismantling the barriers.

1.4 Explain the creative process.

1.4.1 Explain the four-stage creative process.
• Stage 1: Generating knowledge and awareness – the importance of travel, reading and an open mind in the creative process.
• Stage 2: The incubation process – mull over all the information, “sleep on the problem”.
• Stage 3: Generating ideas. Ideas often happen unexpectedly – even whilst asleep. Techniques for generating ideas include brainstorming, analogy, attribute analysis, gap analysis.
• Stage 4: Evaluation and implementation – selecting the ideas that are most promising. May involve discussion, analysis and possibly voting. Many ideas will be rejected whilst others may need to be worked up.

Learning Outcome 2

The learner will Understand how to turn creative ideas into a business opportunity.

Assessment Criteria Indicative Content

The learner can:

2.1 Explain how to recognise a business opportunity.

2.1.1 Explain that creativity alone is not necessarily entrepreneurial. It is only entrepreneurial if it is applied to the process of innovation which leads to the development of new products or services that have a value in the market. "Innovation is the specific tool of entrepreneurs" (Drucker).

2.1.2 Identify and explain the Seven Sources of Opportunity (Drucker 2006) which help turn an opportunity search into a business opportunity.
2.2 Identify and explain the sources of business ideas.

2.2.1 Identify and explain the many sources of business ideas, including:
- existing businesses around the world – what they are offering or not offering
- existing franchises not offered in certain countries
- innovations – your own or from other people
- your patents and licences or those belonging to others that have not been fully developed
- ideas generated by research institutions and universities
- identified gaps in the market
- ideas from business networks, contacts and friends.

2.3 Explain that spotting opportunities is a continuous process.

2.3.1 Explain that even after start-up entrepreneurs must continue to work at spotting opportunities. Identify and explain Drucker’s five-stage approach to purposeful, systematic innovation.
- Start with the analysis of opportunities inside the firm and its industry and the external environment.
- Innovation is both conceptual and perceptual.
- An innovation must be simple and has to be focused.
- To be effective start small.
- Aim at leadership and dominate the competition in a particular area of innovation as soon as possible.

Learning Outcome 3

The learner will: Understand the key issues that need to be addressed when starting a business.

Assessment Criteria

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<td>3.1</td>
<td>Explain why so many small businesses fail in the first three years of trading.</td>
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<tr>
<td>3.1.1</td>
<td>Understand that more than a good idea is needed to start a successful small business. Many fail because they do not have the right skills and attributes.</td>
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<tr>
<td>3.1.2</td>
<td>Identify and explain the actions that could be taken to improve the chances of survival for small firms in their early years.</td>
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<tr>
<td>3.2</td>
<td>Explain the need to have the right personal skills, characteristic traits and qualities to run a small business.</td>
</tr>
<tr>
<td>3.2.1</td>
<td>Identify and explain the skills and traits required to start a small business. These are covered in the Understanding Entrepreneurship Unit (Learning Outcome 2) and will not be duplicated here. However, learners should acquaint themselves with the detail from that Unit.</td>
</tr>
<tr>
<td>3.3</td>
<td>Identify and explain the personal qualities required when starting a business.</td>
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</tbody>
</table>
| 3.3.1 | Identify and explain the personal qualities that are required when starting a new business. These include:  
- stamina: long hours, few holidays, and hard work  
- commitment and dedication: the need to make personal sacrifices and be highly motivated  
- opportunity perception: the need to spot opportunities and continue doing it  
- tolerance of risk, ambiguity and uncertainty: living with uncertainty and taking risks are key character traits of entrepreneurs. |
| 3.4 | Explain the importance of knowing your customers. |
| 3.4.1 | Explain that many people place too much focus on the product or service and that market demand is key to commercial viability. Explain the key issues that need to be determined about customers. These include:  
- Who is going to buy the product or service?  
- Why will they buy it?  
- Is the customer reachable?  
- How big is the market?  
- Is the market growing or declining?  
- Is the market concentrated or fragmented? Explain the importance of market research in answering these questions. |
| 3.5 | Explain the importance of knowing your competitors. |
| 3.5.1 | Explain the importance of understanding the nature of the competition and how appropriate information may be obtained. In particular: |
• the importance of market research and how this is undertaken
• Porter’s Five Forces model, to understand the power of buyers, the power of suppliers, the threat of new entrants, the threat of substitutes and the competitive rivalry within the industry.

3.6 Explain the importance of marketing and how to communicate to customers that you have a product or service that meets their needs.

3.6.1 Explain the importance of marketing and how sustainable competitive advantage can be achieved through marketing activity.

3.6.2 Explain Porter’s Generic Strategy model, how the model can relate to small businesses, and define each of its strategies.
   • Cost leadership (low price).
   • Differentiation.
   • Focus (niche player).
   • “Stuck in the middle”.

3.7 Identify and explain the resources that are needed when starting a business.

3.7.1 Explain that the resources required will be determined by the size of the business which is difficult to predict at time of start-up. Resources required will increase as the business grows and steps must be taken well in advance to ensure that these are available. The key resources required at start-up may include:
   • money (usually from savings, the bank or family)
   • property
   • suppliers
   • customers
   • employees
   • networks and contacts.

Learning Outcome 4

The learner will: Understand techniques for self-assessment of personal skills and how to produce an action plan for self-development.

Assessment Criteria Indicative Content

The learner can:

4.1 Explain a range of techniques that can 4.1.1 Identify and explain several methods of self-assessment for prospective entrepreneurs to be
be used for self-assessment of personal skills. able to evaluate their personal skills and areas for self-development. These include:

- SWOT analysis
- What Makes a Good Entrepreneur exercise
- psychometric personality test
- creativity questionnaire
- GoSmallBiz Entrepreneurial Aptitude Test
- learning styles questionnaire
- Belbin Team Roles.

4.2 Explain how to produce an action plan for self-development.

4.2.1 Explain the four-stage process of action planning for self-development.

- Identify each of the skills that need to be improved.
- Identify specific actions (e.g. training courses or work-based activities) that will be used to develop the skills and timescales for these to take place.
- Monitor the progress of each of the development activities.

Reflect on the success (or failure) of the process to identify what went right or wrong, and any further actions needed to complete the activity.

Learning Outcome 5

The learner will: Understand the processes of leading, managing, motivating and working closely with small numbers of staff in a new or developing business.

Assessment Criteria Indicative Content

The learner can:

5.1 Explain the process involved in leading, managing, motivating and working with small numbers of staff in small or developing businesses.

5.1.1 Explain the ways in which management style can improve and maintain positive relationships with staff in a small business.

5.1.2 Explain the meaning and purpose of staff motivation as part of the process of creating job satisfaction.

5.1.3 Outline and explain the main theories relating to motivation.

- Maslow’s Hierarchy of Needs.
- Herzberg’s Dual Structure Theory.
Learning Outcome 6

The learner will: Understand the importance of producing a properly structured business plan as part of the preparation process of starting a new business.

Assessment Criteria

Indicative Content

The learner can:

6.1 Understand and explain the purpose and benefits of the business planning process.

6.1.1 Understand and explain the three criteria used to define a good business plan structure.
- The need to provide potential lenders, investors and other interested parties with sufficiently detailed information to enable them to make a decision about investment and support.
- The business plan should follow best practice guidelines to ensure it contains the information required for the entrepreneur to make a balanced judgement about the viability and risks of the proposal before going ahead.
- The need to provide the prospective entrepreneur with the knowledge to enable the venture to reach profitability before the start-up capital runs out.

6.1.2 Understand and explain the benefits of developing a business plan when planning a new venture.

6.2 Understand and explain the content and structure that would be expected in a generic business plan.

6.2.1 Understand and explain the main sections of the business plan structure and the information expected within each of those sections when developing a new business proposal.

Assessment:
Assessment of this Unit will be by a three-hour examination.

Recommended Reading:
Please refer to the Qualifications section and Members Area of the ABE website (www.abeuk.com) for lists of recommended reading books.
## Coverage of the Enterprise Start-up Syllabus by the Manual

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<td>3, 5, 7, 10</td>
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<td>3.7 Identify and explain the resources that are needed when starting a business</td>
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<td>6.2 Understand and explain the content and structure that would be expected in a generic business plan</td>
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Unit Specification – Business Plan for Enterprise Start-up

Unit Title: Business Plan for Enterprise Start-up

Guided Learning Hours: 100

Level: Level 4

Number of Credits: 12

Learning Outcome 1

The learner will: Understand how to prepare the introductory part of a business plan to outline the business idea for potential lenders, investors and other interested parties.

Assessment Criteria Indicative Content

The learner can:

1.1 Identify and explain the content that would be expected in the introduction of a business plan.

1.1.1 Identify and explain the information that a potential lender, investor or other interested party would expect to see relating to the business idea in the introductory section of the business plan.

- The type of business proposed and trading status.
- The range of services to be offered (primary and secondary).
- The personal parameters of the proposer(s) that may influence the way the business is started, e.g. full time, part time, hobby, lifestyle factors, family or other constraints.
- The geographical location and/or operating area of the business.
- A brief summary of anticipated customers, the target market and their distribution.
- A statement of viability – why the proposer(s) believe it will succeed.

1.1.2 Identify and explain the information that the lender or investor would expect to see about the proposer(s) of the business idea.

- A brief background/personal history and summary CV of the proposer(s) and key team members.
• Personal skills, expertise and experience relevant to the business of the proposer(s) and key team members, with a SWOT analysis, and identification of any personal development needs.
• Personal influences, ambitions and long-term objectives of the proposer(s).
• Why the proposer(s) want to go into business.

Learning Outcome 2

The learner will: Understand the process of planning the resource requirements of the business including both physical and staff resources.

Assessment Criteria

The learner can:

2.1 Identify and explain the physical resource requirements of the business and their projected costs.

2.1.1 Identify and explain the various physical requirements needed for the business and quantify them, e.g.:

- A list of any equipment, materials already available or owned by the proposer(s)
- Details of any intellectual property rights owned or applied for
- Premises requirements (size, shape, special features, location) and any modifications required, plus details of annual costs of rent or lease, and any other costs such as public taxes
- Plant and equipment, information and communications technology (ICT) and communications equipment, office furniture etc – plus options for acquiring those (lease or buy etc)
- Stock or raw material
- Transport requirements/availability – vehicles for sales activities or product distribution
- Security requirements – alarms, use of external security services.

2.1.2 Identify and explain the need to distinguish between resources that are essential for the start-up, and those resources that would be useful to have but could be acquired later, or could be hired in when needed in the short term.
2.2 Identify and explain the staff resource requirements of the business and their projected costs.

2.2.1 Explain the use of a skills gap analysis to identify the short-term and longer-term needs of the business.

2.2.2 Explain how to identify the staffing requirements of the business in terms of skills and numbers of staff required (a) at the start-up stage, and (b) within the first year of operation.

2.2.3 Identify and describe options for recruiting staff to meet the requirements including the use of combinations of core (permanent) and peripheral (part-time, seasonal or agency) staff.

Learning Outcome 3

The learner will: Understand the financial information required for a business plan to meet the decision-making needs of potential investors, lenders or other interested parties.

Assessment Criteria

The learner can:

3.1 Identify and explain the financial information that is required in a business plan.

3.1.1 Identify and explain the key financial documents that a potential lender or investor would expect to see in the business plan.

- A budgetary plan and cash flow forecast for the first year of operation.
- An explanation of the assumptions underpinning the budgetary plan.
- A profit forecast for years one and two.
- A break-even analysis showing how long it will take to reach profitable trading levels or what revenues or sales volumes of products will be required to break even.
- Personal survival budgets for each of the proposers showing the levels of drawings or salaries they need to take from the business in the early stages.
- A summary of the proposed financial monitoring processes that the business intends to use.

3.2 Explain the process of preparing a

3.2.1 Explain the various sources of revenue that might be listed under the Income section and the
budgetary plan and cash flow forecast, the range of detailed information required within that, and the assumptions on which the data is based.

various cost items that might be listed under the Expenditure section of the budgetary plan.

3.2.2 Describe how the assumptions of costs within the budgetary plan would be justified, e.g. in terms of frequency of payments, changing sales revenues, constant overhead costs, variable production costs linked to sales or production, and the impact of any credit given to customers or received from suppliers.

3.3 Identify and describe the options for funding the proposed business venture.

3.3.1 Identify and describe potential options for funding a new business venture and their respective advantages and disadvantages – e.g. from friends and family, a bank loan, angel investors, grants, hire purchase, leasing.

3.3.2 Describe and explain the proposed funding structure of the new venture and where the funding will come from.
- A summary of the value of capital and resources available from the proposers.
- A summary of additional financial requirements for the business, the phasing of that investment, where the funds might come from, and the proposers’ preferred means of financing those requirements.

Learning Outcome 4

*The learner will:* Understand the market research required prior to developing a business plan, and the preparation of marketing strategies, customer care and quality policies for the business proposal.

**Assessment Criteria**

**Indicative Content**

*The learner can:*

4.1 Identity and explain the market research activities that would be carried out when producing a business plan.

4.1.1 Describe and explain the range of market research activities that would be carried out when planning a new business venture, e.g.:
- evaluating the market size and whether it is growing, static, or shrinking; and assessing what potential market share could be realistically achieved
- identifying the customer expectations from the product or service, and the unique selling points (USPs) that will meet them
• identifying the barriers to market entry and any other anticipated problems
• evaluating the competitors: who they are and what they are offering, their likely response to a new entrant into the market, the comparative price and quality of their goods or services, and the level of loyalty they command from their customers
• identifying any seasonal factors that affect the market.

4.2 Identify and explain the expected content of the marketing strategy section of the business plan.

4.2.1 Explain and describe the development of strategies for market penetration, e.g. competitive pricing, selling on quality and value for money, targeting niche markets or opening up new markets, using loss-leaders, buying market share by acquiring competitors.

4.2.2 Explain the use of the four Ps in developing a marketing mix for a new product (Product, Place, Price and Promotion) or with the additional three Ps (People, Process and Physical) for a marketing mix for a new service.

4.3 Explain the customer care policies and quality standards information that would be expected within the business plan.

4.3.1 Explain how customer care policies and quality standards can improve customer retention and assist with the building of strong long-term relationships with customers, including:
• by ensuring customer satisfaction and enhancing the reputation of the business
• by reducing complaints and the costs of faults, returned goods, warranty claims
• by improving customer retention and reducing the sales costs of replacing lost customers
• by providing staff with clear guidelines about what is expected of them when dealing with customers.

4.3.2 Explain how quality standards can be developed, e.g. by defining them in terms of specific and measurable targets for each element of customer engagement – pre-transactional, transactional, and post-transactional.

Learning Outcome 5
The learner will: Understand the process of planning the implementation of the business plan, the use of risk assessments, and the importance of ensuring legal compliance.

Assessment Criteria  Indicative Content

The learner can:

5.1 Identify the key or critical stages in implementing a business plan and display them on a Gantt chart.

5.1.1 Identify and explain each activity that needs to be completed prior to the start of a new business – e.g. the market research, business plan development, arranging finance, finding and negotiating premises, organising suppliers, sales and marketing activities.

5.1.2 Identify the timescale for each activity (start and completion times) and the activities that are dependent on other preceding activities; and plot them all on a Gantt chart.

5.1.3 Identify which of the activities on the Gantt chart could be crucial to the commencement of business on the planned target date.

5.2 Explain the process of carrying out a risk analysis on the critical stages of implementation and producing contingency plans or actions to mitigate the risks.

5.2.1 Explain how each of the critical stages can be analysed in terms of:
- the probability or likelihood that the risk will go wrong (low/medium/high)
- the impact of it going wrong on the planned start, the operation, or the profitability of the proposed business
- the critical stages that show medium to high probability of going wrong and medium to high impact if they do go wrong – these are the critical risks that need to be addressed.

5.2.2 Explain how critical risks can be:
- mitigated by the use of planning and preventive action to avoid them occurring or to reduce the impact of their occurrence
- managed in the event of them happening by the use of contingency plans that can resolve problems or offer alternative actions.

5.3 Identify and explain the trading status options for a proposed business in order to identify the option that offers the most appropriate means of operating the
operating the proposed business, including:

- **sole trader**
- **partnership**
- **limited partnership**
- **limited company**
- **private limited company**
- **not-for-profit organisation** — e.g. company limited by guarantee, community interest company, charitable association.

(Local variations will apply and learners should be aware of the trading status in their own country.)

5.4 Identify and explain the legal and insurance requirements that a new business venture might have to comply with.

5.4.1 Identify and explain the main legislation and regulations that a new business will need to comply with, for example:

- **health and safety at work**
- **fire regulations**
- **employment Acts** — contracts of employment, dismissal, sickness benefits, statutory holiday entitlement, EU Working Hours Directive
- **anti-discrimination legislation**
- **anti-competition law**/fair trading/misrepresentation of goods or services
- **business registration requirements** and annual returns
- **company taxation** and Pay As You Earn (PAYE) taxation for employees.

(Local variations will apply and learners should be aware of the main legislation and regulations in their own country.)

5.4.2 Identify and explain the examples of sector-based legislation and regulations that a new business will need to comply with, e.g.:

- **environmental health regulations** — food preparation, hygiene and storage
- **transport and slaughtering of animals**
- **transport sector exhaust emissions**.

(Local variations will apply and learners should be aware of the main legislation and regulations in their own country.)

5.4.3 Identify and explain the insurance requirements of a prospective new business, e.g.:

- **public liability**
- **employers’ liability**
• product liability
• professional indemnity
• business premises (structure and contents)
• stock and goods in transit.

(Local variations will apply and learners should be aware of the main legislation and regulations in their own country.)

Assessment:
Assessment of this Unit will be based on a case study (or business scenario) and will involve a three-hour examination.

Recommended Reading:
Please refer to the Qualifications section of the ABE website (www.abeuk.com) for lists of recommended reading books.
Coverage of the Business Plan for Enterprise Start-up Syllabus by the Manual

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<td>1.1 Identify and explain the content that would be expected in the introduction of a business plan</td>
<td>5, 7</td>
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| 2. Understand the process of planning the resource requirements of the business including both physical and staff resources | 2.1 Identify and explain the physical resource requirements of the business and their projected costs  
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Chapter 1

Definitions of Entrepreneurship and Small Business

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INTRODUCTION

The purpose of this chapter is to enable the reader to understand what we mean by entrepreneurs and entrepreneurship, what differentiates them from other types of business people, and their motivations to do what they do best. In recent years, these definitions and concepts of entrepreneurial motivation have generated a great deal of attention and academic discussion, which interestingly does not seem to be of much interest to the entrepreneurs themselves who are more concerned with running and growing their businesses. However, the understanding of entrepreneurs and their motives is of fundamental importance to governments and national economies as with the increased use of technology in business, SMEs have increasingly replaced larger corporations as the source of both innovative ideas and new employment opportunities. In short: innovations create new business opportunities which create new jobs, which create tax revenues for governments. However, the temptation for very small firms to operate within the grey economy (see Section C of this chapter) to avoid taxation often defeats government objectives.

Another important factor in understanding entrepreneurship is the realisation that SMEs are not simply scaled-down versions of larger organisations; they have their own specific features and development needs that require governments to treat them differently from large firms in order for them to thrive and grow. This chapter examines those differences across a number of areas as they have significant implications for the design and provision of government support for small businesses.

A. DEFINITIONS

Enterprise, Entrepreneurs and Entrepreneurship

In common language, “enterprise”, “entrepreneurs” and “entrepreneurship” are often confused or used interchangeably. This confusion over the technical meaning of the words is compounded by whether or not they are used in an economic context or in academic discussion. The economic viewpoint is that enterprise is what entrepreneurs do by creating new businesses, jobs and wealth, all of which add value to the economy. The academic approach is more precise and takes the view that not all firms are enterprising, as some are simply business operations. Those that are enterprising involve the use of imagination and creativity, to generate new ideas; and they are able to deal flexibly with changing situations, by taking responsibility and making decisions.

Enterprise is the term generally applied to a small or medium-sized business. An enterprise can be a start-up, an early stage business or a fully developed business. It can be a lifestyle business, perhaps trading locally with no long-term growth objectives, or it can be a small new business with high growth potential that may one day evolve into a multi-national corporation. It can also be a social enterprise or not-for-profit business. Although the word can also be used in the context of major companies or international organisations, that rarely happens as it tends to reflect adventurous, opportunistic and risk-taking attitudes that are less typical of large organisations. However, the promotion and development of enterprise
cultures are becoming much more relevant to larger organisations that sometimes lack the flexibility and dynamic attitude of their smaller counterparts.

In common language, entrepreneurs are people who start enterprises or businesses, and social entrepreneurs are people that start social enterprises. The more precise academic explanation differentiates between the “true” entrepreneurs who establish enterprises or develop new innovations with high growth potential, and the owner-managers who operate more conventional businesses in localised areas, in low-growth markets, or as lifestyle businesses where stability and sustainability, rather than growth, are the main objectives. They are often seeking to achieve a balance between generating a steady level of profit and income that allows a comfortable lifestyle, and not having to work excessively hard to achieve that income. Therefore, whilst they may have the potential to grow their businesses, they may not want the stress or pressure that accompanies the achievement of that growth. Owner-managers may often be second generation owners, having perhaps taken over the business from the original entrepreneur. Entrepreneurs are also differentiated from other business people by specific attitudes or characteristics and this will be discussed in Chapters 2 and 3.

Serial entrepreneurs find a challenge in the process of creating and growing a new business, selling it for a profit (or delegating its management to others), and then moving on to create another new venture, sometimes in a totally different and unrelated market. Some enjoy the challenge of creating successive new businesses and selling them for a profit, whilst others regard the process as a means of building a substantial business empire, or perhaps a group of companies with overlapping activities that create a synergy.

The final type of entrepreneur demonstrates the entrepreneurial characteristics of innovation and creativity, the ability to deal with challenges, spot opportunities, and break down barriers to change in larger public and private sector organisations. We describe these as intrapreneurs. They thrive in more dynamic organisations and often act as the champions in developing enterprising cultures. They also exist in social enterprises (both large and small) where they may act as the source of innovative ideas, or as the person who is able to access and harness new resources for the benefit of the social enterprise.

The term “entrepreneur” typifies an individual attitude of opportunity-spotting, and the exploitation of business opportunities to create wealth – often with the implicit use of innovation, imagination and balanced risk-taking. Risk-taking is in total contrast to larger public and private sector organisations which tend to be risk averse. The entrepreneur creates and operates the enterprise, and in doing so displays the characteristic of entrepreneurship.

The term “entrepreneurship” is too frequently just used in the restricted context of new business start-up, particularly by academics and educationalists. However, entrepreneurship is also referred to as the process of growing and sustaining the business after the start-up stage, which implies a much broader definition particularly as entrepreneurial firms are regarded as those that achieve higher (or faster) rates of growth. The definition attributed to Harvard Business School is that: “Entrepreneurship is the pursuit of opportunity beyond the resources you currently control”, which opens up scope for the term to be applied equally to non-profit social enterprises, and to intrapreneurship within large commercial and public sector organisations to reflect entrepreneurial behaviour amongst staff.
Small and Medium-sized Enterprises

Before the 1970s, the growing importance of the small business sector was not really recognised by politicians and economists, and its significance in creating economic wealth and employment was overshadowed by traditional heavy manufacturing industry. As the heavy engineering and manufacturing sector in the UK started to decline in the face of foreign competition, particularly from Japan, and with the growth of the service sector from the 1970s onward, awareness of the significance of SMEs began to grow rapidly.

The original attempts to define and understand what was meant by the term “SMEs” were quite unstructured. In 1971, a report was commissioned by the UK Government (the Bolton Committee Report) that attempted to define the sizes of small firms across a number of key industries. For example, a "small" manufacturing firm had fewer than 200 staff whereas "small" mines and quarries had only 25 or fewer. In the motor trade, a "small" firm had a turnover of under £100,000 but in the wholesale trade the turnover was £200,000. "Small" transport firms had fewer than five vehicles, and catering businesses were small so long as they were not multiple outlets or managed by a brewery. With such vague and chaotic definitions, it was not surprising that the Government could not fully understand the SME sector and, therefore, had had no clear or positive policies to support small firms – although the New Enterprise Programme of the 1970s was the first, albeit unsatisfactory, attempt to support small firms by encouraging them to undertake training and development to improve their staff and management skills.

The Department of Trade and Industry of the UK Government defined an SME as having fewer than 250 employees or an annual turnover below £5 million. This had the negative effect of prompting the assumption that the needs of a new small firm with five to ten staff were similar to, or just a scaled-down version of, those of a firm employing 200 staff that may have been established for 20 or 30 years. In fact, with the current high value of new technology, and the emergence of more high-growth, innovative new firms, it is possible for very small firms with just a handful of staff to be involved in high-value contracts exceeding £5 million or £10 million; whereas other much “larger” businesses that employ substantial numbers of unskilled staff on low-paid labour-intensive work, can have a turnover well below that figure.

In that context, annual sales turnover has become largely irrelevant in the definition of SMEs. It makes much more sense to sub-divide the SME sector, for example, into micro-firms (sometimes called MSMEs) with fewer than ten full-time equivalent (FTE) staff, small firms with 11 to 50 FTE staff, and medium-sized firms with 51 to 100 FTE staff. In effect, most firms with 100 to 250 staff are relatively large and well-established these days, and certainly tend to employ the necessary specialist functional management skills that are found in larger companies.

The distribution of the different-sized SMEs is also an issue. In rural areas, there are few businesses in the 100 to 250 employee bracket, and frequently over 98% are micro-firms, which provide the bulk of potential local employment. In reality, that figure is probably higher if small firms and individuals operating in the grey economy are included.

The other issue here is how best to identify, and focus limited amounts of government resources on, those SMEs that can create the largest number of new jobs – the 5% of start-ups with innovative high growth potential that will generate 95% of new jobs and capital
wealth. On this basis, the current government definitions certainly need to be refined to focus business support funding into the parts of the small firms sector that are likely to produce the most long-term growth and potential employment.

In 2003, the EU came up with a framework definition of SMEs that achieved general approval. A micro-firm is defined as having ten or fewer staff, a turnover of no more than 2 million Euros, and an annual balance sheet total of no more than 2 million Euros. A small firm has a maximum of 50 staff, 10 million Euros of turnover, and 10 million Euros on its balance sheet. A medium-sized firm has no more than 250 staff, a turnover of no more than 50 million Euros, and a balance sheet not exceeding 43 million Euros. Whilst these definitions have been accepted across Europe, two issues arise. First, with quite widely varying inflation rates amongst the EU member states, and even between members of the Eurozone (the EU states that use the Euro as their currency), it will be interesting to see how the thresholds are adjusted as time goes on. Second (and more importantly), the new definitions still do not overcome the fact that a "medium-sized firm" with 51 staff and 10 million Euros’ turnover will be substantially different in terms of management skills and structure, access to resources, market influence etc, than a firm with 249 staff and a turnover of 50 million Euros. These differences are exacerbated with the insistence of bankers, government agencies, politicians, academics and policy-makers of treating the three very different groups as a homogenous group called “SMEs”. The definitions also fail to distinguish between lifestyle-based, non-growth micro-firms and those with the high growth potential to create new jobs and wealth, meaning that they are treated the same for government policy purposes.

**Differences Between Lifestyle and High-growth Businesses**

Businesses with potential for high growth are very much in a minority, probably accounting for just 3-5% of all business start-ups, and they are frequently (but by no means always) based around technological or other innovations. The UK Government defines high growth as growth in turnover of at least 20% per annum over three years, but that in itself is quite modest. It has been recognised for some years that the top 3% of growth companies will be the ones that create 95% of the new employment opportunities in the economy. Between 2003 and 2011, the South-East England Development Agency (one of the UK’s former Regional Development Agencies) developed a network of 16 Enterprise Hubs across 22 locations to support early stage businesses with high growth potential. These were defined in terms of both growth in turnover (25-50% per annum) and scalability (being capable of trading nationally within one to two years of start-up and internationally within two to four years). Some (but not all) high-growth businesses operate in growth markets; others develop new and innovative products and services for conventional markets where their products create a niche or competitive advantage.

In contrast, lifestyle businesses typically operate on a more local level, or within one country, although as shown later in this chapter, some 23% of small businesses do export. Some of them start out as having growth potential but never fulfil it, although they still make very good profitable businesses. The reasons for this may be a lack of investment funding or the strength of the competition; quite frequently, though, it is an active decision on the part of the owners not to grow beyond a certain size, perhaps because they have achieved a comfortable, profitable and stress-free lifestyle and would rather retain this than attempt to achieve further growth.

Entrepreneurs operating high-growth businesses will usually be more strategically focused than owner-managers, and will have defined growth objectives. They are also likely to have
shorter-term exit strategies (e.g. trade sales or stock market flotation) whereas owner-managers of lifestyle businesses may have deliberately chosen a low-growth strategy and may have a longer-term exit strategy. This is likely to be based on the sale of the business when they reach retirement age, or perhaps passing the business on to a younger member of the family. It is also claimed that entrepreneurs are change agents with strong USPs, whereas owner-managers do not innovate. However, there are many innovative owner-managers around but their innovations may be targeting smaller niche markets, or may be based around service improvement to customers rather than the invention of new high-tech products.

One other key difference between lifestyle and high-growth businesses is in the financing of the business. Lifestyle firms will usually raise their investment funding from a combination of friends, family, local banks and, possibly, small business angel investments. In contrast, high-growth firms may require a series of funding stages: perhaps R&D grants and proof of concept funding to take them up to patent protection stage for a new product; followed by pre-market funds to launch the product and subsequent seed funding to grow the market; followed by major venture capital investment to break into large international markets. This issue will be examined further in Chapter 4.

B. THE IMPORTANCE OF SMES TO NATIONAL ECONOMIES

Background to the Rising Importance of SMEs

As explained in the Small and Medium-sized Enterprises section of this chapter, the 1970s saw the start of the rapid decline of the engineering and manufacturing industries in the UK economy. With the demise of the larger manufacturing organisations by the 1990s, SMEs had come to be regarded as the main alternative source of employment, particularly when larger organisations began to shed staff, and skilled workers used their redundancy packages to create opportunities via self-employment. As a result, the small firms sector grew in importance to politicians as a potential solution which could help to reduce the politically sensitive high and rising levels of unemployment. By 1998, it was estimated that there were 3.75 million small firms providing 7.7 million jobs, and that of all UK firms, 84% had fewer than ten staff, and 89% had fewer than five staff. By 1998, 96% of all UK firms employed fewer than 20 staff, growing to an officially recognised figure of 4.3 million in 2004.

One problem that persisted during this period was the lack of clarity about how to define an SME, until the issue was resolved by the acceptance of the EU definition in 2003. However, one of the main legacies of a number of years of confusion about the SME definition was the lack of a clearly defined and coordinated structure of support to help SMEs survive, develop and grow. As a result, that support had been shared by three government departments (Education; Employment; and Trade and Industry), each focusing on particular aspects of support provision based on their particular departmental objectives. This divided support was further compounded by delivery at different levels of government – with the export trade support delivered by a national organisation, the start-up and growth support delivered by regional agencies (some of which sub-contracted to small local private organisations such as chambers of commerce and enterprise agencies) and the training for SMEs delivered on a sub-regional basis by local education authorities and universities. In addition, there were also some charitable trusts providing support to particular sectors of the population – e.g. the
under 25s and ethnic minority groups. Overall, the result was chaos, much duplication and wasted money and effort.

The Government's Business Simplification Programme, introduced in 2007, was designed to solve that problem by centralising support and eliminating duplication. However, around the time this started to happen in 2008, and as many of the support agencies ceased to exist, the economic recession hit hard, forcing financial cutbacks and the withdrawal of or a reduction in central support services for SMEs. The result was a disaster for small businesses in the UK: at the time when the Government was hailing small firms' growth as the solution to the problems of economic recession, and when those small firms most needed help to stimulate new business growth, the support provided and funded by that same Government was rapidly disappearing.

**The Impact of SMEs on National Economies**

The importance of SMEs to the national economy can be measured in a number of ways.

- The tax revenues they create for the Government from their trading profit.
- The taxes paid on employees' wages towards social welfare (National Insurance Contributions).
- The net Value Added they create as part of their processing and sales (Value Added Tax).
- The local taxes they pay on premises.
- The jobs and the increased employment opportunities they create as they expand and grow – this is politically one of the most important issues for governments as high levels of employment are good for votes at election times.
- The new innovations (products and services) they generate, and the value of the IP resulting from innovation, including revenue from patent licences.
- The value of export trade revenue, and the foreign currency that exports bring in to help balance the country's balance of payments for international trade.
- The economic wealth (increased capital value) of the small businesses from their profits and balance sheets. This is frequently measured as Gross Value Added, which is a complex measure of the growth in company profits, balance sheet value, wages and salaries paid, investment value achieved, and new jobs created.

It is hardly surprising, therefore, that governments are so reliant on SME growth to sustain their economic growth and tax revenues.

There are two ways in which unemployment can be reduced in a country. One is for the Government to borrow money to spend on creating new public sector jobs (in government administration, health services, the military, the public services etc) which just increases overall government debt without adding positive value to the national economy. The other is to create a business and commercial environment that will stimulate private sector business to invest in innovation and growth, to create new jobs, and to expand their trading activities – thereby creating trading profits that can be taxed to provide government revenue. This will be explored further in Chapter 3.

Innovation is an important factor in new job creation as it is reckoned that 95% of new jobs in the USA are generated by just the 3% of companies with the most innovative and fastest growing ideas and technologies.
One of the most fundamental flaws in government thinking over the past 30 years is the assumption that because successive governments have regarded SMEs as the biggest potential source of new employment and the generation of economic growth, this will just happen by itself. Even with the appropriate business support structures in place, access to funding for growth at reasonable rates of interest etc, growth will only occur if and when the entrepreneurs want it to happen and not when the Government dictates that it must happen. The reality is that entrepreneurs are highly motivated and independent people. If governments create the right economic and business environment to stimulate growth – for example by offering tax incentives for investors, tax reliefs for new job creation, and by persuading the banks to provide funding at affordable rates of interest – then entrepreneurs will respond to the opportunities. We always talk of one of the prime entrepreneurial attributes being the willingness to take balanced risks, but in reality if governments want entrepreneurs to risk growth and expansion, they need to create business-friendly fiscal policies and incentives.

**SME Statistics**

There is a vast amount of statistical data available that relates to small firms. One of the most reliable sources covering global data is the Global Entrepreneurship Monitor (GEM) which was established in 1999 as a joint venture between the London Business School (UK) and Babson University (USA). It now has over 100 teams around the world, and the 2012 survey aimed to collate data from 70 separate countries. It has two components: the GEM Adult Population Survey (APS) is used to produce indicators that measure the entrepreneurial activity, attitudes and aspirations of individuals; and the GEM National Expert Survey (NES) enables the measurement of nine factors that impact national entrepreneurial activity such as finance, government policies and programmes, entrepreneurship education and training, physical and professional support infrastructure, R&D knowledge transfer, changing barriers to market entry and cultural norms. The data is used primarily to research factors that influence entrepreneurial activity and to inform national government policies. The GEM Global Report for 2011 (239 pages/7.87 MB), and some of the most recent national reports, can be downloaded from the website (www.gemconsortium.org) but they are quite substantial documents.

For more specific data about SMEs and enterprise activity, some governments produce annual or bi-annual reports. For example, the UK Government’s Department for Business Innovation & Skills (BIS) publishes an annual statistical survey of small and medium-sized businesses. (www.bis.gov.uk/assets/biscore/enterprise/docs/b/11-p74-bis-small-business-survey-2010.pdf). The survey for 2010 (published in April 2011) reveals some interesting data about SMEs in the UK (Table 1.1).

**Table 1.1: SMEs in the UK, 2010**

<table>
<thead>
<tr>
<th>Legal Trading Status</th>
<th>All SME Employers</th>
<th>Micro-firms (1-9 staff)</th>
<th>Small Firms (10-49 staff)</th>
<th>Medium-sized Firms (50-249 staff)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2010 % (2007 %)</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Private Limited Companies</td>
<td>59 (51)</td>
<td>56</td>
<td>73</td>
<td>72</td>
</tr>
<tr>
<td>Sole Traders</td>
<td>19 (29)</td>
<td>22</td>
<td>5</td>
<td>1</td>
</tr>
<tr>
<td>Partnerships</td>
<td>10 (16)</td>
<td>11</td>
<td>8</td>
<td>5</td>
</tr>
<tr>
<td>Private Companies Limited by Guarantee</td>
<td>3 (2)</td>
<td>2</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Charities/Not-for-profit</td>
<td>1 (0)</td>
<td>1</td>
<td>2</td>
<td>3</td>
</tr>
</tbody>
</table>
• Private limited companies are more likely to be found in manufacturing (73%), construction (76%) and business services sectors (69%).
• London SMEs include 65% of private limited companies, compared with 45% in Scotland, 51% in Wales, and 40% in Northern Ireland.
• 83% of UK SME employers are registered for VAT (down from 85% in 2007).
• 62% of SME employers are family-owned businesses (69% in 2007).
• 14% of SME employers are female-led (no change since 2007), although the figure was 32% in the service sector.
• 17% of SMEs employed more staff than 12 months ago, 21% employed fewer, and 61% employed the same number.
• 28% of all SME employers reported a greater turnover than one month ago, 34% reported no change, and 33% reported lower turnover.
• 71% of SMEs reported a profit or surplus in 2010, including 71% of micro-firms, 72% of small firms, and 81% of medium-sized firms.
• 24% of SMEs reported losses in 2010, including 24% of micro-firms, 23% of small firms, and 16% of medium-sized firms.
• 52% of all firms reported their intention to develop new products or services over the next two to three years, which indicates a healthy propensity for innovation!
• Innovation – 47% of all firms had introduced new or improved products or services during the preceding 12 months.
• 75% of all firms reported their intention to increase turnover by entering new markets in the next two to three years, despite the economic recession. This prompts the question – do SMEs see exporting as a favoured means of surviving the recession?
• 23% of all firms sold goods or services, or licensed products, outside of the UK in the previous 12 months – broken down into 21% of micro-firms, 29% of small firms, and 40% of medium-sized firms.

Similar data is published by a number of other countries, although the depth and detail of analysis may vary, especially in developing countries with large rural economies where the data may not be easily accessible.

C. THE GREY ECONOMY

The “grey economy” is the term used to collectively describe the unofficial trading that takes place in most countries, which can range from an individual who is paid cash for work (in its simplest form) to highly organised, large-scale criminal activities. It is sometimes referred to as the shadow economy, or the black market, or System D (from the French word débrouillard, which refers to resourceful and entrepreneurial unregistered colonial merchants). The reason this topic is included in the syllabus is that many individuals and micro-firms operate either partly or fully in the grey economy, thereby denying their national governments the revenues from the taxes which they are not paying. When the value of each or those small activities is aggregated, it can amount to a significant proportion of the national economy, and a major financial loss for governments.
In 2009, the Organisation for Economic Co-operation and Development (OECD), representing the governments of 30 of the strongest capitalist countries, concluded that half the workers of the world – approximately 1.8 billion people – were working in System D: paid “off the books”, in jobs that were neither registered nor regulated, getting paid in cash, and, most often, avoiding income taxes. The OECD predicts that by 2020 two-thirds of workers around the world will be employed under System D. In 2003, the global value of this unofficial economy was $10 trillion, and the level of activity has grown substantially since then, particularly in some of the European countries that were hit by the economic recession around 2009 (Neuwirth 2011). For comparison, the Gross Domestic Product (GDP) of the USA in 2011 was $15.09 trillion, and that of China was $7.3 trillion in the same year.

The activities that occur within the grey economy vary from what some people might regard as minor or trivial, such as not declaring a one-off cash payment from a friend for a minor repair job, through to large-scale, illegal activities such as smuggling or video piracy. Needless to say that, apart from being illegal and sometimes causing major social problems, serious criminal activities (e.g. smuggling, counterfeiting, importing or dealing in drugs or illicit substances, selling unlicensed firearms, prostitution) contribute to governments’ loss of revenues as the criminals are hardly likely to declare their profits for tax purposes.

The most common issue is tax avoidance, which can take a number of forms, such as the following.

- Individuals working part time for cash alongside other paid work (legal or unregistered). This frequently occurs in the hospitality industry where bar workers or cleaners may be paid for casual work or regular part-time work, but the employer doesn’t want to pay taxes on employees – typically 13% in the UK but up to 42% in some EU countries.
- Individuals working full time for a registered or unregistered business but being paid “off the books” to avoid paying tax. This can often involve family members in a small business.
- Individuals working full time for themselves or operating an unregistered business without paying taxes.
- Small companies employing staff and trading without declaring taxable profits.
- Registered businesses operating secondary unregistered businesses for separate trading activities.
- Registered businesses only declaring part of their sales income (often the non-cash payments) and profits for tax purposes. For example, 70% might be declared, with the other 30% (usually cash) being used to pay the owners or family staff “off the books”.

Individually, the amounts of money involved in these activities in the grey economy might seem quite small; however, when compounded over large numbers of unregistered businesses or activities in any country, the aggregate amount constitutes a major loss of revenue to the government of that country. In 2002, the International Monetary Fund estimated that in developing countries the grey economy may account for 35-44% of GDP, in transitional countries 21-30% and in OECD countries 14-16% (Schneider, F. and Enste, D 2002).

Other issues resulting from dealing with or working for unregistered traders can include the following.

- There is no legal redress for customers supplied with faulty goods or services by an unregistered business.
• Goods may be sub-standard or even dangerous, particularly if they are illegal copies of branded goods.
• Unregistered businesses are less likely to comply with legal regulations, e.g. health and safety, fire safety, food hygiene.
• Unregistered traders may be uninsured, so customers are unprotected if, for example, a builder damages their property whilst carrying out repair work.
• Staff employed in unregistered businesses may be paid less than statutory minimum rates, and will often be working in unpleasant or dangerous conditions. They may not be allowed holidays, and will not be paid if they are ill or if they need time off.
• Staff paid “off the books” may be ineligible to claim state sickness or welfare benefits.
• There can be a substantial loss of revenue for owners of patents or copyrights when pirated copies of products are made and sold, especially for high-value designer clothes or jewellery (e.g. Gucci bags or Rolex watches).

D. DIFFERENCES BETWEEN SMALL AND LARGE BUSINESSES

In the past, one of the major problems involved with the development of business support structures and programmes for small firms has been the assumption that small firms are simply scaled-down versions of big companies, and that the same processes can be applied to both. The problem was thought to have arisen because the support programmes were being developed by civil servants and academics, who had no business experience and enlisted the advice of senior figures from banks and large corporations who had no experience of small businesses.

One of the biggest differences between SMEs of various sizes and larger businesses lies in their attitudes to staff training and development. Traditionally, the uptake of business and management training by small and micro-firms has been low. Staff from those companies often pay their own tuition or course fees, unlike larger organisations which are more likely to have staff training budgets. The majority of management training provision by academic institutions has been focused on the corporate needs of larger businesses and organisations, and has been designed around corporate models and theories. This shows a failure to understand that:

• small firms are not simply scaled-down versions of large firms
• small firms (and in particular the owner-managers of lifestyle businesses) need a breadth of practical business skills rather than a depth of knowledge of more specialist skills.

The main exception to the uptake of training in small firms is the relatively small proportion of high-growth, technology-based start-ups and early stage businesses. The owners of such businesses are frequently well-educated individuals with a professional or technology-based background, who have come to understand that staff development is a key part of the process of achieving the high levels of business growth that they seek.

Table 1.2 compares large and small business organisations across a number of areas (e.g. general characteristics, management skills, financial management and funding, staff employment, attitudes to training, legal compliance and innovation) to illustrate how much they differ from each other, and how that impacts on the ways they operate. Obviously the examples are based on the two extremes of small and large firms; the medium-sized firms that fall between the two groups will demonstrate characteristics of both.
### Table 1.2: Comparison of Large and Small Businesses (Modified from Butler 2006)

<table>
<thead>
<tr>
<th>General Characteristics</th>
<th>Large businesses</th>
<th>Small businesses</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Typically controlled by a board of directors, accountable to remotely located</td>
<td>• Frequently dominated and controlled by one person, accountable to just themselves</td>
</tr>
<tr>
<td></td>
<td>shareholders</td>
<td>• Often heavily reliant on a small number of customers, usually in a single market</td>
</tr>
<tr>
<td></td>
<td>• Diversified product range and customer base</td>
<td>• Small market share, with little direct influence over that market</td>
</tr>
<tr>
<td></td>
<td>• May operate in more than one market</td>
<td>• High levels of personal investment and risk</td>
</tr>
<tr>
<td></td>
<td>• Significant or even majority market share and able to influence market by price/</td>
<td>• Limited internal reserves and limited access to external capital to fund expansion</td>
</tr>
<tr>
<td></td>
<td>strategies and/or advertising</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Greater access to capital</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Management Skills</th>
<th>Large businesses</th>
<th>Small businesses</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Strategic skills at senior level</td>
<td>• Product/service knowledge</td>
</tr>
<tr>
<td></td>
<td>• In-depth/specialist functional skills at middle manager level, e.g.:</td>
<td>• Knowledge of market</td>
</tr>
<tr>
<td></td>
<td>– finance accounting</td>
<td>• Business plan production</td>
</tr>
<tr>
<td></td>
<td>– operations management</td>
<td>• Need to develop a broad and general skills across a wide range, e.g.:</td>
</tr>
<tr>
<td></td>
<td>– marketing</td>
<td>– sales, marketing, negotiation</td>
</tr>
<tr>
<td></td>
<td>– personnel</td>
<td>– book-keeping/credit control</td>
</tr>
<tr>
<td></td>
<td>– quality/customer focus</td>
<td>– production planning</td>
</tr>
<tr>
<td></td>
<td>– technical knowledge</td>
<td>– personnel and legal</td>
</tr>
<tr>
<td></td>
<td>– IT/communications</td>
<td>– staff management</td>
</tr>
<tr>
<td></td>
<td>• People management/planning and organising skills at middle management and</td>
<td>– transport and distribution</td>
</tr>
<tr>
<td></td>
<td>operational levels</td>
<td>– IT and clerical</td>
</tr>
<tr>
<td></td>
<td>• Product/service knowledge</td>
<td>– health and safety</td>
</tr>
<tr>
<td></td>
<td>• Knowledge of market</td>
<td>– stock control</td>
</tr>
<tr>
<td></td>
<td>• Business plan production</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Need to develop a broad and general skills across a wide range, e.g.:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Use of specialist accounting staff</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Accountants may have strong influence over the management of the company</td>
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<table>
<thead>
<tr>
<th>Accounting and Finance</th>
<th>Large businesses</th>
<th>Small businesses</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Heavy emphasis on monitoring financial performance</td>
<td>• Often regarded as a necessary evil/distraction from the job of fulfilling customer orders</td>
</tr>
<tr>
<td></td>
<td>• Systems are regarded as integral to financial planning and control of business</td>
<td>• Book-keepers are an overhead burden that do not contribute to profit</td>
</tr>
<tr>
<td></td>
<td>• Accounting data is used as a primary source of information on business performance</td>
<td>• VAT and PAYE – the small business acts as an unpaid tax collector on behalf of the Government</td>
</tr>
<tr>
<td></td>
<td>• Use of specialist accounting staff</td>
<td>• Financial planning – not always used as a measure of performance: for some small firms this is just an annual chore to keep the bank manager happy</td>
</tr>
<tr>
<td></td>
<td>• Accountants may have strong influence over the management of the company</td>
<td>• Financial monitoring is often a weak and may not be as regular as it should be</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Finance and Borrowing</th>
<th>Large businesses</th>
<th>Small businesses</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Access to funding is easier, and large firms can negotiate favourable interest</td>
<td>• Access to funding for small firms can be very difficult, and borrowing may incur high interest rates</td>
</tr>
<tr>
<td></td>
<td>rates</td>
<td>• Sources:</td>
</tr>
<tr>
<td></td>
<td>• Sources:</td>
<td>– own resources</td>
</tr>
<tr>
<td></td>
<td>– clearing banks</td>
<td></td>
</tr>
<tr>
<td></td>
<td>– merchant banks and financial institutions</td>
<td></td>
</tr>
</tbody>
</table>
### Definitions of Entrepreneurship and Small Business

- stock market flotation
- use of reserves
- venture capital

**Attitude to risk:**
- due diligence approach to investors’ funds
- careful evaluation of risks prior to action

### UK/EU Legislation and Regulations

**Large businesses**
- Represents government interference in business
- Acceptance of need to comply and must be dealt with professionally to keep within law/maintain company image and reputation
- Costs of compliance are normally regarded as part of overheads
- Compliance workload can usually be accommodated within existing staff resources

**Small businesses**
- An additional burden on stretched staff and management time and resources (e.g. record keeping for Working Hours Directive)
- For very small firms, compliance can be disproportionately costly, with direct impact on working capital and profit margins (e.g. care home sector)
- Compliance can sometimes cause major damage to sectors (e.g. poorly considered EU abattoir legislation caused major and rapid spread of Foot and Mouth Disease during 2003 outbreak and significant impact on agriculture/rural industries in the UK)

### Organisational Culture

**Large businesses**
- May reflect the business activity (profit focus/“star” status of professional partnerships/bureaucracy etc)
- Frequently influenced by organisational structure – rigid and highly structured firms tend to have more formal cultures
- Should be compatible with organisational objectives
- Has evolved as the business developed over time, and so may be hard to change quickly or easily

**Small businesses**
- Frequently reflects the personality of the proprietor or owner-manager as a primary influence
- Almost certainly reflects the personal objectives of the owner-manager
- Frequently less formal than in big companies, due to less formal structure and close working relationships
- Generally more entrepreneurial and flexible than larger organisations, but this depends on entrepreneur’s influence

### Employing Staff

**Large businesses**
- Employment policies are designed to complement needs of organisation – e.g. use of permanent core staff supplemented by part-time or outsourced staff
- Personnel expertise in house to handle legal, recruitment, discipline and grievance, safety and training etc
- Financial facilities to handle payroll, pensions, etc

**Small businesses**
- Need flexible staff with broad skills base
- Staff are often seen as an essential but unreliable overhead cost
- Disproportionate burden on owners of administering PAYE, statutory sick pay, minimum wage, holidays, stakeholder pensions, etc
- Problems of cover for absence, sickness, holidays, maternity etc – big impact on work
### Definitions of Entrepreneurship and Small Business

<table>
<thead>
<tr>
<th><strong>Training and Development</strong></th>
<th><strong>Large businesses</strong></th>
<th><strong>Small businesses</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Sufficient resources to the absorb impact of sickness, maternity leave etc</td>
<td>capacity of business</td>
<td>• Rarely any training and development strategy</td>
</tr>
<tr>
<td><strong>Large businesses</strong></td>
<td>• Seen as an important ongoing activity and essential to the performance and growth of the business; acknowledges need for constant up-skilling</td>
<td>• Training often only takes place out of necessity or legal compliance – often via direct observation of experienced staff</td>
</tr>
<tr>
<td>• A medium- to long-term investment in a key resource</td>
<td>• Often seen as an expensive luxury and sometimes just reserved for the boss!</td>
<td>• Wasted if staff leave for better paid jobs, and can be de-motivating if they have no progression opportunities</td>
</tr>
<tr>
<td>• Loss/movement of trained staff is an acceptable risk</td>
<td>• Personal development/opportunities for progression are motivating factors</td>
<td>• Cheaper/easier to buy in trained staff</td>
</tr>
<tr>
<td>• Personal development/opportunities for progression are motivating factors</td>
<td>• Planned and programmed as part of HR strategy</td>
<td>• Causes major disruption to business when staff are away for training, especially for extended courses</td>
</tr>
<tr>
<td>• Planned and programmed as part of HR strategy</td>
<td></td>
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<tr>
<th><strong>Innovation</strong></th>
<th><strong>Large businesses</strong></th>
<th><strong>Small businesses</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Innovation is usually part of a long-term R&amp;D strategy supported by budgeted capital investment and funding</td>
<td>• Small firms are often established to develop and commercialise individual innovations</td>
<td></td>
</tr>
<tr>
<td>• Specialist development teams take new ideas forward using established processes and in-house facilities, laboratories and equipment</td>
<td>• Originators of innovations are often highly technical/lacking business sense and expertise</td>
<td></td>
</tr>
<tr>
<td>• Funding for innovation development is budgeted in advance, usually from internal resources (profits or reserves from previous years)</td>
<td>• There is reliance on external funding, as new or small firms rarely have sufficient internal funds for new product development</td>
<td></td>
</tr>
<tr>
<td>• IP and international marketing expertise are readily available, often in house</td>
<td>• Expensive specialist equipment or external expertise often needed</td>
<td></td>
</tr>
<tr>
<td>• Larger firms can afford to defend their IP against infringements</td>
<td>• Need to employ entrepreneurs to commercialise ideas, which can cause problems with originator</td>
<td></td>
</tr>
<tr>
<td>• Some large firms employ specialist staff to scrutinise newly published patents that can be modified to create new market opportunities, or add value to existing product ranges</td>
<td>• Problems of accessing staged development funding without giving away too much equity/control of business</td>
<td></td>
</tr>
<tr>
<td>• Unwanted IP may be licensed out to small firms for development</td>
<td>• Protection of IP is often unaffordable, resulting in first-to-market strategies</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Customer Engagement</strong></th>
<th><strong>Large businesses</strong></th>
<th><strong>Small businesses</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Employ specialist sales force and customer service staff, but large staff numbers and staff changes can de-personalise relationships with customers</td>
<td>• Small firms tend to have close and long-standing relationships with customers, often on a personal-name basis, creating trust and loyalty</td>
<td></td>
</tr>
<tr>
<td>• Focus on high-volume or high-value customers, and may not want to be involved with very small orders</td>
<td>• Close relationships facilitate good communications and the ability to resolve supply problems quickly. They also enable small firms to pick up on customers’ business problems and create opportunities to expand their business by working with the customer</td>
<td></td>
</tr>
<tr>
<td>• Have a strong focus on achieving market share and growing and retaining customer accounts</td>
<td></td>
<td></td>
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</tbody>
</table>
• Will evaluate new opportunities and respond positively if total potential market is sufficiently large
• Evaluation of new markets takes time, and decision-making processes can be slow, so large firms cannot always respond quickly and easily to new customer demands
• Where demand is too small to justify direct interest, development and production may be outsourced
• Rigid sales, order-processing and distribution systems can make for slow responses to changing customer needs

<table>
<thead>
<tr>
<th>to solve them</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Will usually take on new customer orders irrespective of size or value (if they are still profitable) as these may become larger accounts in the future</td>
</tr>
<tr>
<td>• Entrepreneurs are often directly involved in sales, so can make prompt decisions</td>
</tr>
<tr>
<td>• Small firms have the flexibility to respond quickly to customers’ order requirements, and to longer-term changing needs</td>
</tr>
</tbody>
</table>

In summary, the differences between small firms and large businesses are enormous, but as small firms grow, that gap starts to close. Typically, when a small firm employs about 25-30 staff, it starts to need specialist functional managers for things like accounting, sales management, or distribution. At that stage, the structure and culture of the business starts to change and it begins to take on some of the corporate characteristics, particularly relating to employing, training and managing staff and the increased use of financial information for decision making. It is also able to access funding for expansion more easily, not least because it can re-invest its own profits. Unfortunately, as many small firms start to grow and take on these corporate characteristics, they also risk losing the flexibility and drive that created that growth in the first place, particularly if the entrepreneur that started the business is gradually transposed by necessity into a more conventional managing director role.

REFERENCES

# Chapter 2

## Enterprise Theory and Concepts

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INTRODUCTION

The aim of this chapter is to outline and discuss some of the key theories and models that have been used to explain the characteristics, attitudes and skills that relate to the entrepreneurial personality. It will cover the age-old question of whether entrepreneurs are “made” or “born” and the implicit issue of entrepreneurship as a transferable skill. It will explore the attitudes and characteristics that are said to typify entrepreneurs, and the personality traits that influence their behaviour.

It will also examine some of the models that have been used in the past by academics to classify or characterise entrepreneurial types – although most entrepreneurs see this as rather pointless and as adding little value to what they actually do.

Finally, this chapter will examine the issue of how the objectives of the entrepreneurs’ domestic partners and families should be aligned with the needs and objectives of the business. This, again, was originally a largely academic argument; however, it is a topic that has potential to be explored further in the context of the attitudes and norms of different cultural groups towards enterprise in general, particularly in some Asian countries where family life and the running of a family enterprise are closely integrated.

A. THE “MADE OR BORN” ARGUMENT

The basis for this argument is the question of whether entrepreneurs are made or born, or more precisely whether entrepreneurial skills and abilities are an inherent capability or natural instinct as opposed to something that can be taught or learned. This is the entrepreneurial equivalent of the “nature versus nurture” argument about the human personality from educational psychology that argues about people’s personalities being inherent from birth, as opposed to being cultivated and influenced as they grow up by the environments in which they live and the experiences and education they receive.

For both arguments, there is no clear cut or decisive conclusion, so we will also consider the compromise between the two opposing views.

Entrepreneurs Are Born

The “entrepreneurs are born” side of the argument proposes that certain types of entrepreneurial behaviour and skills are essentially instinctive, such as:

- the ability to be creative and innovative and to spot new opportunities
- the range of personality and character traits that are shared by many entrepreneurs including:
  - self-reliance
  - the need for esteem and self-actualisation (as per Maslow’s Hierarchy of Needs – see Chapter 9)
  - the hunter–gatherer instinct to provide for the family, not just with the provision of short-term basic needs (e.g. food, warmth, security) but in the longer term by creating the wealth that provides a better quality of life.
The argument claims the following.

- Entrepreneurship skills are inherently different from other business and management skills in that:
  - they are instinctive and inherent in certain people but absent in others (where is the genetic proof of this, though?)
  - they cannot be learned or acquired but they can be developed by education and enhanced by experience
  - the extent to which they are present in a person may be influenced by his or her upbringing – e.g. a reaction to childhood poverty/deprivation, or a childhood spent in a competitive business environment (does this imply inherited skills?).

- Enterprise skills reflect the human hunter–gatherer and tribal instincts, e.g. the need to:
  - compete with peers and demonstrate superiority (the leader of the pack)
  - provide for the family (income from profit/accumulation of wealth)
  - be seen as a superior being and/or a good provider (trappings of wealth/materialism/money and possessions as measures of success).

- Entrepreneurs have a high need for achievement, and enterprise skills contribute towards our inherent needs for esteem, recognition and self-satisfaction (Maslow’s Hierarchy of Needs).

- Entrepreneurship activities satisfy the human need or desire for continuous renewable challenge and achievement – serial entrepreneurship is the business alternative to mountain climbing, starting with lower mountains and gradually progressing to the higher peaks, and ultimately Everest.

- Enterprise management skills hinge on personality, i.e. the possession of certain personal qualities and training can sharpen those skills, but it cannot create them if they are absent in the first place. (This is really quite an antiquated view, based on conventional ideas of the type of leadership required for managing large hierarchical organisations – the traditional concept that business or military leaders are born, not made, when in fact their leadership skills most likely resulted from the “nurturing” experience of public school education and military academies).

- The ability to spot new opportunities and the desire to act upon them is an intangible characteristic common to entrepreneurs. (But is it unique to them? Could the same not be said of opportunistic politicians or creative artists?).

Whilst entrepreneurial skills can be learned, educators cannot create successful entrepreneurs by training alone. Training can, in fact, be a bad thing for people who lack the essential entrepreneurial personality traits to succeed, such as tenacity, opportunity spotting, and risk-taking, as arguably without these inherent traits, education alone can set them up to fail.

**Entrepreneurs Are Made**

The “entrepreneurs are made” side of the argument is based on:

- the development of entrepreneurial attitudes by exposure to business and enterprising environments during the developmental years or subsequent working life
- the transferability of entrepreneurial skills such as networking and creative thinking, both by learning and by practice
- the provision of additional business skills by training and empirical experience.
The argument proposes the following.

- Entrepreneurship is a transferable management/business skill that can be learned or enhanced by education and training, just like any other skill such as leadership, delegation, business planning, or financial management. It is further enhanced when the learning is supported by practical experience.

- Conditioning/formulation of pro-enterprise attitudes by exposure to appropriate family and external influences can be a major factor in developing entrepreneurial abilities. If a child grows up in an entrepreneurial family, is exposed to discussions about business, and has contact with the business itself, then a career in enterprise will be regarded as a perfectly normal progression. In some cultures, it is an expectation that as children grow up they will join the family business, at least until they are ready to start a business of their own.

- Constant changes in technology and the marketplace require business owners to engage in constant up-skilling as the old (instinctive) business skills become less relevant or obsolete. This is certainly true of ICT but arguably it is too much of a sweeping generalisation to suggest that all business skills become obsolete over time.

- Many entrepreneurs become so because they do not conform to conventional the requirements for social/employment opportunities, e.g. Richard Branson/Bill Gates.
  - They are highly individualistic personalities who seek self-employment as an alternative to working for an employer, often non-conformists or social misfits.
  - The opportunities available to them have been restricted (for example, because of their race, colour or creed) or where engagement in a family business has formed an integral part of their cultural background.
  - They are self-motivated individuals with high aspirations and the self-confidence to achieve.

- Azjen’s (1991) theory of planned behaviour (in Kirby 2003, pp117-118) suggests that a person will start a business if he or she has:
  - enough information to form a balanced opinion
  - an opinion that is favourable to starting the business
  - the intention to start a business
  - sufficient support and encouragement.

People are more likely to start a business if they believe they have the knowledge/ability to do it. Perceived behavioural control is the strongest predictor. A person’s “intention to perform the behaviour” increases as their control over the behaviour increases (Kirby 2003).

- The “nurturing” effect of family background and environmental influences is key to creating entrepreneurial attitudes. This is evidenced by research showing that a majority of entrepreneurs come from families with parental involvement in business ownership or self-employment (Bolton and Thompson 2004).

**The Compromise View**

Inevitably, the realistic position in the “made or born” argument is a compromise between the two extremes, as follows.
Entrepreneurs are both born and made. Arguably, 75% of our personality traits are due to genetic influences, and 25% are due to family background and environmental influences that mould the entrepreneurs. However, some theorists argue that a more realistic split would be that 40% are due to genetic influences and 60% are due to background, environmental influences, education and experience (Bolton and Thompson 2004, p15).

Very few entrepreneurs are “born”, except perhaps for a few high-flyers/opportunity-spotters/serial entrepreneurs for whom it is a lifestyle (although even Richard Branson attributes his independence and self-confidence to his mother’s determination to make him self-reliant). Most entrepreneurs acquire their traits via experience, childhood development, and external influences. Most entrepreneurs are really just self-employed/small businessmen/women (Burns and Dewhurst 1996).

Establishing a true and typical profile of entrepreneurs would be invaluable for banks, investors and venture capitalists, to help them spot potential winners and losers (Carter and Jones-Evans 2000). However, this would be totally impossible in practice, due to the inherent inconsistency and variability of the entrepreneurial character.

– Entrepreneurial personalities are complex, multi-dimensional, and involve too many variable factors (i.e. the different combinations of entrepreneurial characteristics that they possess).
– Inborn traits (nature) are very heavily influenced by environmental factors and experiential learning.

A more appropriate way to understand entrepreneurs is by defining them in terms of:

– craftsmen entrepreneurs – e.g. self-employed individuals, or micro-firms based on technical or trade skills; often seeking a steady and reliable income accompanied by job satisfaction, rather than striving for continuous growth
– opportunistic entrepreneurs – often with higher education and/or good leadership skills, and are more ambitious, growth orientated, and willing to take risks.

**The Entrepreneur’s View**

From a purely pragmatic viewpoint, whilst the “made or born” argument may be of some academic interest, in reality it is the last thing on the mind of the practical entrepreneur; he or she just wants to get on with running and developing the business, as it is the process of being entrepreneurial that makes things happen, not talking about the theory behind it. In fact, most entrepreneurs would probably argue that engaging in academic arguments of this type is totally contrary to the dynamic process of innovation and entrepreneurship.

**B. UNDERSTANDING ENTREPRENEURIAL PERSONALITIES, ATTITUDES AND CHARACTERISTICS**

**Entrepreneurial Motivation**

In Chapter 3, we will explore the traditional concept of business life cycles and how they fail to fully explain the realities of small business growth and development, not least because of
the ways in which entrepreneurs’ motivations and priorities change as the business moves through different stages of development, especially in the early stages.

The motivations and personal objectives of entrepreneurs form an integral part of their attitudes and characteristics; but they are also an important influence on the way entrepreneurs make decisions. For example, in the early stages of a new business when their personal financial exposure is high, entrepreneurs’ primary motivation is to survive long enough to reach break-even levels of trading before the working capital runs out. Actions and decisions are, therefore, heavily focused on getting as much revenue and cash as possible. Once a level of profitable trading is reached and the personal financial risk and exposure start to reduce, the motivation, consequential actions and decision-making start to focus on increasing profitability (rather than revenue and cash flow). As the business achieves a stable basis on which it can start to grow further, the need to minimise financial risk is replaced by the motivation to achieve greater profits and longer-term capital growth in the business, so decision-making becomes a more strategic process. This will be explained in more detail in Chapter 3.

Much of the analysis and discussion of entrepreneurial motives fails to distinguish between those “true” entrepreneurs who are focused on growth, and the owner-managers who may have less ambitious objectives. Here are some examples of the motives associated with highly entrepreneurial people.

- Profit and wealth creation for the entrepreneurs and investors achieved through growth in the capital value of the business.
- Personal achievement and satisfaction (particularly for serial entrepreneurs), self-belief, proof of ability, independent spirit, self-fulfilment – and also, to some extent, the fear of failure.
- Expansion of the business as a better prospect for sale where the exit strategy is the long-term motivation.
- Power, empire-building, competitive instinct, enjoyment of entrepreneurial activity (e.g. Richard Branson, Bill Gates, Robert Maxwell).
- The opportunity and vision to achieve something special, which in the case of social entrepreneurs may be of social or community benefit rather than financial value.

In comparison, more modest entrepreneurs and/or owner-managers might have the following motives.

- Profit/wealth creation for owner(s) via dividends from profits that provide regular income.
- Strengthening the market position or share, to reduce susceptibility to takeover.
- Reducing personal financial exposure, especially where personal assets are used to secure business borrowing.
- Improving profitability by economies of scale, cost savings or better purchasing power (as opposed to increasing profits by growth).
- Creating a steady personal income or comfortable lifestyle.
- Maintaining the business at its current size, to protect the original investment – a more risk-averse, protectionist approach.
- Growing and controlling the business to protect the income and investment (a business-oriented approach).
- Growing the business to protect investment and pass it on to the next generation (the creation of a business dynasty).
- Keeping the business at its current size to pass it on to next generation (family succession or legacy).
These two lists of motivating factors also reflect what are described as the pull and push motives. Pull motives to starting a new enterprise are essentially opportunity based, where, for example, an entrepreneur spots an opportunity in a market to introduce a new product or innovation, or sees a way of making a profit by solving a customer's problem.

The push motives for starting a new business tend to be more necessity based. For example, a skilled person who is made redundant might create an alternative source of employment and income by using their skills or market knowledge and contacts to start a new business. This may well be something they would not have considered if they were still employed and had not been “pushed” in that direction through a change in their personal circumstances.

We also need to consider the different types of motivator for entrepreneurs and their relative power or influence over the entrepreneur’s behaviour. These include the major motivators that have a potentially significant influence in driving entrepreneurial activity or the pursuit of growth, the lesser motivators that are unlikely to drive growth, and the negative re-enforcers that can actually be very important to entrepreneurs, particularly in the early stages of running a new enterprise.

Major motivators/activators include:
- profit/wealth creation
- power and control – building the entrepreneurial empire (e.g. Richard Branson, Bill Gates, Robert Maxwell)
- opportunity and vision
- push factors – e.g. redundancy, lack of employment opportunity, lifestyle change
- personal ambitions – self-belief, proof of ability, independent spirit, self-fulfilment, achievement
- financial pressures – the need for additional income or improvement in circumstances.

Lesser motivators include:
- a secure and regular income (craftsmen/administrators)
- ongoing job and/or personal satisfaction
- creating a legacy for the family future.

Negative re-enforcers include:
- minimisation of debt risk or financial exposure (start-up/early stages of business)
- fear of failure
- dislike of imposed authority.

Smith (1967; in Kirby 2003) identified three types or classifications of entrepreneur.
- Craftsmen: independent loners with limited social links and a focus on production; sole traders who typically operate the more conventional types of business.
- Opportunists: outgoing and self-confident, market-focused individuals who can spot gaps in the market (e.g. for new products) and act on the opportunity.
- Inventors: creator/innovators who have ideas that create something totally new.

Chell, Haworth and Brearley (1991) described four types of entrepreneur – although in fact, they describe one “true” and three “pseudo” types of entrepreneur.
- Entrepreneurs: pursue growth and positively engage in change.
- Quasi-entrepreneurs: innovators, but perhaps lacking the drive for long-term growth.
Administrators: business operators, for example second generation owner-managers, with a focus on profit margins and stability, rather than growth.

Caretakers: these are similar to Smith’s craftsmen – e.g. self-employed tradesmen with little strategic thinking or desire for growth.

Chell, Haworth and Brearley’s typology raises two important points.

- It makes the distinction between entrepreneurs who are aiming for growth and profit and those who are aiming for steady income/stability. This is as issue of motivation rather than personality or characteristics.
- It makes the distinction between first and second generation owner-managers, i.e. start-up entrepreneurs and the managers of small businesses who do not necessarily need entrepreneurial skills to manage the business.

Lessem (1986; in Kirby 2003) identified seven types of entrepreneurial personality, each with a well-known international example and several characteristics.

- Innovator, e.g. Sir Terence Conran (furnishing and retail) – imagination, originality, inspiration.
- Designer/Enabler, e.g. Mary Quant (fashion designer) – intuition, evolution.
- Leader, e.g. Sir John Harvey Jones (businessman/author) – authority, direction responsibility, control.
- New Entrepreneur, e.g. Jack Dangour (high-tech products) – willpower, achievement, opportunity, risk-taking.
- Animateur, e.g. Nelly Eichner (Interlingua) – sociable, informative, culture, community values.
- Adventurer, e.g. Anita Roddick (Body Shop) – energy, movement, health.
- Change Agent, e.g. Steve Shirley (champion of women employees) – flexibility, adaptability, intelligence, curiosity.

The range of Lessem’s entrepreneurial types is quite interesting in that each one does relate to specific entrepreneurial characteristics that are accepted as being important. However, arguably there are others that could be added to the list (e.g. ones with the capacity for networking and accessing resources, or the serial entrepreneur/empire builder). On the positive side, his theory:

- refutes the simplistic view of a single entrepreneurial type or personality
- acknowledges the significance of entrepreneurs to large and small organisations
- focuses on entrepreneurial attributes
- retains the opportunist/risk-taking aspects of the characters, unlike other typologies.

However, one must ask – where do serial entrepreneurs, social entrepreneurs and intrapreneurs fit in?

**Behavioural Characteristics**

As was mentioned in Chapter 1, the Harvard Business School definition describes entrepreneurship as “... the pursuit of opportunity **beyond** the resources you currently control” (emphasis added).

Entrepreneurship is not just:

- about profit and growth opportunities
- about new ventures, new products or new marketing options
Entrepreneurship is about large projects or achievements in small businesses and the private sector.

It is:
- an attitude of mind that encompasses innovation and the use of imagination to achieve results
- a driving force in generating and managing change
- an ability that is equally relevant to the public and non-profit sectors.

Entrepreneurship is a complex and multi-faceted process and, by implication, the entrepreneurs themselves are a complex mixture of attitudes, personality traits, characteristics and motivations. There have been many attempts to define these attitudes and personality traits more precisely, and although there are areas of common ground, no single definition has yet been achieved. This is probably because it is so difficult to gain consensus on the precise definition of an entrepreneur, and on which of the entrepreneurial characteristics are most important.

There are certainly a number of attitudes and behavioural characteristics that are generally accepted as being of primary significance to entrepreneurs. These include the following.

**Abilities.**
- To spot opportunities.
- To take calculated risks.
- To formulate business strategies.
- To create and exploit networks.

**Individual characteristics.**
- Determination/perseverance/tenacity.
- A strong need to achieve.
- Clear focus on goals/objectives.
- Imagination/creativity.
- Independence/self-reliance.
- Show initiative/take responsibility.
- Honesty/integrity (or the appearance of).

However, simply possessing these behavioural characteristics and abilities does not in itself make an entrepreneur, as the key differential factor is the entrepreneur’s ability to apply them to create profitable and growth-focused businesses. Along with these abilities and characteristics go the **attitudes** that are also commonly shared by entrepreneurs and that help them to utilise their abilities.
- The belief that enterprise behaviour is positive/good/not to be ashamed of.
- The belief that opportunities should not be ignored.
- Taking calculated risks is an acceptable business activity.
- Wealth creation/profit is a commendable pursuit.
- A proactive view of change – engage it/manage it.
- People should make use of innovation/creativity/imagination to solve problems.

Bolton and Thompson (2004) integrated these various abilities, characteristics and attitudes to produce the following list of ten key attributes of entrepreneurs. They:
- are individuals who make a significant difference or impact
• are creative and innovative
• spot and exploit new opportunities
• obtain the resources required to exploit opportunities
• are good networkers – building and utilising networks of contacts
• are determined in the face of adversity – resilient and tenacious
• manage risk – evaluating risks and addressing them, rather than avoiding them
• have control of the business
• put the customer first – listening to customers and understanding their needs
• create capital – capital wealth and value in the business.

Using this ten-point list, Bolton and Thompson explain entrepreneurship as being a balance between:
• talent: abilities, e.g. creativity, opportunity-spotting, networking
• temperament: needs, e.g. urgency, responsibility, performance orientation, opportunity-taking; and drives, e.g. dedication, ego, activator
• techniques: skills sets, e.g. individual skills and experience; and personal techniques for developing talent and managing temperament.

Ultimately, it is the entrepreneur’s behaviour, as demonstrated through attitudes, motivations, skills and characteristics, that differentiates him or her from other business managers.

In Section B of Chapter 6, there is an exercise that lists the various entrepreneurial skills, attitudes and characteristics that can be used to evaluate personal abilities and development needs.

**Trait Theory**

Trait theory is the study of human dispositions, and is used by psychologists as a means of explaining personality and its effects on behaviour. “Traits” are stable characteristics that cause people to behave in a certain way; and because traits, in the form of habitual patterns of behaviour, thought or emotion, can be measured (e.g. by personality tests), they can be validated by research over a period of time to assist the understanding of human behaviour. Several attempts have been made in the past to identify the main human personality traits with Cattell (1965) identifying 16 of them and Eysenck (1992) just three. However, the modern consensus of psychologists is that there are five key human personality traits.

- Openness to experience and intellect, including imagination and insight – the primary cognitive trait that also influences learning.
- Conscientiousness – the adoption and use of principled behaviour, to focus behaviour on achieving goals, and controlling impulsive behaviour.
- The level of extroversion (or introversion) a person possesses – shown by how excitable, sociable, talkative, and assertive they are, or how they express emotions.
- Agreeableness – the extent of a trusting, friendly and cooperative nature, including trust, altruism, kindness, affection, and other socially positive behaviours.
- Neuroticism – the extent to which individuals become emotional or upset, with high levels being exhibited in the form of emotional instability, anxiety, moodiness, irritability, and sadness.

Trait theory has also been applied in specific business contexts, for example in explaining the leadership abilities of management by achievement, leadership, motivation, honesty and integrity, self-confidence, cognitive ability, knowledge of business, emotional stability,
creativity and flexibility – overall, quite a substantial and complex list. The weaknesses of trait theory are that, in addition to generating long and complex lists, the selection of key traits and their relative importance can be quite subjective and open to disagreement. In addition, the situation in which a person finds themselves can also have a significant impact on their behaviour, and may override their personality traits.

Elizabeth Chell (Chell, Haworth and Brearley 1991) identified three key traits that applied to entrepreneurs.

- Their need for personal achievement (and presumably, in some cases, the need to be seen to achieve).
- Their locus of control – the extent to which they believe they can personally influence and control the business environment in which they operate.
- Their propensity to take balanced risks.

Chell further explained the entrepreneurial character in terms of their technical skills (knowledge of the products or services and the markets in which they operate), their management skills and knowledge (planning, marketing, finance, human resources), their personal skills or attributes (tenacity, determination, focus, leadership ability) and their entrepreneurial behaviour (the ability to spot opportunities, procure resources, develop networks and make decisions). Interestingly, some of these additional skills and knowledge – particularly relating to management skills, and product and market knowledge – are very similar to those identified in the core traits of leadership.

However, a few years later (Chell 2008) had modified her views. This suggests that trait theory in itself is insufficient to explain the entrepreneurial character, as human personality is not stable across all situations (a weakness identified earlier), and is affected by reasoning, awareness, perception and judgement. She also argued that trait theory and the cognitive approach to understanding entrepreneurs undervalued the importance of human and social capital – whom and what you know, and the use of business networking and social networks, especially in accessing the market and the financial resources and experience of others.

It is interesting that this change of opinion acknowledges the importance of interactive skills in entrepreneurship, particularly the “social capital” aspects of networking and harnessing external resources. These were not regarded as being of any great significance in 1992, but had been recognised as such by 2008, and since then have become a key element in creating collaborative advantage for businesses. In the last year or two, achieving collaborative advantage has been regarded as just as important for innovative businesses as creating competitive advantage was a few years back.

C. THE FAMILY SUPPORT ARGUMENT

It is estimated that 85% of businesses in the EU and 76% of UK businesses are owned by families, and a very large proportion of them are micro-businesses with fewer than ten staff, which involve the owner-manager’s direct family as paid or unpaid employees, as active or silent partners on the business, or as directors or shareholders of the company. Even when members of the family are not involved with the business, the pressures on owner-managers of starting, operating and surviving in business create significant pressures on family relationships, because the business and the family have different goals and needs.
The Need for Family Support

When a new business starts, previous family stability is disrupted, the needs of the family frequently become a lower priority to the owner-manager, and emotional concerns increase, through:

- transferred stress – when the owner-manager brings work problems home
- financial constraints or problems – when business funds are tight, the family may have very restricted income
- issues of trust and confidence, particularly if the owner-manager does not want to worry the family with business problems
- the risk of family assets (such as the home or other property or funds) which are being used as security for borrowing
- the owner-manager working long or irregular hours, or being unavailable to help with running the family
- the use of the home as an office
- lost social life, being unable to take holidays, having little time to relax or spend with the family
- reliance on the domestic partner to manage the home and children.

Carlock (2001) argues that by ignoring or failing to address the problem, the whole situation just gets worse. In the long term, it weakens the business, and may risk the break-up of the family unit, as follows.

Overemphasis on the business erodes:
- family communications – between family members
- family identification – the identity of the family as a cohesive group
- family loyalty – loyalty between members can be damaged
- family time – little quality time for the family to be together
- family emotions – emotions are affected by stress and worry.

Overemphasis on the family erodes:
- business communications
- business relationships
- business and management performance
- objective decision-making processes
- strategic options – long-term options may be limited.

Carlock argues that in order for a small business to have the optimum chance of succeeding, the family and business must be fully supportive of each other; there must be a balance between the business and the family systems to create:

- trust and commitment (on both sides)
- business effectiveness
- family harmony.

He describes this as the Family Effect. It optimises the chances of the business succeeding by aligning business and family goals and objectives via the Parallel Planning Process (PPP).

In PPP, the family’s values, needs, activities, and expectations, are planned alongside those of the business at a strategic level and for the longer term. This is done by matching family
values to management philosophy, family commitment to business strategy, family vision to shared business vision, continuity of the family enterprise to business succession planning and/or future exit strategies.

A similar solution was proposed by Jaffe (2005), who argued that family priorities can hinder strategic progress and business success, so what is required is a two-dimensional planning process with a business strategy board that plans for business growth and development, and a family council that has input into succession planning for the business. This arrangement might be regarded as too formal to be practical in many families, however.

The Opposing Views

Fachler (2003) argues that “most families are incapable of delivering the level of emotional support that most entrepreneurs crave”, and it is totally unrealistic to expect to run a family like a business for several reasons.

• Decision-making processes are different (more emotional/less rational).
• Future plans are likely to change – direct families involved in the business are also influenced by wider family members and outsiders, who may have little knowledge of the business but will invariably have strong opinions about how it should relate to the family and vice versa.
• Young offspring are incapable of making long-term decisions and/or commitments to succession planning. Their focus is much more short term, and their personal interests and objectives frequently change or are influenced by outsiders.
• If the family had previously been run like a business, it probably would not have started the business in the first place!

Fachler claims that we should not encourage entrepreneurs to believe that:

• they should automatically expect emotional support from their family
• no-one should start a business without family support
• they are naturally equipped to handle adverse reactions from their families, alongside the pressures of starting or running a business.

He continues by arguing that the reality in the Western world is that it is quite likely that the initial reaction to an announcement of an intention to start a business will be one or more of the following.

• Questioning of mental health: “You must be mad!”
• A put-down: “Don’t be so damn stupid/irresponsible/selfish!”
• Outrage: “You’ve got a nerve/Over my dead body!”
• A threat/ultimatum: “You’ll be sorry!/Try it and I’ll divorce you!”

Why these strong reactions and objections? Fachler argues that it is a cultural issue – because the Western educational system is geared towards making people employable, and because, in spite of the late 20th century boom in small business formation, self-employment is still not “the norm” or the first-choice source of income for families. The traditional Western argument against starting a business is that:

• you study to become employable
• employability is the main reason for taking academic qualifications
• education is your passport to employment (i.e. a “good” job)
• a “good” job is secure, has career prospects, and has a pension
self-employment does not offer those things – therefore, self-employment is **not** a “good” job.

In summary, Fachler argues that our domestic partners/families are conditioned to regard self-employment/business formation as a second-class form of employment, inherently risky and insecure, lacking prospects, and usually poorly rewarded. Given that perspective, how on earth can we reasonably expect their total support and commitment when we take up such an option?

Fleming (2000) argues that there are seven deadly sins or consequences that primarily arise from family relationships and that can run a family business into the ground.

- Family members’ childhood beliefs and attitudes follow them into the business.
- People fail to recognise that running a business requires different skills from running a family.
- Some parents are unable to accept or treat their offspring as equal adults in either the business or the family environment.
- The demand for family loyalty requires solidarity with family views. Linked to this is the failure to treat members as individuals with their own ideas and the right to express them. The demand for family loyalty can be a major factor in stifling innovation and change.
- “Father knows best” – there is an assumption that elders are always right/beyond challenge, particularly senior members of the family who have established the business.
- Ignoring problems to avoid family conflict or disruption just adds to their destructive potential.
- Children often enter the business before having resolved childhood issues, and this affects the way they work in the business.

Coulter (2003) identifies two further issues relating to relationships between the family and the business. The first is the issue of complex inter-relationships between family members, including the extended family. For example, a family member needs a job, so members of the wider family regard it as an opportunity for the business to help a family member; the family member running the business, on the other hand, regards it as imposing an additional business expense, and needs to consider the effect on other staff of apparent nepotism (creating a job for someone who may not even be suitable, just because they are a family member). Another issue is that of management succession – only 30% of family businesses survive to the second generation, and only 10% to the third generation. The person who might be the natural successor to the family member who has been running the business may not be the most competent to do it, and may not even want to do it. The issue of succession planning will be explored further in Chapter 3.

### The Cultural Factor

Without maligning Carlock at all, it must be commented that although the principles he espouses are admirable in theory, in the current demographic situation found in many inner cities, where the nuclear family as we know it is in the demise, and with the pressures of modern competitive business practice, the principles of PPP may be less than practical and far from realistic. The concept of PPP was developed in the mid-West “Bible Belt” of the USA, in an area where strong Christian beliefs and principles prevail. However, arguably PPP would be of significance in the context of enterprising Asian communities where, although the
religious beliefs are different, there is a similar culture and ethos of strong family cohesion, social responsibility, moral standards and enterprising culture. However, in more cosmopolitan and materialistic multi-cultural societies, where family discipline, standards, and in particular the expectations of younger generations, are very different, it is hard to envisage the application of PPP being accepted, or achieved, in the majority of family businesses. Equally, it is interesting to consider Fachler’s rather forceful argument in the context of many countries in Asia and the Far East that have very strong cultures of family enterprise in which the family unit and family business are closely integrated, possibly for several generations. Here, his argument falls apart, because it is the norm in those cultures for the family members to expect to be supportive of the family business. Some Asian cultures do not bother to think about implementing Carlock’s PPP; they just do something similar as part of their normal way of life.

In summary, family support is a topic that creates quite strong and vociferous reactions, even in normally moderate academic discussions. It is interesting that the strongest opposing views both seem to fail to fully consider the importance of differing family cultures and their implications for each side of the argument.

The best practice model seems to be to focus on business, rather than family, needs, but with due regard to the family as one of a number of important stakeholders in the business.

One final thought as a footnote to this chapter: according to Dr Barbara Murray (Director, Centre for Family Enterprise, Glasgow Caledonian University, UK) entrepreneurs should beware as in family businesses they will invariably have to engage people who have a vested interest.

BIBLIOGRAPHY

# Chapter 3

## Entrepreneurial Motivation and Business Development

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INTRODUCTION

In the previous two chapters, we have discussed the importance of entrepreneurs as ambitious drivers of business growth and wealth creation as opposed to the owner-managers of lifestyle businesses for whom growth may not be a primary objective. We also started to look at how entrepreneurial motives change during the early phases of business development.

This chapter explores some of the issues of business growth and development in more detail, including the relevance of entrepreneurs’ own motives and objectives, the barriers to start-up and growth, the various development options open to business owners, and the longer-term issues of exit strategies and succession planning. All of these need to be considered by entrepreneurs when developing their long-term business strategies.

A. BUSINESS LIFE CYCLES – THEORY AND REALITY

The conventional view of the business life cycle over the last 40 years is based on what is described as the Hockey-stick Curve (see Figure 3.1) and corresponds closely to the marketing concept of the “product life cycle”. Most of the business life-cycle models follow this similar pattern where at start up stage there is negative revenue but as the company grows and reaches its break-even level of trading, and revenue continues to grow until it peaks, and eventually it starts to decline.

![Figure 3.1: Business Life Cycle Model](image)

Depending on which particular model is being considered, the shape of the curve or the title of each stage may change, but they remain essentially similar. For example:

- Gibb and Davies (1990) talked of:
  
  *Initiation – Development – Growth – Maturity – Decline*

- The Churchill and Lewis (1983) model was similar and covered:
  
  *Existence – Survival – Success – Take-off – Resource Maturity*
• Burns and Dewhurst (1996) took the view that, as two-thirds of firms failed within the first ten years of existence, a more realistic model was:
  \textit{Start-up – Incubation – Growth – Maturity – Decline/Failure}
• Greiner (1972) used a similar pattern but described how the progression between one stage and the next had to be triggered by a crisis facing the business, rather than by positive choice on the part of the entrepreneur.

Butler (2006) took a radically different view, explaining that the traditional views of business life cycles were inherently weak and inadequate in explaining how businesses really develop. This is particularly true in relation to the more innovative businesses with high growth potential that might evolve into a different form of existence (or trading status) relatively early in their development by virtue of trade sales, mergers with larger companies, or possibly through stock market flotation to raise investment capital. He highlighted some significant issues that occur because conventional thought is based on the following unjustified assumptions.
• Entrepreneurs all want continuous growth – some will just want to operate lifestyle businesses.
• Firms will continue to grow until they reach a stage of maturity – that doesn’t necessarily happen, particularly with lifestyle firms.
• The maturity stage is \textbf{not} inevitable for all firms – highly innovative firms may continue to grow and evolve, perhaps on an international scale.
• At some stage, firms will inevitably stagnate and decline – serial entrepreneurs, for example, identify exit strategies that involve the sale of the firm, or perhaps its IP, well before the firm reaches maturity or even the peak of its growth.
• There is no allowance for them to jump a stage, to regress, or to exhibit characteristics of more than one stage at any time (Deakins and Freel 2009).
• Most important of all, conventional theories ignore the objectives and motivations of the entrepreneurs themselves, which will be constantly changing, particularly in the early stages of the business!

\textit{Figure 3.2: Business Development Process (Butler 2006)}
Figure 3.2 offers a more realistic view of the small business development process.

B. UNDERSTANDING ENTREPRENEURIAL MOTIVATIONS

Based on the model of small business development shown in Figure 3.2, Butler identified three key steps in the early development of businesses during which the motives and personal objectives of the entrepreneur/owner are critical to the decisions being made during each stage and to the future development of the business (see Table 3.1).

- **Start-up:** business formation and early trading, when the focus is on survival and growing revenue to reach the break-even level of trading before the initial investment funding and working capital run out.
- **Relative stability and consolidation:** after a break-even level of trading has been achieved, when the focus switches from survival to increasing profitability and starting to grow.
- **Growth and development:** where a strategic decision has been made by the entrepreneur or owner to go for positive long-term growth.

If the start-up business reaches break-even level before working capital runs out, progression to the relative stability and consolidation phase is almost inevitable. This is of major personal and psychological significance to entrepreneurs, due to:

- the relief of hitting break-even level, followed hopefully by a steady and increasingly positive bank balance, rather than one that is constantly falling
- the return of self-confidence/suppression of any doubts that the business will succeed
- the stemming of the growth in personal financial exposure.

Two main risks arise at the relative stability and consolidation phase.

- As performance is consolidated and profits improve, some firms become complacent, or too comfortable in the way they are operating, or they just lose the impetus to grow. Whilst movement to the growth and development phase occurs naturally for some businesses, particularly those led by entrepreneurs who have a long-term strategy for the business, many small firms become stuck for too long in relative stability and consolidation phase and fail to move on. In some cases, they simply decide to stay as lifestyle businesses, and not to opt for further growth.
- Business owners may become bogged down in operational issues and lose sight of longer-term objectives. Moving on to the growth and development stage requires an important change in both thinking and attitude, from operational and tactical thinking to strategic thinking to move the business forward again.

The ability to make this culture shift to strategic thinking is part of what distinguishes entrepreneurs from owner-managers. For business owners, it may mean moving out of their "comfort zone", changing managerial processes that have evolved with the business, perhaps delegating certain managerial functions to free up time for a strategic role or letting go of tight, direct control. There is also the potential issue of the owners re-exposing themselves to personal financial risk and uncertainty if additional finance has to be raised to fund the growth of the business.
### Table 3.1: Development Stages for the Majority of Small Firms (Butler 2006)

<table>
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<th>Development Phase</th>
<th>Duration</th>
<th>Primary Business Objectives</th>
<th>Entrepreneur's Personal Objectives</th>
<th>Typical Behavioural Characteristics</th>
<th>Decision-making Processes</th>
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<tr>
<td>Start-up</td>
<td>6 months to 3 years</td>
<td>- Survival of the business&lt;br&gt;- To reach break-even level before working capital runs out</td>
<td>- To achieve profitability at the earliest opportunity to reduce personal financial exposure&lt;br&gt;- Sense of achievement/personal satisfaction</td>
<td>- Accept all available business&lt;br&gt;- Focus on gaining extra marginal contribution to costs rather than overall profitability&lt;br&gt;- Tendency towards headless-chicken syndrome: much activity and effort generating relatively low profit margins</td>
<td>- Primarily operational&lt;br&gt;- Tendency for tactical decisions to be subsumed by the chance of marginal contribution&lt;br&gt;- Focus on short-term returns with little strategic thinking</td>
</tr>
<tr>
<td>Relative Stability</td>
<td>1 to 2 years</td>
<td>- Consolidation&lt;br&gt;- Review and revise the operational processes of the business</td>
<td>- To increase profit to ensure the long-term survival and stability of the business (and to reduce personal financial risk in the process)&lt;br&gt;- Move towards achieving return on capital investment, and repaying personal effort.</td>
<td>- Consolidation of activities; more focus on profitability/profit margins&lt;br&gt;- More selective attitude to customers, e.g. rejection of slow payers and low-profit business&lt;br&gt;- More attention to customer needs, quality and long-term relationships&lt;br&gt;- Tendency to stagnation and complacency in some firms if this phase lasts too long</td>
<td>- Switch from operational to tactical thinking&lt;br&gt;- Initially not much strategic thinking, but this increases towards the end of the phase as a basic pre-requisite of the next phase</td>
</tr>
<tr>
<td>Growth and Development</td>
<td>Ongoing in future years</td>
<td>- Planned expansion to increase market share, turnover and profit&lt;br&gt;- Capital growth</td>
<td>- Expand market share and sales turnover to generate and increase personal wealth&lt;br&gt;- Continue the reduction of personal financial risk (less urgent now)&lt;br&gt;- Expand personal power and influence</td>
<td>- Confidence and stability achieved in the second phase provides the basis for a more adventurous attitude towards the market place&lt;br&gt;- Future growth financed from profits, and external funding now more readily available&lt;br&gt;- Importation or development of more specialist management skills, and increased delegation of responsibility</td>
<td>- Primarily strategic and tactical&lt;br&gt;- Operational decisions tend to be increasingly delegated as business grows</td>
</tr>
</tbody>
</table>
Table 3.1 explains in more detail how, at each of the three stages, the motivations and personal objectives of the entrepreneur can have a major impact on the behaviour and operations of the business, and on the decision-making process, particularly where the entrepreneur is the primary driving force and motivator behind the business. Fundamentally, it is the personal objectives and motivations of the entrepreneur (or the owner-manager) that will determine the development route that the business takes in the small business development model shown Figure 3.2.

C. BARRIERS TO STARTING A NEW BUSINESS

The most common barriers encountered by start-up businesses fall into five main categories.
- Finance (the high cost of capital investment and the difficulty of accessing finance for start-up).
- The strength and attitudes of the competition within the market.
- The staff skills and expertise required.
- Compliance with regulatory requirements.
- The availability of networks and contacts.

High Investment Costs

Service-based businesses are often able to achieve relatively low start-up costs as, apart from the initial cost of acquiring premises, furnishing them and funding staff, they are generally able to finance the operation of the business from revenues once it is up and running. In contrast, new businesses that intend to manufacture and distribute physical goods, or to import and wholesale them, will have a much larger initial capital outlay for production machinery (or stock), storage space, and vehicles for distribution. Typical start-up investment costs include the following.
- The cost of capital equipment and machinery for manufacturing. This can be one of the biggest barriers to start-ups, particularly where it is necessary to purchase specialist or high-cost equipment for production purposes, or to develop prototypes and subsequent mouldings for components or products to be produced by third parties.
- R&D/proof of concept for technology-based products. A major issue for technology-based companies is where the purchase of expensive analytical or processing equipment is required in order to develop new products. Most biotech companies, for example, will require specialist laboratories with positive air pressure and filtering, a range of high-precision instruments, microscopes, centrifuges etc, and they may also need to buy in specialist proteins or chemicals for their analysis. All of this mounts up to substantial costs that will have to be incurred long before any revenue is achieved.
- Staff time/costs for the pre-start-up stage. The longer the pre-revenue development stages of a business, the more funding is needed to pay for the staff involved in that development, particularly where highly specialist technical staff have to be employed. One remedy is to offer those staff “sweat-equity”, whereby they may work for nothing initially, or accept a lower than normal level of pay in return for some equity in the business. This typically takes the form of non-voting shares that will not affect the voting-share equity that is available to attract investor funding.
- Cost of sales and marketing to achieve market penetration. The issues of barriers to market entry are examined in Chapter 4, but essentially where those barriers are high,
the pre-revenue financial costs of penetrating the target market can also be high and must be considered when estimating the start-up capital requirements.

**Accessing Funds for Start-up**

Gaining access to funding to pay for capital investment, and for working capital to start and operate the business, has become progressively harder in the past few years. This is not least because of the “credit crunch” and recession that started in 2008, which made investors much more wary about new companies, and because the banks are much more reluctant to risk lending to start-ups unless the entrepreneur has a proven track record of starting and growing new enterprises. As a result, start-up businesses have become more reliant on friends and family and boot-strapping to acquire the funds they need to get started and to move the business forward to a point where a sufficient customer base is established to enable them to access business angel or bank funding. Here are some of the problems.

- **Borrowing capacity/availability of security.** Typically lending banks do not expect to lend any more than the total sum of investment made by the entrepreneur(s) or other investors. However, the capacity to borrow more than that may be available where the entrepreneurs (or his/her family) are able to offer security. This is usually in the form of a legal charge on private property or a personal guarantee by a person who owns property or some other form of equity with value greater than the sum borrowed.

- **Perceived risk to lenders/investors.** Lenders are typically more risk averse than investors, as an investor will balance the risk against the potential return on investment, whereas lenders’ return is the interest paid on the borrowing, which would normally be lower. Lenders are more concerned with the perceived risk of not getting their loan repaid, whilst investors accept that risk against the prospect of high capital growth.

- **High costs of borrowing.** Large established companies can usually arrange medium- to long-term loans at 3-4% above base rate. Before the 2008 credit crunch, small firms could arrange such loans for 5-7% over base rate, but subsequently that interest rate has increased to 7-10% and short-term overdraft borrowing can be significantly higher (12-15%).

**Competition**

Competition will be examined in detail in Chapter 10, but the main barriers to market entry are:

- **the number of direct competitors in the market, or the number of competitors offering substitute products**
- **the size and resources of competitors in comparison with the proposed business; e.g. do they have sufficient resources to start a price war that would keep new entrants out of the market by undercutting their prices?**
- **competitors’ strength and control of the market in terms of influence and market share – do they have a good reputation and strong brands that would be hard to compete against?**
- **competitors’ attitudes to new entrants – will they be aggressive/neutral/dismissive?**
- **customers’ loyalty to their existing suppliers and their willingness to consider new or alternative products.**
Staff Skills/Expertise/Networks

The main barriers include:

- the extent of the entrepreneur’s own business skills, experience of launching new enterprises, and the ability to manage staff and other resources
- the problems of sourcing staff with specialist technological expertise and/or market knowledge, especially if they are not available locally
- the problems of attracting staff to work in a small business environment. This used to be more significant when larger companies were regarded as more stable sources of employment, but when national levels of unemployment are high, small firms become equally attractive as potential employers
- the ability of the entrepreneur to utilise existing contacts and networks and to establish and develop new networks that can assist or support the establishment and development of the business.

Legal and Regulatory Compliance

There are two aspects to the barriers around legal and regulatory compliance: the initial problem of establishing just what regulations and legislation apply to a particular new business; and finding out exactly what has to be done to ensure compliance. Problems include the following.

- Identifying sector-specific regulations. Most sectors of business have some form of specialist regulatory compliance – e.g. food hygiene and storage in the catering industry, regulations for financial advisers in the investment sector, pesticide regulations in agriculture. On the whole, these regulations are well known within each sector as new entrants are often well aware of them from having worked in the sector before deciding to start a business. The associated costs, if known, can be factored in along with other start-up costs. However, there are some sectors in which the regulatory compliance can have much more substantial financial implications: banks, for example, have to hold a proportion of their assets in liquid form (not that many entrepreneurs will be considering starting a new bank!); and travel agents and tour operators have to lodge substantial financial bonds with ABTA and similar bodies, in case customers are stranded abroad when an operator becomes insolvent.
- Generic compliance – e.g. health and safety/employment law. These are universal regulations, affecting businesses in all sectors. They do not usually form a barrier to start-up but they do present a substantial burden of red tape that can be disproportionately heavy on small firms because of their size and lack of resources.

D. BARRIERS TO GROWING A SMALL BUSINESS

Some of the barriers to business growth and development are similar to the barriers encountered by start-ups, especially access to finance to fund the proposed growth strategies, issues of market penetration and competition, and the entrepreneur’s own abilities and motivations.
Issues for the Entrepreneur

For the entrepreneur, or more typically the non-entrepreneurial owner-manager, the issues include some of the factors that were discussed earlier in this chapter.

- The business owner have too much operational focus and a lack of strategic thinking or planning, possibly because he or she is too busy concentrating on the operational aspects of running the business.
- The owner(s) have no desire for growth, perhaps:
  - due to a deliberate choice of lifestyle business; or
  - because they are satisfied with the current size and profits of the firm.
- Whilst they want to achieve growth, the owners or investors have no desire for further risk or personal financial exposure; the firm is stabilised and profitable and they may have to provide additional security against borrowing to obtain funds to grow it further.
- There is a lack of the necessary strategic/managerial/sales and marketing skills that will be required to implement a growth programme.
- Despite this lack, the owner(s) are wary of employing other managers because of one or more of the following.
  - The fear of losing direct control of the business.
  - The fear of placing responsibility for their investment in the hands of others.
  - A dislike of delegation or inability to delegate.
- The implicit role change from entrepreneur to manager as a business grows does not always appeal to some entrepreneurs who like to retain a hands-on involvement with running the business, rather than having to delegate the operations to functional line managers.

Market and Customer Issues

- The market has limited or no potential for growth – which suggests the growth strategy of the business needs to be refocused on diversification or new product development.
- The cost of further market penetration is prohibitive – the cost or effort involved in gaining additional market share is disproportionate to the profit or benefits it will generate.
- There is an unstable or depressed market environment – the potential return on investment cannot easily be verified or may be too risky at the time in question.
- There is a lack of knowledge or experience of alternative markets within the business – further in-depth market research and analysis are required to evaluate the options.
- There are potential implications for and risks to the quality of service to current and loyal customers – rapid growth may stretch the business resources and become disruptive to ongoing product or service delivery, causing a negative impact on customers.

Financial Barriers

As stated earlier, some of the financial barriers are similar to the financial problems facing start-ups.

- There may be problems accessing the finance needed for growth, perhaps because:
there are no reserves from previous profits
– the company has limited borrowing capacity, e.g. it is up to existing limits, or is highly geared (i.e. has a high debt to equity ratio) so that lenders want to see more equity investment in the business before they will lend more
– there is no security available from the directors or the business assets to use against further borrowing.

• The cost of borrowing large sums and servicing interest payments is too high in comparison with potential revenues and profits.
• There are potential risks associated with the borrowing, e.g. if it is to finance growth for a single large customer. This is a common problem for small firms that supply large corporations, particularly supermarkets, where the buyers have no loyalty to the small suppliers beyond the duration of their current contract. This makes medium- or long-term borrowing a potential risk.
• There is a risk of over-trading: the growth potential may be highly profitable but the rapid rate of growth outstrips the available working capital and causes cash flow problems, and potential insolvency.

Resource Implications

• Where growth makes it necessary to move into bigger and more expensive premises, the costs may be high or hard to service from current sales revenues.
• Extra staff may be needed, along with the associated overhead, administration and payroll costs. Also, aggravation and disputes may arise where owners and managers do not have experience of managing large numbers of staff.
• Major capital investment may be needed in production plant and equipment to match the increased demand resulting from the growth; again, the costs may be high or hard to service from current sales revenues, meaning that the owners have to look for equity investment rather than borrowing.

Organisational Issues

• There is an additional administrative burden from red tape and legal compliance, particularly as micro-firms start to grow and find they have to start developing formal safety and induction policies, discipline and grievance procedures, and risk and hazard analyses.
• The business will need to start employing functional managers or specialists – e.g. HR, accounting, sales and marketing, production, distribution/service delivery – with associated costs and, for the entrepreneur, the issues of delegation, loss of control, etc.
• The structure and culture of the firm may change:
  – from a small and friendly flexible business, to a larger and more impersonal one that requires more formal procedures; and/or
  – so that there is less direct influence from the entrepreneur's own character and attitudes as functional managers are installed between the entrepreneur and the staff.
E. SUCCESSION PLANNING AND EXIT STRATEGIES

Both succession planning and the establishment of exit strategies are activities that all small businesses should engage with as part of their longer-term strategic planning. Some businesses, in particular those developed by serial entrepreneurs, and those engaged in high-tech and high-growth innovation do tend to think about exit strategies at an early stage, usually in the context of selling all or part of the business to cash in on the growth in its capital value. Unfortunately, many family-owned small businesses don’t start to think about exit or succession until something fairly critical (e.g. illness or accident) happens to one of the family members that disrupts the running of the business. Where the critical event is more serious, such as a death in the family, the accompanying grief and stress are doubled by having to keep the business running at the same time.

Succession Planning in Family Businesses

As explained in Chapter 2, it is estimated that 76% of all UK firms and 85% of EU firms are family-owned sole trader or partnership businesses. Of the remaining 24%, a large proportion are small private limited companies under family ownership or control. Only 30% of family firms survive in that form to the second generation, and only 10% survive to the third generation (Coulter 2003).

Ownership and succession problems can arise when the principal owner (or a partner in the business) dies, becomes long-term sick or disabled, decides to retire or sell up and transfer or offer ownership and control to other family members or company directors.

A very small percentage of family firms grow to become large businesses, i.e. public limited companies where succession planning is not an issue because they are controlled by a board of directors. Even where the originator holds a majority of the shares, it is the control and ownership of those shares that are transferred to others, e.g. via inheritance or by the sale of the shares, rather than the total business ownership. The majority of SMEs are either limited companies, in which the originator/entrepreneur or the direct family has a significant if not majority shareholding, or they are family-owned sole trader or partnership businesses.

Ownership or succession problems can occur in a number of situations.

- The sole owner or one of the principal partners dies unexpectedly, leaving no clear management team or line of management responsibility in place. Issues include family disputes over who should take control, family members’ conflicting personal ambitions or objectives, and the future direction of the business. When no plans have been made for transfer of control, there may be immediate chaos because of the need to maintain operations, retain customers, sort out banking arrangements etc, whilst the various issues around who should take control are resolved. An interim manager may be required to keep the business operating properly during this period. Where there is no obvious route for succession of business ownership, then the business owners will need to consider alternative exit strategies.

- The owner or partner becomes long-term sick or disabled and is no longer able to run the business. As in the previous point, this is a critical time if there is no pre-defined line of management responsibility.
• The owner or at least one partner is approaching retirement age and wants to stand down from the business or to pass it on to the next generation of the family but no-one wishes to take control. The owner is, therefore, faced with a decision about whether to sell the business or to employ managers to continue operating it. Issues arising from this can include short-term problems of maintaining operations pending a decision to sell, and the potential conflict of family interests in maximising the value of the sale for the inheritors versus the pressure for quick disposal of the business. Once it is sold, there are further problems around sharing the proceeds of sale and dealing with tax liabilities.

• The owner or one of the partners decides that they want to sell up to a third party, perhaps because of boredom, wanting a new challenge, or simply to realise the asset value of their business share. There may be complex issues around family buy-out options and affordability, the sale of the whole business and the pay-off of the family, as well as personal issues of alternative employment options, and the new owner’s attitude if any family members should stay in the business. It may potentially leave other family members under new management if they are unable to raise the necessary money to buy out the exiting partner; and it is quite possible that a new shareholder will not get cooperation from other family members, or that a new majority owner may not want them actively working in the business.

• The domestic situation of the owner or one of the partners changes, perhaps due to impending divorce or to the illness of another family member, forcing them to sell their share of the firm. As with the previous point, there are issues around other family members being willing and able to afford to buy the share, and the concerns around introducing outsiders into the business if they can’t afford to buy it.

• The principal owner dies, becomes long-term sick or disabled, or decides to retire or sell up and transfer ownership and/or control to other family members, leading to issues over which of the potential inheritors has the right business skills and abilities to keep the business operating profitably. There may also be disputes between family members, because of nepotism, jealousy, and conflicting personal ambitions or objectives, etc.

• At least one of the partners dies, decides to leave the business or sells their share of it. Issues include the valuation of business assets, the affordability or willingness of the remaining partners to buy the partner(s) out, legal issues around partnership cessation, and a negative impact on customer goodwill.

• Venture capital investors want to achieve their contractual planned exit from a business they have invested in, leading to potential issues of valuation, options for buy-back by the original owners (if they can afford it) or stock market flotation. There is also the risk of litigation for potential breach of contract or liquidation of the business if the venture capital investors are unable to realise their expected return on investment.

It is quite often the case that when one or more of these situations occurs, the family of the owners suddenly find themselves in a situation that has never really been considered or discussed before. Suddenly, there is a whole host of contentious and inter-related issues that have to be addressed and managed, many of which will contribute further stress and/or distress to the circumstances that have caused the situation in the first place. Here are some typical problems that can arise.

• Sudden chaos due to lack of prior planning can occur, particularly where the people involved have never considered (or have deliberately avoided consideration of) the fact that there will eventually come a time when the ownership or management of the business may have to change. The combined pressures of the circumstances – for example, if the family member in question is seriously ill – and the ongoing
management of the firm, plus the management of the change, can create huge stress and tension in some family situations, although equally it can draw other families closer together.

• There is often disagreement about who should lead or take control of the firm, particularly after the death of the head of a family firm. The members of the next generation (often prompted by their own domestic partners) can find themselves in a situation of conflict over who should take control of the firm, and over their respective roles and involvement.

• Following on from the previous point, there is often conflict amongst family members as to the future of the business. One person may want to continue the family firm whilst others insist on selling it either because they have no interest in it or because they want to turn it into cash to use for other purposes. This type of situation, where family members have conflicting personal objectives, is potentially the most acrimonious as far as the family are concerned.

• Even where the continuation of the business is in itself not an issue, the situation can arise where family members disagree as to the future direction of the business; for example, whether it should continue to trade as before, or whether it should start to expand and grow. A lifestyle business that previously supported the originator and his or her family may not be sufficiently profitable to support the widow or widower and the families of the next generation who have inherited the management of the firm.

• The family members faced with the running of the firm may be totally unsuitable or inadequate in terms of the skills and experience needed to manage the business efficiently and effectively. In the short term, this may just be a case of being unfamiliar with the way the business operates which can be overcome quite quickly. However, if there are severe gaps in the skills or abilities of the family that could damage the long-term efficiency of the firm, then unless that can be resolved (e.g. by bringing in a manager from outside of the family) the firm is at threat. Even the suggestion of bringing in an outsider can create further complications if any family members refuse to accept that necessity, or refuse to allow a non-family member to manage the firm without excessive interference.

• The threat of Inheritance Tax can be a major issue in the event of the sudden death of an owner-manager where there had been no previous planning or provision to minimise the tax liabilities for the next generation. With Inheritance Taxes in some countries being set at 40% of the value of a deceased person’s estate (which may include personal property and possessions as well as business assets), it is not unheard of for inheritors to have to sell the business or some private property to pay the tax bill.

• It is not uncommon for the next generation of a family to be totally uninterested in the continuation of the business, especially as the younger generation may have careers of their own. It is, therefore, unrealistic for the business owner to assume that the next generation will want to give up their own careers to take over the business. In this situation, it can be hard for the head of the family to accept that the effort that has been expended in creating and developing the business will not be carried on, and to face the option of employing a manager or putting the firm up for sale.

• Where the business is to be continued by at least one family member, it may be demotivating for existing staff and managers in the business who may see it as the loss of any future chance of advancement or promotion.

• Finally, intertwined with all of the previous issues will be the problems of human emotions that inevitably occur in direct and extended families: jealousy, animosity, greed and potential conflicts of personal ambition. These are often aggravated by the
domestic partners of the successors to the business or by the extended family, if long-standing family arguments or grievances resurface after being dormant for years. That, however, is just human nature – and it is said that there is nothing like a family business to set a family arguing with each other!

For a family-owned business, it is important to establish and review succession plans on a regular basis – ideally at least once per year – and to communicate any changes in the plans to all relevant parties. Most well-established businesses use some form of business continuity plan, especially for their ICT system, as a back-up in times of emergencies. For family businesses that have no external board of directors to rely on, the succession plan effectively forms part of the business continuity plan by specifying who will take control if the business leader(s) are no longer around.

Good practice in succession planning follows a number of basic principles.

- It should be commenced years ahead of when it is needed, and ideally at the outset of the business.
- The options should be examined in the context of the overall skills, abilities and personal objectives of the owners: not just whether or not they have the necessary skills to operate and grow the business in the longer term, but also whether or not they have any interest or inclination in doing so.
- If the inclination to continue the business is present, but the skills are lacking, then actions can be defined to get the necessary skills in place for when they are needed, and transfer of control can be staggered over a period of time.
- A risk analysis must be an integral part of any succession planning process to identify potential risks and to formulate the necessary contingency plans to deal with them if they arise.
- It is in the best interests of the business and all of its stakeholders that succession plans should be published to stakeholders to remove any possible confusion and to give time to address any objections. The confidence of banks, key customers and suppliers in the future of the firm will be sustained if they are aware in advance of the proposed changes and their implications.
- Long-term planning for succession is also essential for the long-term planning of potential tax liabilities, both for owners or directors wishing to exit the company and for those that will remain or replace them. Careful planning to minimise tax liabilities for the inheritors, and the financial impact of that on the cash reserves of the business, should be started as early as possible.

**Exit Strategies**

It is important for entrepreneurs to consider their exit strategies on an ongoing basis throughout their involvement in the business. This is not only because they need to be able to plan how and when they will leave or sell the business, but also because the decisions they make about investment and growth (or otherwise) may impact on the potential exit point, or the exit strategy may influence investment decisions.

Serial entrepreneurs and those planning high-growth and high-tech start-ups tend to integrate their exit strategy with the business plan, so they know at approximately which stage of development they will sell. For example, it is quite common for entrepreneurs involved in biotech start-ups to develop the technology to a point where it is proven and tested and has IPR protection, so that the business has grown substantially in value but growing it further will
require considerably greater external investment. The exit route in this case would typically be a trade sale to a larger rival company, which would buy the company and its IPR, or to a specialist biotech venture capital firm, which would invest in the next stage of growth before realising its profit through another exit route.

Examples of exit strategies include:

- family succession plans – the exit is achieved by transfer of the business to another family member or a manager appointed by and responsible to the family
- sale of the business as a going concern – a trade sale to another company in the same market, or to a company using an acquisition strategy to gain a foothold in the market
- merger with another firm in the same market to create a larger business in which the original owners of each business may retain a shareholding in proportion to the value of their own original business
- sale to staff or managers within the business, called a management buy-out (MBO)
- sale to a venture capital investor or investment institution
- sale by a venture capital firm back to the entrepreneur or to a rival company
- Initial Public Offering (IPO) – a stock market flotation to raise capital and to enable the original shareholders to recover capital (and profit) from their original investment
- sale of business assets, including IP, and voluntary closure
- liquidation – possibly voluntary in the face of financial problems, but more often enforced by banks or creditors.

When most entrepreneurs talk about exit strategies, they are usually referring to their own exit from the business: either selling it to a third party for profit; or passing it on to a relative or installing a manager to run it for them as part of retirement planning. In the context of venture capital funding, it is the venture capitalists who are planning their own exit from the business. For an entrepreneur who wants to raise capital to expand, venture capital is an attractive proposition as it offers interest-free equity, usually accompanied by supportive business expertise from the venture capitalists. In return for the risks that they take, venture capital companies expect to make their profit primarily from capital growth as opposed to dividends from profits. The investigative process of due diligence by the venture capital investor is quite rigorous but once it is completed, an agreement is formulated wherein, after a specified period of time, the venture capital company “exits” the business by an pre-agreed process so that the capital growth can be realised. The specified period of time is usually three to five years, but can be as much as ten.

The method of exit varies, but typically it involves one of these three options.

- An IPO (floatation of the company shares on the Alternative Investment Market or similar). This gives the entrepreneur the option of realising his or her share of the growth at the same time, by selling all or part of the shareholding, if desired.
- The sale of the business to another firm in the same market, known as a trade sale. This usually requires the exit of both the venture capital company and the entrepreneur, unless the entrepreneur makes a private arrangement with the purchasing business to stay on.
- Receivership, if the company fails, or liquidation, if the venture capital company decides that the investment is no longer viable and wants to sell the assets to realise some cash.
F. ENCOURAGING BUSINESS GROWTH

As discussed in Chapter 1, SMEs are considered to be of vital importance to national economies because of the jobs they create for the voting population, the tax revenues that governments reap from their profits to pay for public spending, the foreign currency and revenues they bring in from export trade, the technological innovations and IP they create and take to market, and the capital wealth they create through their growing balance sheets. However, in spite of all this, they still take second place to their larger corporate counterparts, which, although they may have their profits partially shielded from tax in overseas tax havens, still have power and influence and lobbying capability to retain the ear of government ministers, and the power to raise huge amounts of funding from the banks and stock exchanges.

The problem for SMEs is that whilst they may be large in number, and their aggregate contribution to GDP is huge, individually they remain small and without much influence. Also, their highly independent entrepreneurial owners, particularly in developing countries, have neither the will, the inclination nor the spare time to band together and lobby governments for the support they need. Even in developed countries where there is a representative organisation (e.g. the Federation of Small Businesses in the UK and Gibraltar, and the National Small Business Association in the USA), such organisations are reliant on having a strong and vociferous leadership to make their case heard to governments, in contrast to the representative organisations of large corporations that are more readily invited to participate in government consultations.

There are a number of potentially conflicting issues resulting from government policies that impact on the operations of small businesses, including:

- the need for regulatory controls for businesses, and the disproportionate impact this has on the resources of small firms that do not have the spare staff to manage the extra workload or reporting requirements
- the tendency of governments to regard small enterprises as the solution to economic downturns, whilst simultaneously cutting back on support services for those businesses to save money, at a time when the support is most needed
- the lack of continuity of business support caused by changes in national and regional government, particularly after national elections that result in a change in the political party holding power – each new government “knows better” than the previous one just what small businesses are supposed to need
- the lack of coherent funding support, e.g. for small start-up grants, low-interest loans, loans or support for market research especially in export markets, and skills training for staff. Financial support for small businesses is frequently the first to be cut at times of budgetary constraint
- the lack of affordable finance and loans due to the reluctance of commercial banks to lend to small firms, not least because they are regarded as being high risk, and often cannot provide the security (in the form of property or guarantees) that the banks want. Where unsecured loans are available, the associated conditions or approval criteria are often so tight that small firms cannot get approval. The Government Loan Guarantee Scheme for small businesses has existed in the UK for over 30 years and has been re-invented and re-branded by successive governments. Up to 80% of the value of loans to small firms is guaranteed by the Government with the lending banks taking the risk of the other 20%; but the acceptance criteria for loans that are set by
the Government are so tight that banks struggle to get approval for enough to hit their targets for lending that are also set by the Government!

Creating the Right Conditions to Facilitate Growth

There are a number of ways in which governments can create the right environment and fiscal conditions to encourage the development and growth of new enterprises. These include:

• providing business support expertise – training and advice for start-ups, mentoring and guidance for business development, and specialist support for innovative high-tech or high-growth start-ups that will potentially create a lot of new jobs
• assisting with access to loans and investment funding – by establishing investment funds from public and private sector sources, or by collaborating with banks to make loans easily available to small firms at reasonable rates of interest
• setting enterprise-friendly taxation policies – e.g. tax allowances for the owners of start-ups and small firms in their first year of operation, or reductions on taxes on employees to encourage firms to take on extra staff
• providing tax incentives to encourage risk investment – e.g. Enterprise Investment Schemes that offer tax allowances for investors who put money into small firms at their own risk
• providing start-up loans and grants for innovation development – R&D/proof of concept grants and loans for new innovations
• encouraging collaboration with academic research – subsidies to allow small firms to buy in specialist academic expertise, e.g. for new technological product development
• encouraging development partnerships with larger businesses – enabling small firms to identify and contact large corporations with overlapping areas of interest. Some large corporations issue "shopping lists" of new technologies they are interested in, and will support smaller firms that are working in those areas with funding and technical help
• supporting international market access and export trade development – facilitating trade missions, or enabling firms to access overseas market contacts via staff based in overseas embassies or consulates.

One of the most productive ways of supporting new and early stage businesses, and which does not have to rely on government funding, is the provision of business incubation facilities. Business incubators are used throughout the world in both developed and developing countries, and are funded in various ways – by central, regional or local government, universities, economic development agencies, and commercial property developers. There are also a number of national and international business incubation associations that support incubator operators and promote innovation and best practice across the service. The largest is the National Business Incubator Association which is USA based but has over 1,900 members from 60 countries; the European Business and Innovation Centre Network has over 240 member incubators and associates across 25 EU countries, and 11 countries outside of the EU.

The forms of incubator support vary from place to place, but can include the following.

• Provision of dedicated incubator space in specially designed business incubator buildings or innovation centres. These are typically offered for a fixed period of time at low cost, and may include business support services, e.g. reception services, the use
of meeting rooms, fax facilities and broadband connections. Business incubator buildings may restrict occupancy to three years to allow new start-ups to continually access space, but innovation centres are often larger and can be more flexible, often allowing firms to expand into larger spaces as they grow.

- **Flexible licences to occupy space** (as opposed to fixed-term leases). This means that small firms can move in or out without having to give long periods of notice to their landlord, and they can upgrade from a small space to something larger if they grow much faster than expected. This flexibility is regarded by tenants as one of the major benefits of being in a business incubator.

- **Dedicated space within other buildings**, e.g. university campus sites, industrial estates or business parks. Again, these may have low rents and may include a range of support services. They may also include the provision of wet labs or workshops for R&D purposes, or access to specialist equipment that individual small companies might not be able to afford to buy.

- **Business support expertise**, including professional advice (legal, financial and marketing), mentoring for individual companies, and access to loans or investment funds. The support services may be provided within business incubator facilities or may be free standing, and the model of provision varies in different countries and locations. In some cases, it is provided by public authorities or universities; in other cases, by private economic development organisations or inward investment agencies.

- **Specialist business support for high-tech start-ups**, start-ups with high growth potential and early stage businesses. This is similar to general business support and mentoring but with added support for such things as access to R&D resources, IP protection, support to access international markets, and access to specialist growth funding. This is a relatively new concept and frequently involves collaborative support from universities and economic development agencies.

**Sources of Business Support and Information**

Some of the most common types of business support agencies used by small firms include the following.

- **Chambers of commerce** – for networking and information events, export documentation support, and international contacts.
- **Local enterprise agencies and partnerships** – for business start-up support and advice.
- **Economic development agencies** (public or private sector) – for support in developing trade at regional, national or international level, or within specific trade sectors.
- **Inward investment agencies** – which encourage incoming businesses by helping them to establish branches of their business in new countries.
- **International trade agencies and overseas embassies** – to facilitate market contacts for exports and international trade.
- **Export documentation and export credit services** – these manage the often complex paperwork involved in import and export activities.
- **Private commercial banks with international coverage** – for making introductions to overseas contacts, using the banks’ international locations and networks to assist with access to overseas markets and with the financial transactions for overseas trading.

The following websites are just a few examples of potential information sources that are available for market research and information about competitors.

- **Frost & Sullivan** – market research reports – www.frost.com
Here are some examples of national and international chambers of commerce, which can be used for obtaining market access advice and support.

- British Chambers of Commerce (BCC) – lists of accredited UK chambers of commerce and BCC chamber locations abroad – www.britishchambers.org.uk/
- Russo-British Chamber of Commerce – www.rbcc.com
- China UK Business Association – www.cccb.org.uk/
- Paris Area Chamber of Commerce & Tourism – www.parisilchamber.com
- Japanese Chamber of Commerce and Industry in the UK – www.jccj.org.uk
- British Romanian Chamber of Commerce – www.brcc-ccbr.org

The following websites can be used for international market access information.

- National Business Incubator Association – www.nbia.org
- European Business & Innovation Centre Network – www.ebn.be
- World Association for Small and Medium Enterprises – www.wasmeinfo.org
- Asian Association of Business Incubation – www.aabi.info
- Indian STEPs and Business Incubators’ Association – www.isba.in

Here are some very proactive inward investment agencies in different countries.

- Locate in Kent (UK) – www.locateinkent.co.uk
- Fairfax County Economic Development Authority (Virginia, USA) – www.fairfaxcountyeda.org
- Toronto Economic Development Corporation (Canada) – www.tedco.ca
- Montpellier BIC (France) – www.montpellier-technopole.com/bic
- Technopolis Vantaa (Finland) – www.technopolis.fi/en/technopolis/Space/vantaa/

Here are examples of several international banks that support small businesses in trading internationally and have quite extensive branch networks.

- HSBC Bank – www.hsbc.co.uk
- Standard Chartered – www.standardchartered.com

**BIBLIOGRAPHY**

# Chapter 4

## Innovation, Creativity and Enterprise Cultures

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INTRODUCTION

This chapter is concerned with understanding the concepts of innovation and creativity, how they relate to each other, and why they are important in enabling businesses to achieve and maintain competitive advantage over their rivals. They are also vitally important to governments as the source of new ideas, innovations and inventions that businesses can sell and export, to create new employment opportunities and capital wealth for the benefit of national economies. The chapter will also review some basic theories of innovation, current thinking on how innovation can be used in business, and how both businesses and other organisations can encourage and create a culture of innovation and creativity.

Technological innovation often requires significant R&D and financial investment, which is more readily available in universities and large corporations. However, large corporations are also more selective in the way they exploit or commercialise new innovations, and they tend to focus on the innovations that are most closely aligned with their strategic business activities and objectives – unless an opportunity arises to create a major new monopoly market that will generate huge profits. Even then the process of getting support to take a new idea to market can be slow when company policies or priorities may need to be changed, or because of internal company politics or rivalry for limited development resources. Innovations that do not fit with core strategies or do not have an immediate or obvious commercial value may just be put on the shelf for possible consideration in the future; worse still, they may be just locked away so that rival companies can’t benefit from them.

Entrepreneurship and innovation are inextricably linked, and not just because the flexibility that small enterprises can demonstrate in response to gaps or changes in markets facilitates innovation. It is also because it is generally very hard for small businesses or individual inventors to sell their ideas to large corporations, so the obvious way for them to commercialise new innovations or inventions is to take them to market via a new enterprise established for that specific purpose.

A. UNDERSTANDING INNOVATION AND CREATIVITY

Innovation is essentially the process of commercialising new ideas in some form, whether by bringing new inventions or products to market, offering new services to customers, or introducing improvements or cost savings in the way goods and services are provided. The UK Government’s definition of innovation is “the successful exploitation of new ideas”, and within that process of exploitation there are two challenges.

- The challenge in innovation is to transform creative ideas into tangible products or processes that will improve customer services, cut costs, and/or generate new earnings.
- The challenge for managers is to use strategic innovation to create business growth and increase capital value.

The implication of this definition is that it is about commercial applications of innovation, the success of which is primarily measured in financial terms through the value its exploitation produces – e.g. by generating revenue, cutting costs, or creating capital value. It must be remembered, however, that innovation is not confined to commercial business. It can equally be utilised in the public sector or in charities and not-for-profit organisations to improve
services to customers or clients, and where the outcome may also be measured in terms of social benefit.

Creativity is closely related to innovation but is more about the process of generating new knowledge, ideas, concepts or technologies that may or may not subsequently form the basis for new innovations. It is a product of the human mind, but it is also a skill that can be encouraged and developed in individuals.

**Definitions and Explanations of Innovation**

As explained earlier in this chapter, innovation is a process of utilising ideas to generate something new or unique which has some form of tangible or measurable value. The innovation process can take a number of forms.

- Challenging existing thinking, methods of practice, and accepted norms to change attitudes or the way things are done.
- Using creativity and imagination to generate alternative and profitable solutions to problems.
- Anticipating future customer needs, often before the customer does. Henry Ford, who introduced the first mass-produced cars, is reputed to have once said: “If I had asked the customers what they wanted, they would have said a faster horse”.
- Stimulating change by applying imagination to opportunities – the process of envisioning what products or services could be developed in the future to create new consumer demand. This is different from the anticipation of future developments within a market (such as cars) as it is more about “blue sky thinking” that will create new markets for the future, or new solutions to problems.
- Applying new technology to businesses processes and markets to create new or additional value – perhaps through cost savings, improved performance, or better quality of service.
- Connectivity – harnessing resources, utilising network contacts, people, opportunities and ideas to stretch beyond existing boundaries, and to make the innovations happen. This type of activity is one of the strongest characteristics of entrepreneurs and they have been doing for years. However, its application to technological innovations, especially those involving knowledge transfer collaboration, is now being labelled by academics as “collaborative advantage”, on a par in terms of importance to market development with competitive advantage.

There is more to innovation than developing new products and services. It can also include:

- innovative ways of delivering existing services, e.g. the introduction of online shopping and home delivery by supermarkets
- new ways of informing consumers about products and services or promoting them to the consumers, such as the use of multi-media advertising via text, email, and social networking, as well as well as the more traditional platforms of TV, radio and newspapers
- new ways of organising resources to produce or deliver products and services, such as outsourcing HR support functions, or contracting out distribution services to reduce overheads
- new approaches to the management of relationships with customers and suppliers via supply chain management. An example is sharing online data about stock levels to facilitate just-in-time (JIT) delivery and minimise the costs of holding and storing stock.
Small firms often lack the resources to drive innovation but do have the energy and flexibility to facilitate change that is often missing in larger firms. This is due to a number of factors. They have highly committed leaders with a future-focus, and they regard innovation as integral to business evolution. They have more customer and market awareness, along with the ability and flexibility to configure customer relationships, which is often lacking in larger organisations. This means that although large corporations may have the resources to dedicate time to searching for and spotting new market opportunities, the smaller companies, which are more flexible and market aware, are more inclined to exploit those opportunities when they arise.

However, smaller firms are disadvantaged in other ways, as they often lack capital to finance new developments and banks are not necessarily prepared to lend the seed capital to fund innovation. Funding innovations can be difficult: they are often too small to be of interest to venture capitalists or investment institutions; but commercial lenders and private investors cannot easily handle the risk-assessment process to evaluate the investment potential of high-tech innovation. Also, small firms often lack the capital to protect and subsequently defend the IPR of their innovative ideas, and so have to adopt a first-to-market strategy to get their innovations branded and recognised as market leaders before competitors emerge.

Drucker (2006) described Seven Sources – events or occurrences that provoke or generate ideas that potentially lead to new innovations.

- Unexpected happenings – chance events that can lead to the development of new ideas or potential opportunities.
- Incongruous happenings – similar to unexpected happenings but, for example, the event triggers an unrelated idea.
- A need for process improvements – demand-led ideas resulting from a problem or need.
- Changes in industry or market structure – possibly resulting from changing customer demand, but equally likely to be generated by the need to make cost savings, improve profitability, or to keep pace with competitor activity.
- Demographics – changes in demand resulting from social change, especially in specific demographic or age groups.
- Changes in perception, mood and meaning – e.g. the emergence of environmental awareness and the need for energy conservation.
- New knowledge – the development of new technologies offering new opportunities.

To these we can also add:

- customer-led identification of needs or opportunities – sometimes described as open-source innovation
- ideas led by continuous improvement, resulting in incremental innovation
- technology-push innovations where changes in technological capability create new products or services which customers did not realise they needed until they used them. Examples are Henry Ford’s early motor vehicles and modern search engines
- market-pull innovations such as mobile phones where the market and marketing process create the need for the products or services.

**Creativity and the Human Brain**

The two most imaginative groups in modern society are said to young children and criminals.
• Children, because their imaginative ability has not yet been damaged or corrupted by the education process that seeks to induce social structure and compliance with social norms in order to make them good citizens who will work hard and pay their taxes. If you give a group of young children a big cardboard box to play with, their imagination will find a dozen uses for it, from an imaginary house or truck to a boat to tow down an imaginary river. However, as they grow older they become almost embarrassed to display their imagination, to the point that business employers often have to retrain their staff to think creatively.

• Criminals, because when they are imprisoned their lives become heavily regulated and controlled, and virtually the only outlet or challenge for their imagination is to find ways to subvert or beat the systems that control the way their lives are run until they are free again.

The human brain is an incredibly powerful organ with 10,000 billion cells that are interconnected in a highly complex manner, creating an incredible number of alternative routes for messages to be transferred. It is estimated that the brain could be capable of processing 20,000 billion calculations per minute, although only a small part of that capacity is used by an average person. The brain has two main parts.

• The lower (or reptilian) brain controls the sub-conscious, and the more routine and mechanical bodily functions such as breathing, blood pressure, body temperature and chemical processes.

• The upper brain, which has a left and right side to it, deals with the intellectual functions.

Psychologists have discovered that the way the two halves of the upper human brain function and the relative strength of these two halves play an important part in the level of creativity a person shows, because most people have a dominant side of their brain. This dominance also influences some of their thinking and characteristics. Furthermore, the level of creativity can be enhanced with the right kind of training and development.

Essentially, the left-hand side of the brain controls functions such as the logical thinking process, language, expression of emotions, order and pattern perception, reading and writing, tracking of time, and remembering names. People with a more dominant left side of the brain may exhibit a preference for straight-line logical thinking, moving step by step from a problem to a solution. They are focused on reality, look to the past and present, and prefer factual and written information and subjects such as maths and science. They may be risk averse, or may be uncomfortable when forced to think for themselves.

In contrast, the right side of the brain controls creative and artistic activities so that people with a more dominant right side prefer visual stimuli such as pictures and objects, and prefer diagrams, maps or graphs to written instructions. They are ruled by emotions, look to the present and the future, respond to personal relationships rather than authority, and may be easily distracted. They are also impetuous, imaginative, love creativity, act intuitively and are willing to take risks. This makes them much more creative than the logical and rational thinking people who have a more predominant left side of the brain.

For businesses and employers, this has significant implications for recruiting and developing staff. Clearly for job roles such as lawyers, accountants, IT or software specialists, engineers or business analysts, someone with a stronger left side of the brain would be more appropriate; whereas for a design, marketing or advertising role where imagination and creativity are needed, someone with a right-brain preference would be more suited. There are also people whose brains are in balance, with no left or right dominance.
The dominance of one side of the brain or the other is not a permanent and unchangeable feature. It can be tested with a fairly short and simple questionnaire, and it has been found that the dominance may change over a period of time for people who change job roles from a financial or analytical role into a creative role (or vice versa). The implication of this is that creativity is something that can be encouraged and developed in people. After all, if we can educate natural creativity out of children when we send them to school, then we should equally be able to re-educate adults to be more creative with the use of creative thinking training and techniques.

However, although creativity can be encouraged with training, it also needs the right culture to thrive. This means that if we want to get staff to be highly creative, imaginative and innovative, the culture in which they work has to facilitate that. This issue will be explored further in Section E of this chapter.

### Barriers to Creativity

As explained earlier in this chapter, children are highly creative individuals, but we educate much of that creativity out of them at school, in the process of making them good, employable citizens, by teaching them mathematics, language, logical thinking, rules and expected norms of behaviour and social compliance. This was not so bad at a time when large manufacturing companies employed many workers in fairly unskilled and unchallenging jobs; and where even the skilled workers followed standard operating procedures and were closely supervised via a rigid management structure.

This situation has changed as large-scale manufacturing based on human labour working for big corporate companies has been replaced by technology and automated production; and with the growth of huge numbers of small firms that are more involved in providing services to customers, rather than physical goods. These smaller businesses need staff who can be flexible and who can use their initiative to help customers.

Unfortunately the pace of educational change has not followed the commercial and industrial world. Although enterprise activities and creativity are gradually being introduced to the school curriculum, a large proportion of the working population find it hard to respond to the need for creativity. There are several reasons for this.

- First, the need to become more creative or to use personal initiative or imagination often takes individuals out of their comfort zone. Not only does it turn the traditional boss–worker relationship on its head, but staff also find it hard to understand and accept the added responsibility they are being given unless they are provided with parameters and clear and specific guidelines on just how much imagination they can use, just how creative they should be, when they should be doing it, and at which point they should stop before they exceed their new remit.
- Many people find any form of change threatening, especially where it is not fully explained to them and/or sold to them as benefitting both the employer and the employees. If the change is to work, they must be encouraged to buy in to it.
- There will always be a proportion of people who just come to work to earn a regular wage, and who are not interested in taking on extra work or responsibility; especially if it requires any personal effort or carries any perceived risk.

Von Oech (1998) identifies ten blocks to individual creativity, and suggests that the realisation that these blocks exist within each of us can be the first step in dismantling them.
1. **Trying to Find the “Right” Answer.** This is about the almost inevitable desire we have (as a result of the formal education process), when asked a question, to want to give the right answer – although exactly what that right answer may be is hard to tell when there may be several options, or when the questioner may have a different perception to us. If we are unsure just what the “right” answer is, it may be easier to just keep quiet than to use our imagination and risk getting it wrong.

2. **Logical Thinking.** Logical (or straight-line) thinking and critical thinking skills based on logic are valuable tools, especially for use in evaluating the feasibility of a creative idea. However, logical thinking ability can block or inhibit the development of creative thinking. One solution to this blocker is to encourage people to use metaphors (or metaphorical thinking) as we accept these concepts when we communicate without feeling the need to analyse them logically.

3. **Following Rules.** One way to view creative thinking is to look at it as a destructive force, because it tears up the often arbitrary and accepted rules and conventions that others have set by challenging convention and by asking “why” we should do it this way, or “why not” try something different. People dislike perceived rule-breaking or challenging established conventions, and will often try to avoid it.

4. **Being Practical.** It is important not to challenge developing ideas, designs or inventions on the grounds of practicality before they have been fully developed as that will stifle them before they can show their true potential. In Von Oech’s words: “Don’t allow the editor into the same room with your inner artist”. Use “what if?” questions and let your imagination run free.

5. **Play Is Not Work.** Allowing your mind to be at play is perhaps the most effective way of stimulating creative thinking, and yet many people disassociate play from work. The process of relaxing and using external (non-work) activities to develop a different approach to solving a work problem can generate great ideas and solutions.

6. **That’s Not My Job.** Don’t let your job description define the parameters of your imagination. This is about the need to allow yourself to explore beyond the given boundaries of your own job role to gain a broader understanding of the context of problems in order to apply creative thinking to that more integrated picture.

7. **Being a “Serious” Person.** Most of what keeps us civilised boils down to conformity, consistency, shared values, and thinking about things the same way that everyone else does. Von Oech argues that this “group think” approach limits creativity and that if people really want to be creative, they should take on the role of the “fool” and give themselves permission to turn the accepted norms upside down.

8. **Avoiding Ambiguity.** Our rationality allows us to argue that most situations are ambiguous to some degree. So, although dividing complex situations into black and white boxes can lead to disaster, we still do it because we have an innate desire for certainty. The creative thinker needs to reject the false comfort of clarity when it’s not really appropriate, as ambiguity is your friend if you’re looking to innovate.

9. **Being Wrong is Bad.** Making mistakes should be regarded as a natural and acceptable part of the creativity process, as long as we learn from those mistakes. However, at the same time, creative thinkers should not be afraid of mistakes, as if we are not allowed to make mistakes, we will never learn from them.
10. I’m Not Creative. People should not deny their own creative capability as that in itself places a limit or restriction on their capability. Everyone has inherent creativity but that has to be recognised as the first stage in becoming more creative.

The Creative Process

Creativity as a process is important for the development of new ideas, new inventions, new ways of doing things to save money or improve products or services, and for the benefit of customers. Creativity as the feeder of ideas for new innovations is important to businesses to enable them to develop new products and services that will give them competitive advantages over their competitors, and will enable them to grow in size and capital value through increased profits. It is equally important for national governments because that same business growth creates more jobs for the population, and generates tax revenues and foreign currency from export sales.

Although it is important for entrepreneurs to focus on creating commercial opportunities that lead to new products/services for the reasons just described, it is equally important to appreciate that out of every 11 ideas only one will be successful (Page 1993). In reality, this figure may be quite low, particularly regarding knowledge-based industries and technologies: for example, most pharmaceutical companies reckon that out of every 100 new potential drugs that are identified, only one or two will actually get to market. James Dyson, who invented the bagless turbine vacuum cleaner, worked through 5,127 prototype versions before it was launched in 1993.

When working with creativity and innovation, it is essentially a numbers game in that the more ideas that can be generated, the more chance there is of one of them successfully reaching the market.

There are various versions and interpretations of what are called the Four Stages of Creativity, and various thoughts about who developed the model – including Henri Poincaré (the 19th century mathematician) and Graham Wallas (who was co-founder of the London School of Economics).

Wallas’ (1926) model was based on the following.

- **Preparation.** This stage involves generating knowledge and awareness – it is important to participate in creative activities to prepare oneself to be more creative and to keep an open mind in the creative process. This has also been described as the stage in which the problem is investigated.

- **Incubation.** The incubation process is the stage in which the problem is thought about during time away from the problem, or unconsciously; where people mull over all the information or “sleep on the problem”. This has no connection with the process of business incubation and support for early stage companies.

- **Illumination.** This is the stage during which ideas start to be generated and come together towards a solution or goal, and is sometimes known as the “Eureka moment”. Ideas often happen unexpectedly – even whilst asleep, or when engaging in activities unconnected with the problem. Techniques for generating ideas include various forms of brainstorming, use of analogy, attribute analysis, envisioning, and gap analysis. However, Wallis argued that illumination often occurred when the person was not at all focused on the problem, and was not engaged in positive idea generation; although it sometimes occurred during a period of rest or relaxation, following active efforts to create ideas.
• **Implementation (or execution).** In this stage, efforts are made to see if the proposal actually solves the problem. As not all new ideas work in practice, this final step is vitally important to the success of any project. The stage involves evaluation of how feasible and acceptable the ideas are, in order to select those that are the most promising. This may involve discussion, analysis and possibly voting to achieve a decision, and some theorists argue that this is where the left side of the brain reasserts its dominance. Many ideas will be rejected, whilst others may need to be worked up in more detail.

**B. THE INNOVATION SPECTRUM**

Innovation can mean different things to different people, but Sean O’Faolain, a little known Irish author captured what most people understand innovation to be: “There is only one admirable form of the imagination: the imagination that is so intense that it creates a new reality, that it makes things happen” – a dynamic and inspiring activity that can achieve real and meaningful outcomes and results.

*The Innovation Continuum*

The term “innovation” is open to a broad range of interpretations. In its simplest form, often utilised by public sector bodies under the guise of “sharing best practice”, it could involve directly copying someone else’s idea or good practice, or perhaps copying and modifying it to suit the needs of the organisation. However, in the strict sense this is not innovation at all as nothing new or significantly different is created.

As we move along the continuum (illustrated in Figure 4.1), the depth of innovation becomes more significant. Beyond copying and modifying we see innovation in the form of expanding on what already exists, again arguably not innovation in its true sense. The next stage of producing something novel is really the point where the process begins to generate something different, but it takes the creation of something new, perhaps a new invention or a new solution to a specific problem, to really be considered as innovative. Finally, we reach the stage of **breakthrough innovation**, by which we mean the types of innovation that will make a major impact on markets, in the delivery of products and services, or as a solution to problems. By way of example, we are talking about things like the light bulb, radio, TV, personal computers or, in the medical context, X-rays, penicillin, heart transplant techniques or even Viagra, each of which was a major technological breakthrough and created opportunities to open up massive new markets from the benefits they offer to users.
Figure 4.1: The Innovation Continuum

Depth of innovation

- Copying
- Copying and modifying
- Expanding
- Novel
- New
- Breakthrough innovation

Low-level innovation

High-impact innovation

Figure 4.2: Innovation Breakthrough

Customers’ perception of value

Breakthrough or step-change allows firm to leapfrog over competitors’ performance over a period of time

- Best competitor
- Continuous improvement

Improvement

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Innovation Breakthrough

Innovation is not about doing the same things differently, e.g. producing old products in new colours, re-inventing old ideas, or sticking to conventional norms or boundaries that restrict change by inhibiting the use of imagination and creativity. Whilst the use of innovation for continuous improvement of business processes and practices does help to maintain competitiveness in the marketplace, too much focus on incremental product improvement/marginal efficiency improvements can inhibit major development. Therefore, to gain real competitive advantage sometimes requires a major breakthrough or step-change – to create a disproportionate increase in the customers’ perception of value, as illustrated in Figure 4.2.

The value of innovation to businesses lies in the competitive advantage that it can create. Continuous improvement by itself is insufficient to keep companies ahead of their competitors, whereas innovation creates new market opportunities that enable companies to grow faster, which in turn generates increased profits. From another perspective, everything is constantly changing and as the pace of change in the 21st century is accelerating, those firms that fail to change fail to keep up with the competition, making engagement with innovation and change a necessity for survival.

C. INNOVATIVE AND HIGH-GROWTH-POTENTIAL TECHNOLOGIES

A very small minority of start-up businesses, probably less than 1% and usually those with innovative ideas for new technologies, will fall into the category of high-tech and/or high-growth companies. These are the new enterprises that have developed potential breakthrough innovations or have identified new and unique products or services with the potential for huge competitive advantage, possibly creating a near monopoly situation until competitors can catch up with them. They are usually also within the 3% of companies that create 95% of new employment opportunities as well as the major share of capital growth.

However, that type of high growth and market domination is not cheap or easy to achieve. It usually requires significant investment to get to market, specialist management expertise and business support, and frequently involves academic collaboration for research, often taking a good deal of time to get to market.

Barriers to Technological Innovation

The barriers that high-tech and high-growth firms face are not so much potential market-entry blockers, like the barriers to small firms described in Chapter 3, as the innovations and new technologies these companies have to offer have frequently been developed as solutions to specific problems or in response to identified gaps in the market. The main problems are usually the scale of the investment needed to get them to market, and the business and technical expertise required for product and market development. Here are some examples.

- High-tech and high-growth-potential start-ups will usually require a quite sophisticated management team that can provide high-level expertise across a number of areas of the business – expertise in sourcing finance and investments, expertise in managing
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substantial budgets, national or international marketing and product licensing experience, strong management and leadership skills, and specialist technical knowledge, often coupled with research and product development experience.

- Capital is needed to finance the high costs of new developments, especially those involving complex technologies, the outsourcing of specialist research, and the purchase of expensive capital equipment – but lead times may be extensive before any product is ready for market.

- Different forms of funding need to be accessed from potentially different sources during the development stages of the innovation – e.g. R&D grants from research councils, follow-on funds for proof of concept to prototype and to demonstrate the viability of the innovation for potential commercial production, funds to protect IP, for the pre-market development of commercial designs and production processes, and then for the production and launch of the products in the marketplace. For biotechnology companies, it can often take five or six years to get a new product ready for market, and longer if international medical authorisations are required.

- The working capital requirements for funding rapid growth will be much more accelerated and much greater for high-growth-potential businesses than for conventional firms that fund incremental growth from profits. By definition, high-growth firms will expand rapidly and that expansion needs proportionately high levels of working capital to fund it.

- There may be a need for costly protection of IPR, and where the innovation is generated from an academic research source, those rights (or a proportion of the equity of the business) may have to be shared. Even with patents in place, the publication of a patent for an innovation can alert potential rivals to the market opportunity, and if they have greater resources, they may be able to get an alternative product to market faster than the original innovation. This makes a strong argument for ignoring patents and going for the straight-to-market option.

- Small or independent private investors, such as business angels, find it very difficult and often costly to evaluate the risk of investing in new innovations against the potential returns on investment. Even larger and more sophisticated venture capital companies have the same problem and expect to write off up to 20% of their investments.

To this list, we can add some additional factors.

- The earlier that external investors are involved in the development funding, the larger the equity stake (shareholding) they will expect, in order to reflect the degree of risk they are taking. In some cases, this can mean that by the time a new innovation gets to market, it may be 80-90% owned by external investors. Business advisers will always recommend borrowing from banks or other sources (e.g. personal loans, bootstrapping or the 3 Fs – friends, family and fools) to fund early-stage development, before approaching external investors. This way, the owners can build value in the innovation, which will then mean they have to give away less equity for subsequent funding. Unfortunately, the lending banks often take the opposite view, asking to see private investment (e.g. business angel funding) before they will risk any lending.

- In the two to five years it may take to get a finished product innovation ready for market launch, the product development is effectively “work in progress”, which, apart from any patents that have been registered, offers no tangible value on the company balance sheet against which lenders or investors can assess the risk they may be taking.

- There is also the risk, at any time, that someone else may have been working to solve the same problem that the new innovation addresses, and may come up with a similar
innovation much quicker, or a better innovation that takes over the market. This is what happened in the 1980s when the Betamax video tape format was taken out of the market by its VHS rival, which arrived soon after but was a better product.

**The Funding Escalator Model**

The funding escalator model (Figure 4.3) relates to the staged funding that is typically required by technology-based R&D companies (producing, for example, biotech and pharmaceutical products, technical product innovations or nanotechnologies) and by high-growth-potential businesses. Both of these types of business require different forms of funding for each stage of growth, and may take several years and several stages of funding to reach the point where they start to generate revenue from sales.

Prior to the start-up stage, the requirements may be relatively modest in order to establish the company and to develop a basic concept. This might be a sum of up to £50,000 which will typically be obtained from the entrepreneur's own funds, personal loans, friends and family, university start-up grants, or business angel investors.

For the start-up stage, a further £50,000 to £150,000 might be required for R&D, product prototyping, proof of concept testing, IPR protection, and getting a commercial product ready for market launch. The next phase of this funding might come from R&D grants, proof of concept or follow-on R&D funds, or angel investors. The subsequent product launch funding would be more likely to come from short- to medium-term bank loans, second-round angel investments, hire or lease purchase, and invoice factoring.

Once the sales revenue is flowing, further funding for early growth would typically be sought from regional development growth or accelerator funds (loan or equity based), syndicated groups of business angels or private investors, longer-term bank loans (including those covered by government loan guarantees to support business growth), investment group seed funding and, of course, profit re-investment from the company itself.
Further growth funding would normally involve larger sums, and could be sought from the same sources as the funding for post-revenue growth, although it may be too large for individual private investors. For sums in excess of £2 million, the venture capital companies or trusts provide ideal sources, but require substantial equity stakes and normally apply strict conditions (including board of directors representation) and specified exit dates and strategies. They are generally seeking to profit from capital growth of at least 25% per annum, rather than receiving annual dividends. One of their preferred exit strategies is the IPO, whereby the company is listed on one of the minor stock exchange listings such as the Alternative Investment Market.

**Picking Winners**

The challenge for lenders and investors when assessing proposals for new innovations is to pick the winners. For the business owners themselves, their innovation needs to be a winner for the survival and growth of the business. Bankers, who want to ensure that their money will be repaid in full with interest, must pick winners to minimise the risk of the borrower failing and defaulting on the loan. For investors, the objective is to pick winners that will enable them to achieve their targets for returns on investment. They are looking for growth in capital value rather than interest or dividends, and will usually expect that growth in value to be a minimum of 25% per annum over the investment period. The underlying problem is that whilst everyone loves a winner – not everyone can spot it!

There are many sophisticated models used by the analysts in institution investment and venture capital organisations and they still sometimes get it wrong. There are some simpler, but still very effective, evaluation tools available for smaller investors. Bishop and Jones (2003) use a form of cost–benefit analysis that evaluates costs in terms of capital and investment resources required, timescale for implementation, people needed, and skills requirements; and benefits in terms of likely impact on profits and revenues, strategic fit with objectives, likelihood of success, and uniqueness or competitive stance. These factors are scored for each potential investment proposal and plotted on a graph (Figure 4.4).

![Figure 4.4: Cost–benefit Analysis](image-url)

Once the relative positions have been plotted on the graph, the proposal’s potential to receive investment funding can be evaluated. Broadly speaking:

- if ideas fall into the high cost/low benefit part of the graph, then there are probably better ways to invest the money
• low cost/low benefit ideas are fine for companies looking to achieve continuous improvement, but will never allow the leapfrogging of the competition that breakthrough innovations can achieve. Again, these ideas do not have ideal investment potential
• high cost/high benefit proposals could be the breakthrough opportunity, but they could equally be high risk
• low cost/high benefit proposals are the ones that everyone is looking for as they offer the real breakthrough innovation potential.

D. CREATING INNOVATIVE AND ENTERPRISING CULTURES

Enhancing Creativity and Innovation

Some staff are naturally creative, whilst others, and perhaps the majority, just don’t want to know. That may be very much determined by the environment in which the business operates. For example, in some sectors such as design, advertising and the media, employees tend to be naturally creative by virtue of their job roles. In contrast, assembly workers using standard operating procedures to produce consistently identical products will have no such opportunity. It is also interesting that in new start-ups and micro-businesses, the culture of the business may very much reflect the attitude of the business owner. As a result, a highly motivated and enthusiastic entrepreneur can generate a positive attitude amongst the staff, whereas a risk-averse and careful owner is likely to make staff reluctant to take risks or to put forward unsolicited ideas for innovation.

Enhancing creativity and innovation can be achieved by employers in the following ways.

• Positively expect staff to be creative – make it the norm – and inform the staff of these expectations. Introduce this gradually, as something that will benefit both the company and the employee, and get staff to buy in to the idea to break down resistance to change.
• As a part of the process of expecting staff to be innovative, the annual staff appraisal process can be used to encourage innovation by building it into staff targets and objectives. Initially, this may just involve asking a member of staff to identify two to three improvements in the way he or she works over the next year. Once staff appreciate the concept of being involved in the innovation process, their targets can become more ambitious. Ideally by the third appraisal cycle, they will start to choose and take responsibility for the targets themselves. That is where the innovation culture really starts to move the business forward.
• Encourage and support staff with skills development, perhaps training in creative thinking or other activities outside the workplace that will challenge them to solve problems or use their imagination. This development can take simple forms as part of everyday activities – for example, involving staff in brainstorming sessions to help solve problems or via quality circles to identify and investigate improvements in the business. Managers do not have a monopoly on good ideas, so the key is to create a situation in which everyone feels that their ideas and suggestions are equally valued and listened to. Again, this can give a major boost to the development of an innovation culture.
• Expect and tolerate failure – innovation is risky and will inevitably involve a proportion of failures, so staff must be pre-warned that this is a normal part of the innovation process. Business owners and managers need to understand that it is essential to
avoid a blame culture that might dissuade staff from trying out other innovations. They need to encourage experimentation and accept failure without blame as a normal part of the innovation process.

- Be prepared to invest time in investigating innovation opportunities. Some companies specifically allocate regular time out of normal working duties (e.g. one day per month) and often in an environment outside of the office, during which staff are expected to focus on developing new ideas or opportunities, or to work on new projects. However, for business start-ups this option may be neither practical nor affordable until they become more securely established.

- Encourage people to ask questions/challenge convention/look for causes and explanations, and positively encourage questioning from all levels of staff. Ask “what?”,”where?”,”when?”,”how?”,”and “why?” – and remember that often the more important question to ask is “why not?”

- Encourage staff to build relationships with customers and listen to them to identify any potential problems they might have. One person’s problem is another person’s opportunity so if a business can solve a customer’s problem, it both enhances the relationship with the customer and potentially adds to revenue and profit.

- Be prepared to challenge current thinking and/or working practice – query the reasoning behind it, and query whether or not alternatives have been considered. “We’ve always done it that way” is not an acceptable answer or a good reason to refuse change. There is nothing like an inflexible standard operating procedure to stifle the consideration of innovation or improvement. Don’t ask “what is the risk of doing it?”; instead ask “what advantage could be lost by not doing it?”

- Finally, reward innovation – whether that is by celebration of achievement, public acknowledgement or praise for success, promotion, or financial incentive or reward. Staff suggestion boxes – which were themselves an innovation 50 years ago – don’t just relate to improving working conditions. There are many companies that use them exclusively to promote suggestions for improvement and innovation. Some, for example, pay staff a fixed sum, or even a percentage of cost savings or extra profit that is generated by implementing the improvement, over the next one or two years.

**BIBLIOGRAPHY**

# Chapter 5

## Business Planning and Enterprise Start-up

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INTRODUCTION

Starting a new business always involves the risk of:
- its potential success or failure
- raising and possibly losing money for start-up
- that customers may not want or like its products or services
- that the entrepreneur could potentially lose his or her personal assets or property and go into debt if it fails.

Set against those risks are the prospects of the entrepreneur making substantial profits and becoming very wealthy in the process. The purpose and value of business plans are that by working carefully and systematically through the planning process, the risks can be minimised, and the actions and activities that will lead to profit can be identified and targeted.

Producing a detailed business plan can be a time-consuming process so it is always tempting to allow the enthusiasm to get the business started to override the need to plan properly or to skip over the detail of the plan. However, a good, well-researched and detailed business plan can be a valuable asset, not just to help raise the money needed to start the business, but also to identify and plan for the potential problems that might occur, and to set goals and targets that will enable the business to succeed.

It is estimated that some two-thirds of business start-ups in the UK fail in the first three years. Some of the reasons for that high rate of failure are as follows.
- Inadequate working capital to reach break-even level.
- Inability to access or borrow money.
- Poor cash flow and/or credit control.
- Lack of proper marketing, sales or promotion.
- Failure to research and fully understand the market.
- Excessive overhead costs.
- Poor business or management skills.
- Lack, or loss, of customers.
- Poor budgeting and financial planning.
- Inferior quality products or services.
- Failure to research or understand the competition and their products.
- Over-trading – expanding too rapidly and running out of working capital.
- Lack of business support advice or mentoring.

The common factor shared by all of these reasons for failure is that by developing a high-quality and detailed business plan most of these problems could have potentially been identified, considered and hopefully addressed; or if they could not have been addressed, then the risk-assessment part of the business plan should have identified them as high-impact/high-probability risks that could compromise the viability of the proposal. There will always be a small proportion of people who start new enterprises oblivious to problems and convinced that they cannot fail, and who will ignore the business plan process. However, for the others, the business plan should be used as a major test of the viability of their business ideas.

It is also important to remember that business plans are not just a necessity for business start-ups, but should also be an integral part of the management of the business to plan for
its ongoing growth and development. This may take the form of an annual update to the business plan, but as the company develops and grows, it may need to consider developing separate plans for each part of the business, especially if it operates multiple locations or diversifies its product lines or services. It may also require strategic business plans that look four or five years ahead but focus on broader targets and capital investment costs without going into the detailed operational costs.

A. THE IMPORTANCE OF BUSINESS PLANNING

The most obvious reason for preparing a business plan is to enable the entrepreneur to raise the money needed to start and operate the business. Very few entrepreneurs will have the necessary capital to completely fund a start-up, especially if it needs substantial investment in equipment or stock. They, therefore, have to look for the funds from other sources – possibly friends and family, but more frequently external lenders (banks or credit unions) or private investors – and those people will expect to see a business plan.

However, there are a number of other good reasons and justifications for developing proper business plans, including to:

- focus the minds of the entrepreneurs on the purpose of the business and what it will offer its potential customers
- clarify for the business proposers just what they want and expect from the business; whether that be huge growth and profits or just a comfortable income and standard of living
- research and identify the target markets and customers and what they would expect from the business
- identify the resources (human, skills-related, physical and financial) that will be needed to set the business up and run it efficiently and profitably
- quantify the financial costs of those resources and how they are best funded
- plan the implementation of the business and the budget implications of this
- evaluate the risks involved and how to eliminate or manage those risks
- test the viability of the business in terms of markets, break-even levels, investment costs and returns to ensure that it can survive and grow.

As mentioned in the introduction to this chapter, business plans are not just used by start-ups. They are a valuable management tool for planning and monitoring the successful operation of the business; and they are also important for long-term, strategic planning to investigate future development options – growth, diversification, acquisition, exit strategies or sale of the business. They can be used to raise external funding or investment to finance those strategies, or to develop new products or innovations. Most importantly, they provide the targets and objectives to measure and evaluate the profitability and success of the business, and to determine what dividends the owners and investors can draw to repay their investment and effort. Clearly, though, the format and content of each of those types of business plan will vary substantially. The focus of this chapter is on the business plans used for business start-ups.
**Focusing the Ideas for a New Business**

The production of a comprehensive business plan is all about working through a sequence of questions and answers about different aspects of the business; and the more complex the business is, the more of these questions need to be answered. Most people who consider buying or setting up a business, or becoming self-employed, have a fairly general idea of what they would like to achieve from it in terms of their personal ambitions, wealth and lifestyle. However, those general ideas need to be defined more precisely to ensure that the business model being developed will be able to deliver them. So it is important to identify specific objectives, in order to start to define the precise parameters within which the proposed business will operate. Typically, prospective entrepreneurs only do this for the first time when they start to fill in a bank’s business plan form to open a bank account or to borrow some money.

The primary objectives (often called the mission statement) of the business need to state clearly and specifically the purpose for which the business exists, and the market in which it will operate. For example, “I intend to operate a high-quality and profitable bicycle repair business, based just north of the centre of Mumbai, that will offer a 24-hour turn-around service for customers”, or, “We will be providing a daily delivery service, supplying freshly made chicken and goat burgers to meet the growing demand from food shops and restaurants in Kathmandu”. Obviously such statements such will immediately prompt questions such as “How will this be achieved?” This requires the potential entrepreneur to examine and explain in much more detail the financial, operational, marketing and control aspects of the proposition, which form the core of the business plan.

The next aspect to be considered is the viability of the proposition which prompts yet another question: “It sounds like a good idea, but what makes you think it will work?” Unfortunately, hunches, gut feelings, innate beliefs, and intuition cannot guarantee the viability of a business venture, so the answer to that question requires more tangible explanations, such as: “I am offering a service for which there is a growing awareness and demand and, at the current time, the nearest alternative supplier is located 100 miles away”.

The assessment of viability usually involves a range of considerations including market research and customer segmentation, producing feasibility studies, assessing potential sales turnover and profit margins, break-even analysis, exploring the availability of regular supplies, ensuring that competent staff are available, and of course assessing the level of working capital needed. Again, the potential entrepreneur is required to focus in much more detail on the practicalities of the proposition, including his or her own personal skills and abilities to make it all happen. The business idea itself may be perfectly viable for development by a competent or experienced business person, but the budding entrepreneur must seriously and objectively consider whether he or she actually has the necessary skills and competencies to make it work. These can include any necessary technical knowledge of the product or service, knowledge of the market, sales experience, and the ability to manage staff and delegate work. Does the entrepreneur have the necessary financial skills for book-keeping, credit control and managing budgets? If any of these skills are lacking, can they be learned quite quickly, or will it be necessary to buy them in, and what will be the cost?

Whereas large established businesses can afford to buy in or develop the staff skills they need, in start-up or early stage companies the money is often not available to do that, so the owner or entrepreneur will need to possess a breadth of general business skills, as well as a
depth of knowledge of the product or service. These are factors that banks and investors will consider and explore as part of their evaluation of a proposal.

**Setting Goals and Targets**

The finance and marketing sections of a business plan are where the performance targets of the business are set, and this will be explained in more detail in later chapters. The purpose is to establish parameters and specific targets that provide a yardstick against which the progress and profitability of the business can be measured. These targets will typically be expressed in terms of quantifiable numbers and financial figures that will form the budgetary plan for the business.

Essentially, the process involves forecasting expected sales in terms of target numbers for each month or quarter and for the year as a whole. The sales forecast numbers are used to generate revenue forecasts and the estimated costs of producing and delivering those sales to the customer. The difference between these two is the forecast gross profit margin, which, after overhead costs are subtracted, will provide the actual net profit forecasts that will determine whether or not the business has exceeded its break-even level of trading.

The process is relatively simple, but these forecasts are only as good as the accuracy of the information on which they are based. It is imperative that the prospective entrepreneur treats this process very seriously, attempts to make the figures as detailed and accurate as possible, and can justify the figures and underlying assumptions when challenged by a potential lender or investor. This is probably the part of the business plan that first-time entrepreneurs find most difficult; however, once the importance and value of the process are understood, the entrepreneur will find the forecasts easier to produce as a regular and essential part of the process of running the business.

For new businesses, the process is always particularly difficult as there is no historical performance data on which to base these forecasts. For this reason, many businesses prefer to prepare two forecasts that enable them to compare worst case and best case scenarios. These are particularly useful where sales or market conditions are volatile as they enable the entrepreneur to see when they could be facing problems – for example, in worst case situations where remedial actions or cost-cutting may be needed, or if sales are higher than expected, where the increased level of trading may create potential pressure on cash flow or working capital.

**Measuring Progress and Achievement**

As explained earlier in this chapter, it is imperative that every new business has clearly defined objectives and parameters within which it will operate, but these only have purpose and value if they can be used as a basis for measuring the performance of the business on an ongoing basis.

To achieve this, the objectives have to be broken down and expressed as a series of specific measurable targets for each key performance area of the business. Here are some examples from the financial context.

- Annual budgetary plans, forecasting income and expenditure on a month by month basis, against which actual income and expenditure can be monitored.
- Forecasts of gross profit margins and net profit margins, derived from the budgetary plans, which can be monitored to pick up any problems due to rising costs, falling sales, or seasonal fluctuations in sales, etc.
- The effects of specific sales or promotional activities on sales revenues or profit margins.
- Cash flow forecasts, and the effects of giving or taking credit.
- The need for additional working capital to sustain the business, e.g. by means of short-term overdrafts or longer-term loans to facilitate expansion of the business.
- Affordability of capital investment. Do we replace or repair? Do we produce components ourselves, or buy them in? Do we use loans or hire purchase to buy equipment, or do we lease?

Here are some examples from the resources context.
- Identify the physical resources needed by the business to start up and operate efficiently.
- Identify the additional resources needed as the business grows, and when they will be required.
- Ensure that resources are being used efficiently and at optimum capacity so that they generate a good return on their investment costs.
- Plan the staff requirements and associated costs to ensure that there are sufficient staff with the right skills mix available when they are needed.

Finally, here are some examples from the sales and marketing context.
- Forecasts of market share that will be achieved by each range of products or services.
- Sales forecasts and projected revenues for each individual product or service.
- Expected profit margins or contributions to overheads achieved by those revenues.
- The costs of sales activities to expand the customer base and volume of sales to individual customers.
- Costs of special promotions and expectations of increased sales and revenues generated by them.
- Costs of customer service and retention.

The planning and monitoring of progress and achievement are integral parts of the ongoing management of business operations. The initial business idea formulates the initial policies that determine the financial and marketing plans and targets, and the achievement (or otherwise) of those targets. Those plans and policies may need to be modified in response to external influences and changes, and that may influence the resources available for the future, which in turn impacts on future business planning. This is the constant cycle of:
- plan
- implement
- monitor
- revise.

Ideally, of course, any revisions should take the form of proactive plans made in anticipation of future changes and events, rather than as a series of reactions in response to past events or circumstances. It is important for the business to control these changes rather than being controlled by them.
An Ongoing Management Tool

Most business plans are updated on an annual basis. For most small firms, it is unrealistic to prepare very detailed budgets and cash flow forecasts more than a year ahead, and preparing them for less than a full year would be too short a time to generate useful information. It is important to remember that the business plan is a live document to be used as part of the ongoing process of managing the business – it is not just something prepared for the bank manager at the start of the year, and then put in the filing cabinet and forgotten until next year. Most firms revise their plans quarterly or at the half-year stage if it looks like there will be any major changes happening that might affect their original forecasts. For example, a fall in product demand will reduce sales revenue, so costs may also need to be trimmed back to maintain profitability. In contrast, if sales are significantly higher than forecast, the budgets will need to be adjusted to reflect not just the increased revenue, but also the associated increases in costs of production or distribution.

Plans need to be monitored on a regular and frequent basis if they are to be of any productive use. Budget outcomes (actual figures) should be compared with forecast figures at least once each month, and then within two weeks of the end of the month. This will enable prompt identification of any major discrepancies or problems which lie on the horizon. When discrepancies occur, they must be questioned.

- Why has this happened?
- Is it a one-off occurrence, or the start of a longer-term trend and potential problem?
- What has to be done to resolve the situation?

Unfortunately, when faced with apparent problems, too many people are more concerned with the question of who is to blame than with identifying the cause of the problems and working to find a solution. The subject of financial monitoring and control will be examined in more detail in Chapter 11.

One other aspect to be considered here is the fundamentally different approaches to planning by small firms and their larger counterparts. Small firms, and especially those at an early stage, rarely follow the structured and defined approaches of management that are used by big companies – the traditional big company model of management and career development simply cannot be applied to small businesses. Larger organisations normally have the resources, stability and security to facilitate long-term strategic planning, typically three to five years ahead, and the immediate year ahead is seen as the short term. For entrepreneurs or owner-managers of small firms, the immediate problem is often simply a case of day to day survival – i.e. where is the next order coming from? This is particularly true in the early stages of the business, when planning just six months or a year ahead counts as long term. In the early stages, most small firms focus on short-term plans and goals with cash flow and survival as their main priorities. This means that they will invariably look to the equally short-term actions and policies that will enable them to meet those short-term goals. As discussed in Section B of Chapter 3, only when they have achieved some measure of stability and security can they start to look at longer-term planning and investment.
B. EXPECTATIONS OF LENDERS AND INVESTORS

Raising Finance for Start-up or Expansion

Few start-up businesses are in the fortunate position of not having to raise funds to start trading – for example, if they have savings or other cash they can use – and virtually all of those who have ambitions of growth for the future will need some form of finance to expand and grow. In most European countries, even those not requiring start-up funding are usually asked by their bank to provide a basic business plan in order to qualify for an initial period (usually the first year of trading) of free bank charges on their business accounts.

The various options for raising business finance are discussed in Section E of Chapter 11, but for the majority of small firms, the starting point is their local bank manager. Inevitably, the first question asked of a budding entrepreneur is: “Can I see your business plan?” This is usually closely followed by: “What forms of security or collateral can you offer?” Obtaining start-up funding from banks has never been easy but since the credit crunch that started in 2008 and particularly affected the USA and Europe, many start-ups are finding it almost impossible as the banks become increasingly risk averse. This is particularly true of a number of major lending banks that had to be nationalised in 2008-09 because of their profligate lending in the previous few years, when it was easy for anyone who had a reasonable amount of security to borrow money to start a new business.

Today, the clearing banks take a much more responsible (and risk-averse) attitude to potential business customers, seeing themselves as stakeholders in the businesses. This is reflected in the questions they ask, and the risk analysis process they use to review the viability of new business proposals.

The ability to prepare a comprehensive and coherent business plan is an imperative for anyone starting in business, particularly if finance is required from outside of the business. The UK Government’s VAT registration statistics suggest that only half of new businesses survive more than five years, so a strong business plan will not only make raising funds less difficult, it should also make the proposition more likely to succeed. Preparing a plan for a bank is not difficult, given the many standard formats that are available. However, it is important that the content of the plan is not just about satisfying the bank manager’s information requirements; it should also provide the entrepreneur with the knowledge and information needed to ensure the business can survive the difficult early stages to become profitable and grow. For that reason, the standard business plan formats required by banks should not be regarded as sufficient, as they frequently lack the essential information that entrepreneurs need to survive and succeed. For this reason, a more comprehensive business plan format is included in this chapter.

The Differing Objectives of Lenders and Investors

It is important for potential entrepreneurs to be aware of the differences in objectives and expectations that lenders and investors have when they provide funding to businesses, as this can influence the way they pitch their business proposals to either provider.
Lenders, especially the conventional lending banks, are essentially managing funds that they have obtained from investors, savers or their own institutional profits. They have to be seen not only to invest those funds prudently but to achieve a certain level of return for their savers and investors. They are, therefore, looking to lend money at minimal risk, with the expectations of repayment over a fixed period of time along with a pre-defined level of profit from accrued interest. Even for low-risk ventures, they may typically expect security, collateral or directors’ guarantees against any losses, possibly in the region of 2:1 coverage. They will want to see investment from the entrepreneur, preferably matching the sums they are being asked to provide, although they also look favourably on proposals that are supported by independent private investors. They also expect the companies to provide them with regular progress reports, and warnings of any problems arising.

In contrast, most private investors are using their own money. They accept balanced or measured risk, knowing that any new business is inherently risky, accepting the risk if the potential return on their investment is sufficiently high, and also knowing that it may take several years to achieve. Their profit may be partially achieved by the payment of dividends from company profits, but not always as what they are really looking for is capital growth in the value of the business. They look to exit the business after an agreed period of time when they will sell their shareholding back to the entrepreneur or perhaps to a third party for a much higher price that they invested. This will reflect the increased capital value – perhaps in the region of 25% of the value of their investment for each year of the investment – to reflect the risks they have taken. They may also want to be represented in the management of the business. Some entrepreneurs might regard this as interference, but it can contribute valuable business experience.

The one common factor that is shared alike by entrepreneurs, lenders and investors is the need to pick winning ideas. Entrepreneurs need to pick winners to be successful; investors want winners (as opposed to losers or partial successes) to achieve the high level of capital growth that will give them a good return on their investment; and bankers just want to get their money back with interest. The process of identifying winning propositions is explained in Chapter 4.

**What Do Lenders and Investors Expect from a Business Plan?**

When experienced lenders or investors take a first look at a new business plan proposal, they rarely read it through from front to back. Typically, they will skim over the introduction to get an idea of what the proposal is about and then jump straight to the finance section to look at the profit and revenue forecasts for the first two years. If they are comfortable with that, they will move on to examine the marketing section to gain an understanding of the realism of the marketing proposals. Only if they are satisfied with this will they bother to read the proposal in detail, and even then there are usually many questions that need to be answered before they reach the stage of being ready to make a decision about whether or not to lend or invest.

Essentially, when reviewing a proposal, investors and lenders are looking for answers to a number of specific questions.

- How financially viable does the business proposal look, and what is the likelihood of a loan being repaid, or making a good return on capital investment (via interest/dividends/capital growth)? Does this constitute an acceptable level of risk?
- How reasonable are the sales and profit forecasts and projections – do the figures look realistic?
• Do the proposals demonstrate a good degree of understanding and analysis of markets and customers? Is this supported by market research information?
• How detailed and realistic is the marketing plan?
• How strong are the skills, experience and competences of business proposers? Does the business have a strong management team?
• How realistic is the timescale for implementation? If the timescale is protracted, is there a risk of the business failing to get started?
• Do the proposers understand their break-even position – in terms of units sold, or sales revenue, or time taken to reach break-even? Is there enough working capital in the proposed budget to enable the business to reach break-even before it runs out of money?
• Has a detailed risk analysis been carried out, and have contingency plans been identified to address or mitigate risks?
• What opportunities have been identified for investors to exit at the end of the investment period (exit strategies)?

Due Diligence

Due diligence is the process used to evaluate business proposals for lending or investment. In its simplest form, for a start-up business, it may comprise a detailed risk analysis of the proposed borrowing against the business plan, coupled with checks on the financial position of the proposers – taking up bank and personal references; carrying out credit checks; insolvency list searches; and property searches where property is offered as security, etc. The process can also include the drafting of formal terms of agreement between the investors and the entrepreneurs.

Where substantial borrowing or investment is required, e.g. for staged funding of high-growth companies, the due diligence process will be much more complex. It might include searches and reports from the Registrar of Companies, references from suppliers, dialogue with customers, patent searches and checks on licences or other IP, market analysis reports, reviews of published articles relating to company research projects, and detailed scrutiny of technical processes by independent experts. All of these items can involve a great deal of time, effort and expense which is why a lot of venture capital investors will not even consider investments under several million pounds.

C. BUSINESS PLAN FORMAT AND STRUCTURE

Generic Business Plan Format

The following generic business plan format is an update of a model developed by Butler (2006) that has been designed to cover the content required to meet three specific objectives.

1. It has been synthesised from a number of business plan formats used by major UK clearing banks (HSBC/Barclays/Lloyds TSB/RBS etc) and modified to provide the content and coverage required by most lenders and investors to enable them to make a balanced decision about providing funding for the business proposal.
2. It follows the Small Firms Enterprise Development Initiative (SFEDI) National Occupational Standards for Business Enterprise, which define best practice for the
business planning process and form the basis for many qualifications. SFEDI (www.sfedi.co.uk) is the Sector Skills Body for Enterprise in the UK.

3. Most importantly, the plan’s content and structure should require the potential entrepreneur to understand and address a range of key questions and issues that are essential to survival during the start-up and early stages of a new business

This format is intended to be generic, in that it covers a very broad range of content that might possibly be required for a potential new start-up business, but not all aspects will be relevant to all start-ups. This is explained in the following section of this chapter in more detail, and the content of each section of the business plan format will be explained in much more depth in subsequent chapters.

<table>
<thead>
<tr>
<th>1</th>
<th>THE BUSINESS IDEA (introduction/executive summary of business plan)</th>
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<tbody>
<tr>
<td>1.1</td>
<td>Brief outline of type of business proposed and trading status</td>
</tr>
<tr>
<td>1.2</td>
<td>Range of services to be offered (primary products/services, and secondary services that generate additional or ancillary revenue)</td>
</tr>
<tr>
<td>1.3</td>
<td>Personal parameters of owners, e.g. full-time or part-time business operation, hobby business, lifestyle factors and influences, time constraints or physical ability</td>
</tr>
<tr>
<td>1.4</td>
<td>Geographical location of business/operating area (e.g. local, regional, national, or international)</td>
</tr>
<tr>
<td>1.5</td>
<td>Brief summary of anticipated customers/target market and their distribution</td>
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<tr>
<td>1.6</td>
<td>Statement of viability – why I/we will succeed with business proposal</td>
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<table>
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<tr>
<th>2</th>
<th>THE BUSINESS PROPOSER(S)</th>
</tr>
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<tbody>
<tr>
<td>2.1</td>
<td>Brief background/personal history/summary CV of key team members</td>
</tr>
<tr>
<td>2.2</td>
<td>Personal influences, ambitions and long-term objectives of the proposer(s)</td>
</tr>
<tr>
<td>2.3</td>
<td>Why I/we want to go in to business</td>
</tr>
<tr>
<td>2.4</td>
<td>Personal skills, expertise and experience relevant to business</td>
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<tr>
<td>2.5</td>
<td>SWOT analysis, and identification of personal development needs</td>
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<tr>
<th>3</th>
<th>RESOURCES REQUIRED</th>
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<tbody>
<tr>
<td>3.1</td>
<td>Costed start-up inventory of equipment and materials</td>
</tr>
<tr>
<td>3.2</td>
<td>List of equipment/materials already available</td>
</tr>
<tr>
<td>3.3</td>
<td>Details of any IPR owned/applied for</td>
</tr>
<tr>
<td>3.4</td>
<td>Premises requirements and any modifications required?</td>
</tr>
<tr>
<td>3.5</td>
<td>Transport requirements/availability</td>
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<td>3.6</td>
<td>Staff and skills requirements in early stages (if needed)</td>
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<tr>
<th>4</th>
<th>FINANCE</th>
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<tbody>
<tr>
<td>4.1</td>
<td>Spreadsheet(s) showing first year budgetary plan and cash flow forecast</td>
</tr>
<tr>
<td>4.2</td>
<td>Explanation of basis for planned budget</td>
</tr>
<tr>
<td>4.3</td>
<td>Personal survival budget – to determine owners’ salaries/drawings</td>
</tr>
<tr>
<td>4.4</td>
<td>Break-even analysis – in terms of timescale/revenue/units sold</td>
</tr>
<tr>
<td>4.5</td>
<td>Profit forecasts for years one and two</td>
</tr>
<tr>
<td>4.6</td>
<td>Value of current resources/capital available/investment to date</td>
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<tr>
<td>4.7</td>
<td>Further finance required (and phasing if appropriate)</td>
</tr>
<tr>
<td>4.8</td>
<td>Potential sources of finance – loan capital/equity options</td>
</tr>
<tr>
<td>4.9</td>
<td>Preferred sources of finance and reasons for choice</td>
</tr>
<tr>
<td>4.10</td>
<td>Financial monitoring procedures within business</td>
</tr>
</tbody>
</table>
MARKETING

5.1 Detailed description of target market and operating area
5.2 What is special/unique about my/our services, or how do they differ from those offered by my competitors?
5.3 Market research carried out and/or further research planned
5.4 Description of relevant seasonal factors and other influences
5.5 Analysis of competitors’ services, activities, prices etc
5.6 Marketing plan
5.7 Schedule of fees and charges for products or services
5.8 Statement of quality standards and customer service policies, and how these will be monitored to maintain and improve services
5.9 Monitoring of sales, and changes in marketing trends

IMPLEMENTATION AND MONITORING (describe the following)

6.1 Chosen means of operation (limited company/sole trader/partnership/community interest company etc), and reasons for choice
6.2 Maintaining compliance with relevant legislation (including brief summary of why other key legislation may not be relevant) – e.g. health and safety/data protection
6.3 Timetable and phasing of start-up (including pre-start-up R&D-proof of concept activity, if relevant)
6.4 Identification of key/critical stages of implementation, with risk analysis including key tasks, potential delays etc, and contingency plans for dealing with problems
6.5 Longer-term objectives for business once established, and exit strategy if relevant
6.6 How success of business will be measured

SUMMARY

7.1 Re-affirm reasons for viability and expected success of proposal

APPENDICES (other information supporting plan)

8.1 Letters of intent/support from potential customers/suppliers
8.2 Market research data
8.3 Estate agents’ information on potential business premises
8.4 Design material/copyrights/patent information (if relevant)
8.5 Technical product information
8.6 Detailed CVs of proposers and/or associates
8.7 Samples of advertising material, leaflets, business cards

How Much Detail Should the Business Plan Contain?

The amount of detail a business plan should contain will very much depend on the type of business for which the plan is being prepared. For example, a self-employed window cleaner with no overheads or equipment apart from a car, ladders, a bucket, chamois and scraper will have quite simple requirements – in fact, the biggest problem will probably be planning where to get the clean water from, on each part of the daily round. In comparison, someone setting up a wholesale or manufacturing business, or as a hotelier, an import/export agent, or a specialist holiday tour operator, where longer-term capital funding is required or where specific and possibly complex legislation applies, may have quite a detailed business plan.

Some self-employed people who have no need of external funding simply do not bother to prepare business plans. Others working on a part-time basis may have a very simple plan, as they may not depend on that particular business activity as their sole source of income (for
example, part-time hairdressers or book-keepers who have another regular day job or perhaps a working spouse or domestic partner who also has an income). Hence, the size and content of any particular business plan will depend on the type of business it relates to, the borrowing requirements, and the personal circumstances and resources of the entrepreneur or owner-manager.

As explained, the business plan format shown in the previous section of this chapter is intended to be generic. It contains just about all the types of information that someone who is starting a new enterprise may need to provide for a lender or investor if they need to raise money. It also covers the range of information a new entrepreneur will need to know to survive. However, this does not mean that every part of the generic format will be relevant to every business.

If the business proposal does not require funding from external lenders or investors, the business plan could be much less formal, and the information in it could be less detailed. However, that should not be used as an excuse to not prepare a plan. Although the planning exercise may be regarded as tedious or a waste of time by people who are keen to get their business started, it is still a very valuable exercise in providing the knowledge and information required to help the business to succeed. In particular, the market research, financial and budgetary planning, break-even analysis, and risk analysis are all essential pre-start-up activities that nobody should ignore.

D. PLANNING AND FUNDING HIGH-TECH AND HIGH-GROWTH START-UPS

Summary of Main Factors

Here is a summary of the key aspects of planning and funding high-tech and high-growth start-ups (covered in more detail in Chapter 4).

- High-tech and high-growth-potential start-ups will usually require a more sophisticated management team that can provide a high level of expertise in sourcing finance and investments, managing substantial budgets, and national or international marketing, product licensing experience, strong management and leadership skills, and specialist technical knowledge, often coupled with research and product development experience.
- Such companies will often take a number of years to reach the revenue generation stage, and en route to that will require successive stages of funding from potentially different sources – R&D grants, proof of concept funds, pre-market product development finance, market launch funding, subsequent seed or accelerator funds for growth, and longer-term, potentially large-scale investment for expansion. For biotechnology companies, it can often take five or six years to get a new product ready for market, and longer if international medical authorisations are required.
- The typical capital investment costs of starting up will be higher for technology-based innovations, and may have to be obtained from a range of different sources over a period of several years.
- The working capital requirements for funding rapid growth will be much higher for high-growth-potential businesses than for conventional firms that fund incremental growth from profits.
• There may be a need for costly protection of IPR, and where the innovation is generated from an academic research source, those rights (or a proportion of the equity of the business) may have to be shared.

BIBLIOGRAPHY

Chapter 6

Enterprise Skills and Self-development

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INTRODUCTION

This chapter will examine and address three basic questions relating to skills knowledge and expertise that every new business needs to consider.

- What skills will be required to start the business, take it to the point where it is trading profitably and subsequently enable it to grow and succeed?
- Does the entrepreneur and/or other business proposer(s) possess the necessary skills?
- If not, how can the business obtain them?

The chapter will focus on some of the practical methods of evaluating personal skills and the process of preparing personal development plans for owners, managers and staff to gain the skills they need. In particular, it will look at evaluating the specific skills that relate to the entrepreneurs themselves to ensure that they have the right attitude and temperament to survive the start-up process.

For most entrepreneurs or owner-managers starting a small business, the main requirement (apart from specialised knowledge or expertise relating to the products or services offered to customers) will be a breadth of business skills, covering the basic operational activities of managing operations, financial planning and accounting, production, sales and marketing, distribution, and customer relations. The breadth of cover is more important in the early stages than the depth of knowledge. However, as the business grows that situation may change and extra staff or functional managers with more specialist expertise may be needed (and much sooner in the case of high-growth or high-tech start-ups).

Most entrepreneurs will have basic knowledge or experience of some of the business skills they need, but few will be able to cover them all by themselves. This poses the first dilemma – do they take time out to learn the extra skills when they are already very busy, or do they try to obtain them from outside the business, putting potential pressure on already very tight budgets? It also challenges the entrepreneurs to question where their time and efforts should be targeted. For example, it might be quite easy to take a short course in accounting to gain some basic knowledge of business finance; but should the entrepreneur really spend time on book-keeping? This time may be better spent on sales and finding new customers, which would pay for the cost of a part-time book-keeper and contribute to the business profits.

That takes us to the third question about how the business can find the required skills. For most small businesses, the answer usually comes in several forms: by development of the entrepreneur’s own skills (or those of any partners/co-directors); by training for members of staff (if any); by outsourcing to specialist providers (eg book-keepers/HR and recruitment specialists) who are paid as and when needed; or by use of part-time staff who may become full-time employees as the company grows.

It is important that skills requirements are considered at a very early stage, not just because the lack of certain skills could adversely affect the company’s ability to survive and grow, but because the costs of employing or developing staff also need to be factored in when determining the overall staff resources (Chapter 9) and their implications for the budgetary plans for the business (Chapter 11).
A. KNOWLEDGE AND SKILLS REQUIREMENTS FOR BUSINESS START-UP

Before we start to examine the skills requirements of the business, it is important to emphasise that the skills and personal characteristics that an entrepreneur may need to succeed in a new business venture can be quite different from the skills that are needed within the business.

Business Skills Requirements

The first important question is: “What skills does the business need in order to operate efficiently?” We are looking here at practical business skills such as:

- broad but fairly basic management skills – e.g. planning and organising work, supervising staff (if any), negotiating with suppliers, purchasing, managing stock, distribution activities, monitoring performance, managing information, and health and safety
- basic accounting skills – e.g. planning and monitoring budgets, book-keeping, credit control, paying customers, staff payroll
- sales and marketing skills – organising sales and marketing materials, advertising, finding, contacting and selling to customers, customer service and after-sales support activities
- technical and/or product knowledge – understanding of the products or services being offered and the markets those products or services will be sold to; this knowledge must be of sufficient depth to convince potential customers that they are dealing with a competent supplier who understands what the customers want.

The important factor about these various activities is that unless the business only has one person working (i.e. the entrepreneur), the skills don’t have to be provided by the entrepreneur alone. They can be delegated to members of staff or bought in as required from external sources. Whether or not that prospect is affordable must be considered when the business plan is being prepared. If there is no money to pay for the resources, then the entrepreneur may have to do the work – but that raises questions about the viability of the business plan. For example, if the business cannot afford a book-keeper, should the entrepreneur do that work when his/her time would be better spent on gaining new sales (which could potentially fund a part-time book-keeper)? How long should the entrepreneur expect to do both jobs before the workload has a negative impact on his/her business performance? Is the business viable in its present form or should the entrepreneur consider raising more working capital at the start-up stage to cover such costs?

The second question that needs to be considered is: “What skills does the business need to succeed and grow?” These skills requirements will certainly include those covered by the first question, but additional expertise will be needed relating to operations management, sales management and market development, and financial and strategic planning. Once again, it is not essential that these more advanced skills are provided by the entrepreneur alone. In fact, if the business is dependent on the entrepreneur dealing with all aspects of management, it is quite probable that he or she will become so heavily involved in the operational aspects of the business that the more strategic forward-planning activities will be overlooked. This is a
quite common occurrence in early stage and growing businesses (as discussed in Section D of Chapter 3) and is a factor that, if allowed to continue, can become a problem as it may inhibit the potential growth of the business.

**Entrepreneurial Skills Requirements**

The question that we really need to ask of anyone who is proposing to start a business is: “Are you a suitable person to start and operate a new enterprise?” This raises a number of broader issues about their personal skills and characteristics.

- Have they got the necessary broad-based business and management skills to get the business started, to manage day to day operations and to ensure effective use of limited resources?
- Do they possess the required knowledge of their products? Do they really understand the market(s) for the products or services?
- How good are they at planning their time and prioritising their work? Do they have the ability to deliver products or services to customers on time? Are they capable of balancing simultaneous pressures from multiple sources – suppliers, customers, staff, finances, legal compliance, etc?
- Are they able to manage stress and sustained pressure of work over a period of time?
- Are they actually aware of any gaps or limitations in their own skills?
- Have they got the ability to identify and recruit other people who can provide the skills they lack? If they don’t possess the necessary experience, are they willing to take advice from people who have?
- Are they able and willing to trust staff and to delegate responsibility? Do they have the ability to supervise, delegate work, train and motivate staff to get the best from them? For new owner-managers who have never previously managed staff, one of the hardest aspects is delegation – trusting the staff to get on with their jobs without constant supervision.
- Have they got the personal commitment, tenacity and endurance to succeed in business, and the resilience to face the many problems and challenges they will encounter?
- Have they got strong networking skills and the ability to access and harness external resources to benefit their business?
- Have they got the vision and strategic thinking to move their business forward and to make it succeed?
- Can they analyse situations or problems and make prompt but rational decisions when required?
- Most important of all, do they learn from their mistakes?

It is very easy to answer “yes” to all or any of those questions, but in the case of personal characteristics it is much harder to actually prove that they exist within an individual person. The existence of product knowledge, accounting and management skills can be assessed or evaluated quite easily by asking a few pertinent questions – and the production of a business plan is also a good indicator of the presence and extent of those skills. However, characteristics such as personal resilience or tenacity are much less measurable. Sometimes the easiest way to evaluate these intangible characteristics is by seeking the opinions of friends, family and colleagues – listing the various characteristics and then asking those people who know the person well to score them on a scale of one (low) to five (high).
In the following section of this chapter, we will look at various methods of self-assessment. Some of them are specifically designed or ideally suited for assessing entrepreneurial skills; others offer useful insights into personal characteristics but are more appropriate for general self-assessment or personal understanding.

B. SELF-ASSESSMENT OF SKILLS AND ABILITIES

There is a vast range of tools and techniques available to help with self-assessment. Many of them are free and easily accessible via the internet, whilst others are administered and interpreted by trained and approved providers only, and often at a significant cost.

In general, the assessments fall into two categories: those that evaluate personality and interests, and those that evaluate aptitude and abilities. Many of the assessments, in particular the psychometric tests, are designed for assessment against specific types of jobs or employment, and are frequently used for recruitment and selection processes, particularly for highly paid or specialised roles where recruiting the wrong person can prove to be expensive.

The following sub-sections examine several types of assessment method, starting with three that have been designed or proved ideal for the business start-up situation. Several others are then examined that can provide useful insights into aspects of personality that may be relevant to the workplace (career development, learning styles, and team roles). However, although they frequently appear in business plan documents, they should perhaps only be used in support of or as supplementary to the assessment methods designed for entrepreneurial skills.

Self-assessment Methods for Entrepreneurial Skills

The GoSmallBiz Entrepreneurial Aptitude Test is an online multiple answer test, specifically designed to test entrepreneurial skills by using a very detailed sequence of questions. The assessment process evaluates and compares responses about personal background, behavioural and lifestyle factors, and generates a diagram showing the potential entrepreneur’s propensity for running a small business. The results are plotted on a grid, which is divided into the following four quadrants.

1. True Entrepreneur: results in this quadrant indicate that the participant has traits and characteristics commonly found in successful entrepreneurs.

2. Independent Sales: results in this quadrant indicate that the participant has traits common to successful sales professionals. People with this profile can be successfully self-employed, earning top incomes from commissions and bonuses, without getting into the personnel and infrastructure requirements faced by an entrepreneur. However, the sales ability is also something that is highly appropriate to entrepreneurial businesses, particularly in the early stages before the business can afford specialist sales staff.

3. Professional or Trade: results in this quadrant indicate that the participant has traits commonly found in self-employed accountants, physicians, electricians, etc – people
who have a marketable skill. These skills may lend themselves to an owner-managed business rather than an entrepreneurial or growth-focused business.

4. Keep Your Job: results in this quadrant indicate that the participant has traits that would make it difficult to succeed in an entrepreneurial environment, and possibly even as an owner-manager. People with results in this quadrant should be extremely cautious about starting a business, and need to ask themselves some tough questions about their will to succeed, tenacity when faced with problems, and willingness to take risks.

The assessment is free and can be accessed online. There are quite a few other similar online tests for prospective entrepreneurs but many are extremely brief or simplistic and should, therefore, be treated with caution.

**SWOT analysis** is an extremely simple, popular and versatile tool that can be used in a wide range of situations. For use in a business start-up situation, the person making the analysis should list their personal **strengths** and **weaknesses** (i.e. those factors that are a part of themselves) that affect the proposed business. They also examine and list the **opportunities** and **threats** (i.e. the external factors) that might affect the business. Here is an example.

- **Strengths:** sales experience, good technical product knowledge, enthusiasm.
- **Weaknesses:** no knowledge of accounts, poor computing skills.
- **Opportunities:** offer of cheap premises, existing customer base.
- **Threats:** shortage of working capital, strong local competition.

In view of the subjective nature of the SWOT analysis, it is quite possible for people to under- or overestimate their personal skills and capabilities, or to overlook certain aspects. To make the process more objective, it is recommended that once the subject has carried out their own analysis they should get at least one other person (colleague and/or friend) to complete the analysis for them, and then compare the outcomes.

The **Entrepreneurial Skills Exercise** (adapted from Butler 2006) uses a list of 80 personal skills, characteristics, and technical abilities. It can be used on an individual basis to identify personal development needs, or shared between a group of participants to develop their knowledge and understanding of the range of abilities that entrepreneurs need and, through a process of discussion and negotiation, to jointly prioritise the skills and abilities under three headings. The priorities are then used by participants to develop their own personal list for planning their own development needs.

The process involves examining the 80 skills, characteristics and abilities and placing each under one of three headings:

- the skills needed to start a business
- the skills needed to ensure its survival
- the skills needed to make it grow.

Each of the 80 items must only be allocated to one of the three headings. The full list is shown in Figure 6.1, followed by an example form, showing the three headings and some sample entries (Figure 6.2).

The exercise was specifically designed to provoke thought and discussion about what the various skills and characteristics mean, and which are more important than others at different stages of business development. Some of the 80 items are deliberately quite vague, to make
the participant(s) think carefully about their meaning. Some of them overlap with each other or incorporate the same aspects; where overlaps occur, participants need to think carefully about which are the broader or more important choices.

From the resulting three lists, the items are prioritised and the top five items in each list (for individuals) or top ten (for groups) are identified. From these priority lists, each participant then rates his or her personal ability on a scale of one (very weak) to five (very strong). The two items with the lowest rating in each list will then become the participant’s action points for self-development.

**Figure 6.1: What Business and Management Skills Does an Entrepreneur Need to Succeed?**

| 1. Showing enthusiasm                      | 41. Knowledge of employment law |
| 2. Managing under pressure                | 42. Prioritising work           |
| 3. Being assertive                        | 43. Concentrating on the task in hand |
| 4. Taking responsibility                  | 44. Managing change effectively |
| 5. Being flexible                         | 45. Monitoring and controlling  |
| 6. Being objective                        | 46. Adapting                    |
| 7. Active self-development                | 47. Being proactive             |
| 8. Showing resilience                     | 48. Implementing decisions      |
| 9. Dealing with uncertainty               | 49. Project management          |
| 10. Knowledge of IP                        | 50. Handling complexity         |
| 11. Evaluating and managing risks         | 51. Collecting and organising information |
| 12. Having a positive management style    | 52. Thinking conceptually       |
| 13. Cash flow management                  | 53. Thinking logically and analytically |
| 14. Exercising self-discipline            | 54. Problem focusing            |
| 15. Setting and achieving personal standards | 55. Thinking and acting strategically |
| 16. Showing sensitivity to others         | 56. Being creative              |
| 17. Credit control                        | 57. Making judgements           |
| 18. Measuring performance of self and others | 58. Possessing common sense     |
| 19. Listening and questioning             | 59. Using time efficiently      |
| 20. Influencing others                    | 60. Being decisive              |
| 21. Handling conflict                     | 61. Being consistent            |
| 22. Developing strategic partnerships     | 62. Treating people fairly      |
| 23. Developing staff and management teams | 63. Sourcing business finance   |
| 24. Challenging and confronting           | 64. Avoiding waste              |
| 25. Being supportive                      | 65. Awareness of health and safety |
| 26. Being at ease with people             | 66. Setting clear targets and objectives |
| 27. Encouraging ethical behaviour         | 67. Applying equal opportunities principles |
| 28. Motivating staff                      | 68. Displaying care and attention |
| 29. Working effectively in groups and teams | 69. Being a strong negotiator  |
| 30. Networking                            | 70. Optimising use of resources |
| 31. Envisioning                           | 71. Delegating responsibility   |
| 32. Using market research and segmentation | 72. Managing budgets and finances |
| 33. Consulting-seeking opinions of others | 73. Organising work             |
| 34. Encouraging quality and excellence    | 74. Being an effective leader   |
| 35. Managing business performance         | 75. Willing to consider innovation |
| 36. Identifying and grasping new opportunities | 76. Encouraging individual initiative and innovation |
| 37. Learning from mistakes                | 77. Being environmentally aware |
| 38. Understanding customers               | 78. Acting ethically            |
| 39. Book-keeping                          | 79. Being honest with staff and customers |
| 40. Sales and marketing                   | 80. Being respected by others   |
**Figure 6.2: Sample Analysis Form**

| What Business and Management Skills Does an Entrepreneur Need to Succeed? |  |
|---|---|---|
| To start a business? | To ensure its survival? | To make it grow? |

**General Assessment Techniques**

**Psychometric Personality Tests**

Psychometric personality tests include personality questionnaires, aptitude tests and assessment centres (using multiple methods of assessment including personality and aptitude tests, interviews, exercises and role plays). Questionnaires relating to personality and interests focus on the individual’s own characteristics, whereas aptitude and ability tests are more job- or task-related, to determine suitability for a specific role. The same questions are often asked from differing perspectives as part of a checking process to reduce the chance of participants attempting to pre-judge what the questions are trying to discover. A psychometric test must be:

- objective: the score must not be affected by the tester’s beliefs or values
- standardised: it must be administered under controlled conditions
- reliable: it must minimise and quantify any intrinsic errors
- predictive: it must make an accurate prediction of performance
- non-discriminatory: it must not disadvantage any group on the basis of gender, culture, ethnicity, etc.

The **Myers-Briggs Type Indicator** personality test is designed to measure psychological preferences in how people perceive the world and make decisions. It is based on four preferences.

- E or I (Extraversion or Introversion).
- S or N (Sensing or Intuition).
- T or F (Thinking or Feeling).
- J or P (Judging or Perceiving).

The preferences are combined to give the person’s Myers-Briggs personality type. For example, having preferences for E, S, T and J gives a personality type of ESTJ. There are sixteen Myers-Briggs personality types. This test is particularly suited to assessing potential job roles and it often used by careers advisers to identify the types of job that an individual might be suitable for. It is normally only performed by people or organisations that have been trained and licensed to use it by the Myers & Briggs Foundation.
Psychometric tests are also often designed to relate to the five main personality traits, for example the **Big Five Personality Test**. This is a free online personality test that uses a good range of questions, and relates to the five personality traits described in Section B of Chapter 2: openness, conscientiousness, extroversion (or introversion), agreeability and neuroticism.

The **Eysenck Personality Questionnaire** is available free of charge online, and based on 100 yes/no questions (note, though, that there is little preliminary information or instruction on the website). The test is designed to analyse a person’s temperament in the context of the extent to which three traits of behaviour and personality are revealed by the test: extraversion/introversion, neuroticism/stability and psychoticism/socialisation.

The **Keirsey Temperament Sorter** is another free online personality questionnaire that uses 70 questions, each of which has two optional answers.

According to the instructions, the objective is for participants to understand themselves as they really are, rather than in terms of things like others’ expectations of their behaviour or the requirements of their job. The instructions also state that effectiveness as an individual or leader is related to how well people know themselves and others, rather than any particular personality style. The results can be stored online with a personal password for later use.

The **Honey and Mumford Learning Styles Questionnaire** was developed by Peter Honey and Alan Mumford, based upon the work of Kolb (1984) who developed a circular model of the way people learn through the processes of:

- concrete experience
- reflective observation
- abstract conceptualisation
- active experimentation.

Honey and Mumford identified four distinct learning styles or preferences that correspond to Kolb’s model: pragmatist, reflector, theorist and activist. These are the four approaches to learning that individuals naturally prefer. The theory is that by identifying their preferred learning style, individuals can maximise their own personal learning capability. It is important, therefore, for learners to understand their own learning style, and to seek out opportunities to learn using that style. The Learning Styles Questionnaire can be accessed via the Peter Honey Publications website for a fee, but colleges often have copies in their libraries.

The **Belbin Team Roles** test is a very famous and well-used model (developed by Dr Meredith Belbin) for examining how people behave in teams. The model identifies nine different roles that team members naturally adopt, according to their personalities, although in practice most people have a preferred role and a secondary role.

- Shapers challenge the team to improve but could risk becoming aggressive and bad-humoured in their attempts to get things done.
- Implementers put ideas into action but might be slow to relinquish their plans in favour of positive changes.
- Completer Finishers ensure thorough, timely completion but may sometimes take their perfectionism to extremes.
- Coordinators act as the chairperson but might delegate too much, leaving little work for themselves.
• Teamworkers encourage cooperation but might become indecisive when unpopular decisions need to be made.
• Resource Investigators explore outside opportunities but might forget to follow up on a lead.
• Plants present new ideas and approaches but could be unorthodox or forgetful.
• Monitor Evaluators analyse the options but could be overly critical and slow moving.
• Specialists provide specialised skills but may have a tendency to focus narrowly on their own subject of choice.

The ideal team combines all, or most, of the nine roles, which together can enhance the team’s performance.

Whilst most people find the Belbin Team Roles test to be a very interesting exercise, it was designed primarily for management training for large organisations, so cannot (and perhaps should not) be readily applied to small businesses, especially start-ups where such teams rarely exist. However, it can still provide a useful insight into personality if used, for example, alongside the Entrepreneurial Skills Exercise.

Assessing Creative Ability

There are a number of creativity questionnaires and tests available, some of which relate to the individual person’s creative potential and others which relate to the creativity quotient (or capacity) of organisations. Some tests are better than others so it pays to examine them carefully. There are plenty of very short tests with fewer than 20 questions, and with equally short explanations of the outcomes. Others have more questions but vague or brief explanations. The Creax test and the Creative Problem Solving test shown below are two examples of free online questionnaires.

The CREAX Creativity Self-assessment test is available free of charge online and takes just ten minutes to complete. It uses 40 questions across eight metrics: abstraction, connection, perspective, curiosity, boldness, paradox, complexity and persistence. Brief additional information is provided on each when the results are viewed. The results show the person’s percentage score compared with a global average, and display a spider-web diagram showing relative strengths against the eight metrics which is visually easy to understand.

Psychology Today’s Creative Problem-solving Test is a free online test that takes a few minutes. It shows a summary percentage figure for the creative ability to solve problems, but the full report has to be ordered and paid for. The test uses just 20 questions, the first 18 being graded answers to specific statements, and the final two being scenario based. This may be considered very short for a proper test of creative potential, but it is perhaps acceptable because of its specific problem-solving focus.

In Section A of Chapter 4, we considered aspects of creativity and the human brain, and how the two sides of the brain influence a person’s capability for creativity. The following exercise is designed to assess the left and right brain preferences (creativity).

In the Figure 6.3, you will find a list of 32 types of behaviour. Put a tick against those which you think are most like you, and put a cross against those least like you. Do not linger over each word: be guided by your first reaction as it is your first thought that is required.
Figure 6.3: Exercise – Are You Left-brain or Right-brain Dominated?

<table>
<thead>
<tr>
<th>Left-brain score</th>
<th>Right-brain score</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>3</td>
<td>4</td>
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<td>5</td>
<td>7</td>
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<td>29</td>
<td>30</td>
</tr>
<tr>
<td>31</td>
<td>32</td>
</tr>
</tbody>
</table>

A: Total ticks  A: Total ticks
B: Total crosses  B: Total crosses
A minus B  A minus B
Left-brain score  Right-brain score

As explained in Section A of Chapter 4, the left-hand side of the brain controls functions such as the logical thinking process, language, expression of emotions, order and pattern perception, reading and writing, tracking of time, and remembering names. People whose left-brain score is highest are most likely to have a more dominant left side of the brain and may prefer activities that involve straight-line logical thinking, moving step by step from a problem to a solution. They prefer factual and written information and studying or working in the fields of science and technology. They may be risk averse, or may be uncomfortable when forced to think for themselves.

In contrast, a higher right-brain score indicates that the person is more likely to be artistic and creative, and will relate more to visual images, such as pictures, objects and maps, rather than theoretical concepts. They may also be ruled by emotions and intuition rather than logic and they respond to personal relationships rather than authority. They may also be impetuous and imaginative, and they love creativity, act intuitively and are willing to take risks, which makes them much more creative than the logical and rational people who have a more predominant left side of the brain.
Some people will achieve a quite balanced score in which the left- and right-brain scores are similar. This demonstrates a good blend of characteristics and preferences from both sides of the brain, and the ability to utilise creative processes as well as logical and rational thinking.

C. ACTION PLANS FOR SELF-DEVELOPMENT

The various exercises in the previous section of this chapter presented ways of assessing personal skills, abilities and characteristics. Having gone through that process and hopefully having identified some personal development needs, the next step is to plan how these will be achieved. Some entrepreneurs regard this process as a waste of time that distracts them from the process of working up their business idea; however, aside from the fact that an analysis of the skills of the entrepreneur and any associates or key staff is actually expected by many banks as part of the business plan, it can be a valuable exercise in itself. It forces the entrepreneur to think about developing the necessary skills that will facilitate the main objective of creating a successful new business.

Think back to last year: how many New Year’s resolutions did you actually manage to keep, or have you simply given up trying? Entrepreneurs and owner-managers are very busy people, so it is important for them to make some tangible declaration of intent in the form of a self-development action plan, to keep their personal development objectives in constant view and prevent them being forgotten or relegated into oblivion by the sheer pressures of work. A simple action plan, in the form of the example given later in this section, will act as a regular reminder if pinned in a prominent (although not necessarily public) location.

The most important reason for using an action plan is to provide a means of monitoring progress on a regular basis, and to set specific review dates. To use an analogy, how many times have you heard someone say: “I’m going on a diet and I intend to lose ten pounds/five kilos in weight?” In this situation, the action plan challenges them to consider a number of questions.

- When will you start – right now or after the barbecue next week?
- When will you lose the weight by – next month, next year or by December 2020?
- How often will you check your progress – daily, weekly, monthly or never?
- If you do manage to hit your target weight, how will you ensure that it doesn’t go up again?

The answer should be: “I will use my action plan to set specific targets and review dates to monitor my progress, and to highlight any problems or reasons for failure, and identify any necessary corrective action”.

The action plan for self-development should enable the entrepreneur or owner-manager to do the following.

1. Define the action: identify the specific problem that needs to be addressed, or the skills or competencies that need to be developed or improved. This does not necessarily have to generate a training need that requires formal training – it could be an aspect of management practice that needs to be modified or improved, such as the need to delegate more work or responsibility to other members of staff.

2. Specify the process that will address the action: identify appropriate activities or methods that will address the problem. Again, this might involve formal training in
some form, or it could consist of a series of activities that will enable the entrepreneur to change an aspect of management style.

3. **Define how achievement will be measured:** identify how the achievement of the required development activity will be monitored and measured.

4. **Review the outcomes:** review the extent of success or failure. If successful, then what is the next step that will take this further, or what further personal development might be appropriate? In a case of failure, what went wrong and why, how can that be corrected or made to work, and when will the process be restarted?

Action planning for both entrepreneurs and employees should be carried out on an annual basis as part of the review of personal development needs.

**Action Plan Example**

Figure 6.4 shows an example of a completed action plan.

**Figure 6.4: Action Planning for Skills Development (Modified from Butler 2006)**

<table>
<thead>
<tr>
<th>Skills/competencies to be improved</th>
<th>Activities/methods of improvement</th>
<th>Means of measuring achievement</th>
<th>Review of extent of success/reasons for failure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Example: Effective delegation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Problem:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Work needs to be delegated to release time for other management duties</td>
<td>• Review daily/weekly job activities to see which of these could be delegated</td>
<td>• Is delegated work progressing suitably well?</td>
<td>• What problems have occurred?</td>
</tr>
<tr>
<td></td>
<td>• Select potential staff and assess their suitability to take responsibility, and any training needs they may have etc</td>
<td>• If not, why not?</td>
<td>• Are there still jobs to be delegated?</td>
</tr>
<tr>
<td></td>
<td>• Define staff objectives and how their progress and achievement will be monitored and assessed against their targets</td>
<td>• Are there still more jobs that I should delegate?</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Review own workload once more</td>
<td>• What else have I been doing with my time?</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Review progress after a further 30 days, and 60 days</td>
<td></td>
</tr>
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BIBLIOGRAPHY


SOURCES OF INFORMATION

- Belbin Team Roles – www.belbin.com/rte.asp?id=10
- Big Five Personality Test – www.outofservice.com/bigfive/
- Eysenck Personality Questionnaire – http://xestia.net/tests/epq.php
- Honey and Mumford Learning Styles Questionnaire – www.peterhoney.com/ (now owned and distributed by Pearson TalentLens)
- Myers-Briggs Type Indicator – www.myersbriggs.org
- Psychology Today’s Creative Problem-solving Test – http://psychologytoday.tests.psychtests.com/take_test.php?idRegTest=3201
# Chapter 7

## Developing and Presenting the Business Idea

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INTRODUCTION

The introductory outline of the business idea is probably the most important part of the business plan in that it outlines the business proposal and starts to sell the idea to the reader as a viable and attractive proposition. Most potential lenders or investors will look at this section first; only if they like what they see will they bother to move on to examine the financial projections and marketing information to see if that justifies their initial interest. If so, they might then move on to read the remaining sections of the proposal.

The figures for the numbers of business proposals that actually receive bank lending are hard to find as banks do not like to divulge that information. However, angel investors will often review 40, 50 or more business proposals to find just one that merits further investigation; even then there is no guarantee that they will invest, as they still have to go through the process of due diligence with the details of the proposal, and to ensure that the proposers are legitimate and financially sound individuals with the appropriate skills and knowledge to succeed.

This chapter looks at the drafting of the outline of the business idea, and its presentation as a sales document to promote the idea in a strong and positive manner. It looks at the process of identifying target customers and segmenting them to establish which groups will become the priority targets. It also considers how to carry out broader market research and the identification and evaluation of the competition.

A. THE BUSINESS IDEA SECTION OF THE BUSINESS PLAN

Presenting the Business Idea

There may be a great deal of prestige in being the market leader, particularly in major international markets, but the majority of small businesses are not in that league and probably never will be. Their primary concern is to achieve and maintain profitability rather than overall market share, so they need to be competitive without having to aim for competitive advantage over the market as a whole. However, the concept of competitive advantage is still relevant to them in helping them to differentiate their businesses from the competition by asking a number of basic questions to help them on the way to achieving profitability.

- What makes the products and services stand out from the competition?
- What unique features do they have that will make people want to buy them as opposed to the alternatives?
- How can we ensure that this uniqueness persists?
- If that is not possible, what else can be done to keep ahead of the rivals?
- What can we do that will make customers remember the business and come back for more?

The answers to these questions will start to form the options for the strategic marketing plan that will be developed in Chapter 10. They are also very relevant when outlining the business idea to potential lenders or investors, though, as unless those readers can immediately see
some clear indication that the business has something unique to offer, it is unlikely that they will bother to read the remainder of the proposal.

In Section B of Chapter 5, we examined the different expectations of lenders and investors and what each group expects from a business plan. The introductory section of the business plan for a new enterprise is the very first thing they will look at. It is the section where the proposers outline the main aspects and features of the proposed enterprise, and it is, therefore, the point where the proposers must grab the readers’ attention and tempt them to read further. As mentioned earlier in this chapter, the business plan is a sales document in which the proposers sell the viability and profitability of the proposed enterprise to potential lenders and investors. That being so, the introductory section that outlines the business idea must form the core of the sales pitch, and it must be presented in a way that will convince the readers that they really want to find out more about the idea. Essentially then, it must be a positive sales document in which the proposer summarises and projects to the readers:

- precisely what is so good/special/unique about the proposed products or services, and makes them stand out from the competition
- why the customers will want them and will be happy to pay a good/fair price for them
- that the proposers understand the market sector and are confident that they can develop a market share
- why the proposed enterprise is viable and will succeed.

The business idea section is most definitely not:

- where you describe the specific financial, marketing, resources, and implementation issues in detail – that comes later
- where you discuss at length any negative issues or risk aspects – that also comes later under “implementation”, where you list and address them at the same time
- where you entertain any doubts or thoughts of failure – if you are so unsure about the proposal, you may need to rethink the whole idea before presenting it to potential lenders or investors, as unless they have specifically asked for revisions to the business plan they will rarely consider it a second time!
- an opportunity to boast about your entrepreneurial abilities, or to bluff about the potential viability of the idea. It is important to be firm, positive and realistic – the aim is to warm the lenders to yourself and your business ideas, not to put them off before you get started!

**Example of Content of the Business Idea Section**

The following sample text is based on the format proposed in Section C of Chapter 5 for the business idea section. Typically, this should be no longer than about two A4 pages of text. It must be clear, concise, factual and, above all, it must present a positive prospect to the reader. This example is based on a woman who wants to start up a part-time book-keeping service that initially fits around her children’s school hours, but which can be scaled up to full-time work quite quickly.

1.1 Type of business proposed and trading status.

“I intend to operate a book-keeping service for small businesses. I will operate as a sole trader, initially working part time, but within three-months I expect to have sufficient work to keep me occupied on a full-time basis, and within a year I expect to be employing at least two part-time staff.”
1.2 Range of services to be offered (primary and secondary).
“The majority of the work will comprise simple book-keeping on a week by week basis, but I will also offer the preparation of annual accounts to trial balance stage, the preparation of annual income tax returns, the completion of quarterly VAT returns, credit control and debt collection.”

1.3 Personal parameters of owners (e.g. full time, part time, hobby, lifestyle factors, constraints etc).
“One of the main reasons for choosing this form of business is that it gives me the flexibility to work the hours I choose, allowing me the opportunity to achieve a good level of regular income and to still accommodate the demands of a young and growing family. In later years, when they have grown up, I will have the basis for a substantial and thriving business. I have a working partner so this business will not be our sole source of income.”

1.4 Geographical location of business.
“In the first few years I expect most of my customers to be located in the XXXXX region, typically within a 20-mile radius of my home in YYYYY.”

1.5 Brief summary of anticipated customers/target market and their distribution.
“Within my operating area, there are an estimated 45,000 small businesses (with fewer than 20 staff) and self-employed individuals who need book-keeping facilities and have to make tax returns, but for whom the cost of paying a chartered accountant would create a substantial financial burden, adding significantly to their overheads. The key features that attract my customers are:

- a highly professional but affordable accountancy service, designed to meet the needs of small businesses and to ensure they are legally compliant for tax purposes
- the weekly updating of clients’ accounts
- options for their accounts to be processed on site, or at my own base
- a client support service offering 24-hour turnaround on requests for advice and support about tax or VAT by telephone or email
- a pre-agreed annual contract with monthly charges so that outgoings are known to them up front, and are paid by direct debit on fixed dates.”

1.6 Assessment of viability and risk factors – why I will succeed.
“I already have three regular clients for whom I carry out book-keeping on a part-time basis, and those clients have referred me to several other potential clients for whom I will start to work in the next few weeks. I believe I have the qualifications and experience to offer a high-quality and reliable service to my clients, which is supported by my record to date. I propose to grow my business steadily so that the costs of expansion can be financed largely from ongoing profits. My prices are competitive but sufficient to cover my overhead costs and to give me a substantial regular income, and I will only start to employ staff when there is sufficient business coming in to justify doing so. Overall, I believe I have the basis for a thriving and profitable small business that complements my personal and family objectives with minimal financial risk.”

This example is just one page long, but it describes precisely and concisely what the proposal is about, the various services to be offered to customers, the personal factors influencing the start-up, who the customers are and where they are located, and the potential size of the market, and it then sells the USPs and the viability to the reader in a positive and confident manner. It is presented in a way that would hopefully prompt a bank manager to
think: “Yes, this looks like it could be a viable proposition, so I will look at the rest of the proposal to see if that first impression is justified”.

B. IDENTIFYING THE TARGET CUSTOMERS

USPs, Product Features and Benefits

The first and foremost principle that is taught during sales training courses is: “Don’t sell products or services – sell the features, benefits and solutions they offer to the customers”. This idea is explored further in Chapter 10, but it is important to remember that two of the prime purposes of market research are to identify the following.

- What are the USPs of the product or service that will appeal to the customer? It is these that will distinguish the products or services from those of the competitors; the more distinctive those points of differentiation are, the less likely it becomes that the competitor can offer a direct or indirect substitute that might be of interest to the customer. The exception to this may be where the competitor offers a price advantage for a direct substitute that is so attractive to the customer that it overrides the perceived value of the USPs. Implicit in this question is also the issue of whether or not that product or service may actually have more than one USP that may appeal to alternative customers. This takes us on to the importance of using the market segmentation process to analyse customer needs and motivations in more precise terms.

- What are the features and benefits that the product or service can offer the customer? To answer this question, the market research process also needs to determine exactly what the main problems or priorities facing the customers are. This is important, because if a sales person is able to identify that a customer has a specific need or problem, the features and benefits of the product can be sold as a solution to that problem. If all other factors are equal (price, quality, product availability, after-sales support etc), it is much more likely that the customer will commit to buy the product on offer.

It is also important to remember that by combining strong USPs with features and benefits that provide solutions for specific customer needs or problems, it is possible to create a strong motivation for the customer to buy that can override a competitor’s cost-leadership or price-cutting strategy. In simple terms, people are usually willing to pay a bit more for a product that can solve a specific problem, rather than buying a cheaper alternative that may be less effective. In the event that the competitor’s low prices are still an issue for the customer, the option remains open to introduce a marginal reduction in price whilst still maintaining the sales focus on the USPs, features, benefits and solutions.

In addition, strong USPs, features and benefits can also increase the customers’ perception of differentiation between the product on offer and what may in reality be similar or substitute products offered by the competitors. That effect is further reinforced when coupled with strong product branding.
Identifying the Potential Customers

Before commencing the detailed market research process, there are some basic questions the potential entrepreneur needs to ask in order to understand more about the customers who will hopefully be buying the products or services.

- Why should the customers want to buy the products or services? What features and benefits do they offer that cannot be obtained from other products or suppliers? What is the competitive stance of the business (i.e., the individual or combined selling points of the products or services, such as offering unique features, meeting the needs of the niche market, competitive pricing, product or service quality, or after-sales service, which market research has shown to be the most important to customers)? These are the components that will ultimately be refined and developed into the marketing strategy for the business.

- Where are the customers located? How will they be supplied—face to face, by mail order, using delivery services, or via a wholesale or distribution network? For some businesses, particularly those that are offering locally based services or retailing direct to the public, the geographical location will be of major importance, but for mail order or internet sales that use postal or contract courier services, location may not be very relevant. What is most important is that the customers can get the products or services they require, at the right price and quality and at the time they want them.

- What are the customers’ buying criteria or expectations? These may be expressed in terms of service levels, product reliability, convenient access, flexibility of service or product supply, or prompt availability.

- What is their financial or quality motivation and what are their expectations of the price–quality balance? For example, are they looking for the cheapest option; will they tolerate lower quality to reflect a lower price; would they prefer to pay a high price for high quality or luxury appeal; or are they just looking for value for money?

- How frequently will they buy the products or services? Will they be regular long-term customers, or occasional purchasers? However, frequency of purchase also needs to be considered alongside the relative size and value of purchases. Regular long-term customers are ideal for providing a steady revenue stream, but if the value of those regular purchases is low, it may pay the business to target larger but less-frequent purchases.

- Do the customers share common features that are relevant to the market? For example, are they in similar age groups, or of the same sex, marital status, social class or ethnicity?

- Taking the analysis of customers further, are there typical groups of customers that will buy the products or services, such as teenagers, single parents, sick or disabled people or elderly or retired people? Do the customers have any common lifestyle factors, hobbies or interests? Are they, perhaps, health food or fitness enthusiasts, do-it-yourself enthusiasts, environmentalists, young home owners, rock musicians, car owners or football fans? Are there any social or psychological factors involved, such as public image, prestige, wanting to be fashionable, following social trends, needing to identify with others or a desire for self-improvement?
Market Segmentation

The answers to the questions in the previous section of this chapter will obviously vary substantially between different groups or types of customer; it is the analysis of the common or shared aspects of those answers that enables the customers to be “segmented” into groups and, subsequently, specifically targeted by the company via different marketing approaches.

This process of segmenting customers serves several purposes. It helps to identify the groups of customers with the best potential to generate sales revenue. This might be because some of them will be willing to pay more for what is being offered, or because some have bigger needs than others. It also helps to identify those groups of customers that may contribute most to profitability via higher profit margins. For example, larger commercial clients offering higher-value contracts over specific periods of time may provide good regular business but at tighter profit margins than smaller irregular sales. The ideal situation, therefore, is to achieve a balanced spread of regular income, ideally from ongoing customer contracts alongside more profitable income from customers who may buy less frequently. The first group provides the revenue to pay for overhead and operating costs, whilst the second group contributes to company profits.

Identifying customer segments can also help to define targets for more detailed market research. This, in turn, will generate the information needed to develop future marketing strategies and allow the business to focus the sales and marketing effort on the parts of the market that offer maximum long-term potential. A good example of how suppliers segment their offer to meet the different needs of customers is the structure of tariffs for mobile phone usage. Table 7.1 illustrates how the prices from one of the major European networks for the i-Phone 4S (shortly after its launch) reflected the different levels of customer use. The heaviest business users pay high monthly contract costs, but the phone is provided free of charge; for medium usage, there is a lower contract charge, but a modest purchase price for the phone; and for low usage, there is a pay as you go option, with no contract, but the phone has to be purchased up front at the full retail price.

Table 7.1: Mobile Phone Usage-based Tariffs

<table>
<thead>
<tr>
<th>Length of Contract</th>
<th>Phone Minutes</th>
<th>Free Texts</th>
<th>Internet Usage</th>
<th>Cost of Phone</th>
<th>Cost of Monthly Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>24 months</td>
<td>600</td>
<td>No limit</td>
<td>1 GB</td>
<td>Free</td>
<td>£41.00</td>
</tr>
<tr>
<td>24 months</td>
<td>900</td>
<td>No limit</td>
<td>1 GB</td>
<td>Free</td>
<td>£46.00</td>
</tr>
<tr>
<td>24 months</td>
<td>1200</td>
<td>No limit</td>
<td>750 MB</td>
<td>Free</td>
<td>£41.00</td>
</tr>
<tr>
<td>24 months</td>
<td>600</td>
<td>No limit</td>
<td>1 GB</td>
<td>£99.97</td>
<td>£36.00</td>
</tr>
<tr>
<td>24 months</td>
<td>200</td>
<td>250</td>
<td>500 MB</td>
<td>£169.97</td>
<td>£31.00</td>
</tr>
<tr>
<td>24 months</td>
<td>50</td>
<td>100 MB</td>
<td>£309.97</td>
<td>£20.00</td>
<td></td>
</tr>
<tr>
<td>Pay as you go</td>
<td>n/a</td>
<td>300</td>
<td>100 MB</td>
<td>£489.99</td>
<td>£10.00/top up</td>
</tr>
</tbody>
</table>

In the context of a business start-up, the form that the segmentation takes will very much depend on the type of product or service being offered. For example, a commercial window cleaning business in a large-sized town might analyse its customers as shown in Table 7.2.

In this example, the customers are identified by type of premises, frequency of service provision, contract (for businesses), annual value of spend per customer, and service criteria. When combined, they will generate an annual income of £150,000. The percentage profit
margin is the contribution to the company overheads and profits after the variable costs of delivering the cleaning services are taken into account.

**Table 7.2: Window Cleaning Business – Customer Analysis**

<table>
<thead>
<tr>
<th>Type of Customer</th>
<th>Frequency of Cleaning</th>
<th>Number of Customers</th>
<th>Type of Contract</th>
<th>Annual Unit Value</th>
<th>Motivation</th>
<th>% of Total Revenue</th>
<th>% Profit Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>Town centre shops (large)</td>
<td>Weekly</td>
<td>15</td>
<td>Rolling contract (three month’s notice)</td>
<td>£1,600</td>
<td>High-quality, reliable service</td>
<td>15%</td>
<td>35%</td>
</tr>
<tr>
<td>Town centre shops (small)</td>
<td>Weekly</td>
<td>36</td>
<td>Rolling contract (three month’s notice)</td>
<td>£1,000</td>
<td>High-quality, regular cleaning</td>
<td>25%</td>
<td>50%</td>
</tr>
<tr>
<td>Office buildings</td>
<td>Every three months</td>
<td>3</td>
<td>Annual</td>
<td>£5,000</td>
<td>Competitive price</td>
<td>10%</td>
<td>20%</td>
</tr>
<tr>
<td>Private homes</td>
<td>Ten times per annum</td>
<td>600</td>
<td>No contract</td>
<td>£125</td>
<td>Good quality and value for money</td>
<td>50%</td>
<td>40%</td>
</tr>
</tbody>
</table>

**C. RESEARCHING AND EVALUATING MARKETS**

There are three main types of information that market research is looking for.

- Information about the customers – who they are and where they are located, buying frequency or patterns of purchase, motivation to buy, average spend, demographics and other factors that offer potential for segmentation (as described in the previous section).
- Information about the market itself – the market size in terms of units sold or total revenue value, the scope for market expansion, changing trends such as growth, stagnation or decline, national and/or international coverage (or lack thereof that could indicate potential for market growth), average selling prices and profit margins for products, and the identities of the main players.
- Detailed information about the competitors – their name, size, market share, reputation, location and areas of operation, brand strength and potential customer loyalty, their products as direct competition or potential substitutes, price and quality strategies, USPs, sources of supply, after-sales service and customer care policies.

**Market Research Sources, Methods and Techniques**

Most start-ups and early stage small businesses do not have the financial or staff resources to carry out extensive research into new markets above and beyond some basic research via the internet, which may be limited to quite general information. This problem is frequently compounded by the lack of any depth of marketing knowledge or skills. In the case of start-ups, time may also be a limiting factor if the entrepreneur is planning and researching the new business whilst still working full time elsewhere. There is often also a lack of financial resources to employ the services of specialist market research companies. For more specific information, therefore, potential entrepreneurs have to look to published sources or other secondary data.

There are some substantial market research specialists such as Mintel and Frost & Sullivan that compile annual market- or sector-focused reports based on both national and
international research. They typically collect and collate data from major players in each market and generate aggregated and anonymous summaries of the markets as a whole. These market reports can be purchased by anyone wanting to research a specific market and although they are costly (often between £1,500 and £7,000 each) they are still much cheaper than commissioning primary research from a market research agency. Key Note offers some more basic data, such as market focus and business ratios, for a few hundred pounds, but it is still quite easy to run up a large bill for this information. The key to using these services is to define precisely what is needed and to ensure that the data on offer is:

- relevant to small businesses, as much of the published data is aimed at multi-national corporate companies
- up to date, as some of the cheaper options may be several years old.

It can be hard to obtain information about customers if they are widely distributed, unless they can be segmented in some way according to their demographic characteristics. National Census data may be useful to help determine the relative size of regional or local populations. If the target customers have a specific common interest, such as a hobby, their potential interest in a new product or service may be determined by the use of a small advert or questionnaire posted in magazines or on websites; but often it is necessary to carry out more detailed and face to face research in order to understand how potential customers might respond to the offering; this is frequently obtained using questionnaires.

It is also important for the entrepreneur to achieve the right balance between quantitative research and qualitative research activities. Quantitative research will mainly focus on facts and figures that are quantifiable and can be used to make decisions relating, for example, to the size of markets, potential sales volumes and corresponding sales revenues; hence the value of published market research that has collated data from a broad range of sources and analysed and presented it in a form that offers relevant in-depth information. However, quantitative marketing data does not entirely consist of numerical data about sales forecasts and revenues, or numbers of potential customers in a geographical area or market sector. It can also include numerical analysis of information collected about people’s attitudes and preferences, likes and dislikes etc; this is essential to help the entrepreneur understand customers’ perceptions and the reasons that underlie their buying decisions.

Published research is cheaper and easier to access and is usually more objective, so it reduces the potential for bias when conducting primary research. However, published research tends to be historical in nature and is, therefore, often out of date. This means it is not always accurate. It may also be unsuitable for purposes of benchmarking or making comparisons between products or markets because different research methods may have been used to generate the data.

Qualitative data is equally important to the entrepreneur but in a different way, as it has the potential to capture the views, opinions, needs, preferences and motivations of the customer population. This will enable the entrepreneur to develop a market strategy that will focus on meeting the needs of the customers and utilise the product’s features, benefits and USPs to persuade them to buy. Qualitative information is much less readily available from published sources, so it is usually sought directly or indirectly from the customers themselves, e.g. via questionnaires or interviews.

The use of questionnaires or interviews also raises issues about the reliability of research including the issues of ensuring a sufficiently large sample size, and avoiding interview bias or subjectivity. Bias can be caused by an inappropriate choice of sampling technique and
through the selection of an unrepresentative sample or one which is too small in terms of the size of the population.

There are several sampling techniques that can be employed to achieve statistically valid and unbiased outcomes to research, such as random samples, sampling frames, probability samples, quota samples and stratified samples. These techniques are used by trained and experienced market researchers or consultants, but the majority of start-ups and small firms do not have the expertise to use these techniques themselves. Nor do they have the time to learn about them and incorporate them into the design of their market research, or the money to pay consultants to do the work for them. The research methodology and sample populations also have to be considered in the context of what is appropriate for the size of business and the complexity of the proposed product or service. For example, the depth and accuracy of research required to justify investment in a sophisticated nanotechnology device to detect explosives at airports by analysing gases in air samples will be much more complicated than the research needed to justify opening a new high street shop selling sports goods.

In reality, the research process can become quite ad hoc. What is, or is not, a sufficiently large sample population or a sufficiently broad cross-section of interviewees may well be decided by what is deemed acceptable by the potential lenders or investors who are evaluating the research. Quite simply, if they are not satisfied that the research is adequate to justify funding, it will be rejected. For this reason, when describing the market research that has been carried out during the preparation of the business plan, it is always worth mentioning any further research activities that may need to be conducted (for example, to identify new market opportunities for future expansion) using part of the loans or investment funding. This is a perfectly legitimate and sensible action, and it also helps to create a positive impression about the business proposer’s ability to plan for the future.

**Researching the Competition**

The barriers to market entry facing business start-ups are outlined in Section C of Chapter 3. Whilst some of them relate to accessing finance and resources, the majority are based on competition within the markets. In order to fully understand and evaluate the relative importance of, and potential threats posed by, these barriers, they need to be researched as fully as possible. Unfortunately, most start-ups lack the skills to carry out in-depth analysis of competitors, and the financial resources to pay an experienced consultant to do the work for them.

The competitor analysis should ideally include a detailed review of the following.

- The number of competitors with directly competing products or services that operate in the market, and/or the competitors that offer potential substitute products within that market or from other markets. Ideally, the main competitors should be identified individually, and comparisons made with their respective products or substitutes to identify those that present the biggest threats.

- The size and resources of competitors in comparison with the new entrant to the market. This includes factors such as capital value, borrowing capacity, financial reserves and economies of scale, as well as the marketing skills and expertise available within those businesses or the external expertise they can afford to buy in. In the case of very large companies, the actual size or value of their resources may be of less relevance than their potential attitude to new entrants: if they are very large and determined to dominate the market, the whole question of going into direct competition
with them must be reconsidered. However, if the new product presents a niche opportunity that does not threaten the major competitors (and can be clearly differentiated as such), those competitors may not perceive it as a threat.

- The competitors’ strength and control within the market of in terms of influence, dominance and market share – particularly in markets with few suppliers where the customers may be deterred from trading with new entrants in case they put their supply line with the main supplier at risk.
- The competitors’ attitude to new entrants – e.g. is it aggressive, neutral or dismissive? In some newly created markets, new entrants with similar or indirectly competitive products are actually welcomed as their existence can help to increase the overall demand and size of the market. However, in other markets the dominant companies may ignore new entrants until they grow sufficiently to present a threat to market share, or they may fiercely resist new entrants. The classic example of this was Freddie Laker’s attempts to introduce low-cost airline flights in the 1980s, when the established airlines worked together to undercut the prices until he was forced out of business, after which they restored their original pricing structure. Another example of aggressive attitude is where large dominant companies will attempt to block the introductions by using their financial resources to employ lawyers to object to patent applications for new innovative products that might threaten their market share. Although they know that the objections to the patents will be rejected, this delaying tactic can buy them time to develop their own alternatives to the proposed innovations.
- The brand loyalty of the competitors’ customers and their willingness to consider new or alternative products. The longer customers have experienced established and positive supply chain relationships in a market with large, well established and reliable suppliers, the harder it will be for new entrants to persuade them to try buying from an alternative supplier – unless, of course, the new supplier can offer a significant advantage in price, quality or an innovative solution to meet the customers’ needs.
- The market knowledge that the established companies hold in terms of detailed understanding of how the market operates and the key factors that influence the market and the way customers behave. This also relates to the marketing experience and expertise of staff that they can afford to employ compared with the relative paucity of skills and knowledge that a new entrant to the market may possess. Smaller businesses also find it much harder to attract such expertise, even if they can afford it, as they may not be able to offer the same prospects for advancement as are available in a large firm.

Information about competitors can be gained from primary sources – for example, by carrying out internet searches to identify the main competitors and then researching their websites, or by investigating them more directly by requesting or buying samples of their products or by posing as a potential customer to obtain information from them. At a local level, if the competitors are small businesses, the simplest solution may be to use local directories such as Thompson Local or Yellow Pages, or just to look for advertisements in the local press.

More detailed information can be obtained from secondary sources such as trade or business directories (Kompass or Kellysearch), trade association yearbooks or, for local competitors, via chambers of commerce. It must be remembered, though, that information obtained from secondary sources may need to be checked for validity and accuracy, as well as to ensure that it is up to date. Advertisements in trade magazines can also be very useful as they not only reveal the potential competitors, but also indicate the means of advertising that those competitors prefer to use to reach their customers. For more specific information about the companies as opposed to their products, it is quite simple to obtain details by payment of a small fee to the Registrar of Companies for annual reports, to Experian or Equifax for credit
checks, or to the Fame database for a broader overview of the business including annual reports and credit status.

**Porter’s Five Forces**

Porter (1998) proposed a model (Figure 7.1) that identified five forces that exist in the competitive market environment in which businesses operate. The model acts as a means of analysing and understanding the nature and extent of the competition that influences the potential of the business to operate and succeed in the market.

By ascertaining the relative power of each of these forces on itself, a business can identify how to position itself to take advantage of opportunities and to overcome threats. It is also important to remember that the forces are constantly changing, so the analyst must focus on the key forces at work at any one time. This should be a regular periodical review rather than a one-off exercise.

*Figure 7.1: Porter’s Five Forces (adapted from Porter 1998)*

**Force 1: The Threat of New Entrants into the Industry**

What are the main barriers to market entry and how big is each one? Porter identifies:

- the capital costs of entering the market – the high costs of capital investment to set up a new business can restrict potential new entrants
- any legal or regulatory constraints that have to be overcome – the more complex they are, the more they will deter new entrants
- brand loyalty and the cost to customers of switching to new products compared with the convenience of staying with the existing supplier with whom strong relationships may already exist
• the economies of scale (for purchasing and materials costs and for the unit costs of production) available to larger established firms in the market, making them more cost-efficient than smaller rivals can hope to be until they can grow to a similar size
• access to input and distribution channels – existing distribution channels are not always available to new entrants and may have to be developed from scratch, which can be both costly and time consuming.

Force 2: The Threat of Substitute Products
How strong is the threat of substitute products?
• Can the price, quality and performance of the substitutes match the existing products in the market? Is there a sufficient price or quality difference that might make the substitute product more attractive in spite of, perhaps, not being quite as good? For substitutes in the same market that are very similar, the costs of switching from one to another can be low, but for indirect substitutes they might be higher.
• Would the customers be willing to switch to the new products? High levels of customer care or loyalty could deter any switch; however, if the new products are priced very competitively, the price difference may be more important to some customers than brand loyalty.

Force 3: The Bargaining Power of Buyers or Customers
How strong is the customers’ buying power?
• This is about the number of customers in the market and their respective volumes of purchases. The larger the number of small customers and the fewer the number of suppliers (and the bigger their volumes), the more power suppliers will have over the customers (e.g. the major supermarket chains can use their size and spending power to influence customer purchases via targeted advertising, and promotional discounts). In contrast, if the number of customers is low and they spend large sums with suppliers, they will have much more power and influence over the suppliers.
• Another factor is the number of other businesses (competitors) supplying the market, as bigger numbers create more choice, giving more bargaining power to customers.
• How much does it cost to switch between substitutes? Low switching costs give more power and flexibility to customers. Where costs are high, e.g. because of penalties incurred when exiting fixed-term supply contracts, the power lies more with the supplier than the customer.

Force 4: The Bargaining Power of Suppliers (to Businesses in the Industry)
How strong are the firm’s suppliers in the market?
• How unique and/or scarce is the product? Is there a plentiful supply in the market? Scarce supplies of essential products facilitate influence and control over the market. A good example of this is the way that oil prices increase dramatically whenever there is political unrest in the Middle East.
• Can it be easily substituted and is the cost of switching low? If there are few alternatives and/or the cost of switching is high, supplier power remains high.
• Do the suppliers sell to other markets or are they dependent on this single market? Broader market access can strengthen the bargaining power of suppliers, especially if those other markets offer equal or better profit margins.
• How many suppliers are there in the market? Is it highly competitive with lots of small suppliers, or dominated by just a few large and strong suppliers?

Force 5: The Level of Rivalry Between Businesses in the Industry
How much rivalry is there between firms in the market?
The other four forces feed into this rivalry.

Is competition between rivals based on price or non-price aspects (branding, advertising, quality, service, warranty, uniqueness, availability of substitutes)? The more aspects they all compete on, the higher the level of competition will be in the industry sector.

The intensity of competition will be influenced by the barriers to entry. High barriers will restrict competition from outsiders, but low barriers will make it more likely.

Mature markets may lead to the periodic “shake-out” of weaker rivals, perhaps by merger or acquisition, or because they are unable to compete and eventually fail.

Strong buyers and the availability of close substitutes will increase rivalry, especially if there is little brand loyalty with customers.

Table 7.3 summarises the five forces and their influence on profitability.

**Table 7.3: Summary – How the Five Forces Can Influence Profitability**

<table>
<thead>
<tr>
<th>Force</th>
<th>Profitability will be higher if there are:</th>
<th>Profitability will be lower if there are:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bargaining power of suppliers</td>
<td>Weak suppliers</td>
<td>Strong suppliers</td>
</tr>
<tr>
<td>Bargaining power of buyers</td>
<td>Weak buyers</td>
<td>Strong buyers</td>
</tr>
<tr>
<td>Threat of new entrants</td>
<td>High entry barriers</td>
<td>Low entry barriers</td>
</tr>
<tr>
<td>Threat from substitute products</td>
<td>Few possible substitutes</td>
<td>Many possible substitutes</td>
</tr>
<tr>
<td>Competitive rivalry</td>
<td>Little rivalry</td>
<td>Intense rivalry</td>
</tr>
</tbody>
</table>

However, there are several limitations to Porter’s model that need to be considered.

- Porter’s theory assumes relationships between suppliers, customers and competitors are, and will usually be, adversarial, when in fact cooperative alliances are often developed within markets. An example is the alliance in the aircraft industry between British Airways, Iberia, and American Airlines.

- It overlooks the positive and effective management of customer relationships as another influencing factor.

- It implies that the five forces apply equally to all competitors in an industry – but they will each vary in size, brand strength, product range and quality of products. In *Competitive Advantage*, Porter (2004) discusses “good competitors”, which can be tolerated in a market as they present no threat or have a positive use by limiting the “bad competitors” that do pose a threat by attempting, for example, to disrupt or distort the market for their own benefit (although isn’t this exactly what free market competition is all about?).

- It assumes that the market and external environments are static, but markets constantly change and external factors (economic influences, new legislation or political interference in the market) change them further.

- It focuses mainly on product-based markets, not the provision of services or resources that make up the sales of a large proportion of SMEs.
REFERENCES

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Planning Physical Resources

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INTRODUCTION

Potential lenders and investors are primarily concerned with the finance and marketing content of the business plan. However, before the detailed budgets can be prepared and the sales and distribution cost aspects of marketing can be finalised, there are a number of practical decisions need to be made about the physical resources the business will need in order to operate. This is because these physical resources will affect both the start-up budget (when they are acquired) and the ongoing operational budget (a proportion of the physical resources will become overheads of the business and will incur ongoing expenditure). This expenditure will influence the break-even situation of the business, so the pricing structure of the goods or services offered must be sufficient to cover them and to generate additional profit.

Identifying and planning the initial resource requirements (and their associated costs) are key elements of quantifying the investment required to start the business. Often, the hardest part of that process for many budding entrepreneurs is to make the distinction between resources that are absolutely essential, those that can wait for a few months until revenue starts to flow, and those that it would be nice to have but are not really justifiable until the business is making a steady profit. It is equally about affordability so, for example, a second-hand delivery van might be essential and affordable at the time of start-up and a second larger van may be needed as sales grow, but brand new vans and a new Ferrari for the chief executive officer (CEO) to drive are luxuries that can wait until the first million pounds of profits have been banked.

Subsequently as businesses grow, their physical resource requirements will constantly change, particularly if they have to employ and find space for more staff to support the growth, or if they open up new business locations. The size, volume and extent of physical resources may well pre-determine the premises requirements; conversely, the availability of premises may place limitations on the physical resources that can be utilised. This chapter examines some of the issues relating to planning and organising the various resources that are needed by early stage businesses.

A. LOCATION, PREMISES AND SPACE REQUIREMENTS

Identifying a Suitable Location for the Business

The type of premises required for a business and the appropriate location for its base will depend primarily on the type of goods or services it is offering and how they are delivered to customers. For example, a mobile hairdresser who visits clients in their homes may be able to simply work from his or her own home, with just the need for a small amount of space for storage. A self-employed professional consultant may be able to do likewise, by converting a spare room at home into an office; however, a small office in a business centre and the associated mailing address might create a better image in the eyes of clients and customers, should they need to visit. An engineering or manufacturing process would almost certainly require premises designed and approved for industrial use, particularly if the work involved noisy machinery, dusty or dirty processes, etc. For a retail business, the location of the premises is a primary factor: it will need to be either in a place where the customers already
go, such as a shopping centre, or where it is easy and convenient for the customers to get to, such as a retail park. A wholesaler would need to be in a central position from which the customers could be supplied, and ideally close to a good road network.

There is no specific formula for finding the ideal location for business premises although the nature of the market will have fundamental implications for the location and vice versa. With the exception of e-commerce and mail order firms where the clients are based at a distance, the business needs to reflect the community it serves and, therefore, its location within that community must be selected to match the needs of that community. A business selling commercial hydraulic hoses and their fittings is ideally situated in an industrial estate where commercial clients can call and park easily, but it would be as much out of place in the high street as a fine china shop would be in an industrial estate.

The location of competitors must also be considered. Where the market community is large, it is not unusual to see competing businesses located near each other. In a smaller community, however, two rivals competing for the same small market would probably put each other out of business as neither would make enough profit to survive. There is an exception to this situation in certain specialist markets such as specialist sporting goods, where several rival suppliers might set up in a location that is heavily used by visiting skiers, fishermen or water sport enthusiasts. An example of this situation is the retail diamond market in places like Antwerp and Hatton Garden in London, where the up-market retailers form clusters in a very small location because they know that their wealthy customers will pay to travel to a location where that market is centred.

It is also important that the location should match the image of the product or service on offer, and that the premises themselves should reflect that image. It is not enough for an up-market clothing shop to be located in the main street of a town; it needs to be on the right side or at the right end of the high street where more affluent customers are likely to be found, and it must project an image of up-market quality.

The cost of retail premises is largely determined by their location. Town centre shops are normally relatively expensive to rent, lease or buy, but those same high rents also mean that town centre shopping centres or arcades frequently have a proportion of empty property due to the high turnover rate when businesses fail or move to out-of-town retails parks because of the high rents in town. Shops located in retail parks can still be quite expensive to rent because of the infrastructure costs (e.g., access roads and parking); however, the ease of access and the free parking tend to generate more customer footfall, which outweighs the costs.

The cost of business premises on industrial or commercial estates will depend on a number of factors including their proximity to road networks and motorways, the age and condition of the premises themselves, and the extent and quality of customer parking, security and services. The same basic principle applies to storage and warehousing. To rent space in a farmer’s barn may be very cheap, but remote locations and muddy access roads may not be so good in winter. On the other hand, a modern warehouse will be much more secure and accessible, but correspondingly more expensive to rent. This is why many start-ups will initially look for small or low-cost premises to keep their overheads to a minimum, but with the full expectation that they will need to move to somewhere larger (and probably more expensive) within a year or two — by which stage they will hopefully be generating the revenue to afford larger premises.
Selecting and Preparing Premises

When exploring the various options for acquiring premises, there are a number of factors that need to be considered.

- The type of business that is proposed and the type of premises most appropriate to it. The physical environment may be important to the product or process – e.g. hygienic and easy to clean for food preparation, secure for storage of valuable products, or a specialist environment for sterile services.
- Whether or not customers will need access to the premises on a regular basis, where these customers will be coming from in terms of distance, and how they might be travelling (re car parking or public transport links).
- The visual appearance of the premises, particularly if they will be visited by customers on a regular basis. This issue is examined further in Chapter 10 in the context of customer perceptions and expectations.
- The need for easy access to motorways, road networks, rail links, or airports, particularly where the premises will need to accept high-volume deliveries by truck, or where its uses a fleet of vehicles to deliver to customers. When the cost of vehicle fuel is high, choosing a central location can be critical to controlling operating costs, for fuel consumption, length of delivery times and travelling distances.
- The likelihood of obtaining planning consent for the proposed use. In countries that have strict planning regulations for the use of premises, there may be restrictions on which business activities are allowed in certain areas. For example, no industrial activity may be allowed in residential areas, protected rural areas or national parks, or limits may be put on the use of domestic premises for retail or commercial purposes. There may also be restrictions on parking or access by delivery vehicles during the daytime when businesses need that access the most.
- The availability of suitable and affordable high-speed and high-capacity broadband access for ICT businesses. This is often lacking in rural areas and remote locations.
- The need for security to prevent intrusion, or to protect valuable stock from theft or damage. Quiet rural locations may be desirable working environments and possibly cheaper than urban sites, but where high-value stock is being held, they may be too isolated to be effectively secured outside of working hours, and the costs of insuring against theft could be disproportionately high.
- The space requirements and the affordability of the premises, both present and future. At the point of start-up, the need for space may be quite modest and the money available to pay for it may be limited, but it is still necessary to look at what will be needed in the future. Relocating to larger premises can be expensive in terms of legal and removal costs, and it can be very disruptive to the business and possibly to the customers, so that potential cost and disruption needs to be factored in when selecting premises. It might, therefore, be more prudent at the start of a new business to look for a location that is possibly larger than is currently needed, but which would facilitate the growth of the business without the need for relocation in the medium term. Another option is to look for premises that have potential for expansion at a later date, or adjacent space for an extension to the building.
- The availability of staff in the locality who have appropriate skills or expertise, or who could be trained to perform specific roles within the business. Recruiting staff with specialised skills can be both expensive and time consuming, especially if they have to be persuaded to relocate.
• Convenience of access for the owner and staff. This can be quite an important issue for staff recruitment: what may be an idyllic location for the owner of a business, and perhaps conveniently close to where he or she lives, may be a different prospect for staff who need to travel substantial distances from their own homes, or lower paid staff who rely on public transport, particularly in rural locations. The issue is not just about the convenience of staff travel, but also about having staff on site at the right times to interface with customers and deal with enquiries.

• Specific environmental requirements for the space, determined by the products being stored or manufactured. This might include the need to ensure an ambient temperature or humidity within certain specified ranges, or the need for sealed and bunded floors to prevent potential leakage of toxic substances into nearby watercourses, or the need to be vermin proof. There may be a need for air filtering and positive air pressure in rooms where biotech research is carried out, to prevent cross-contamination from the air outside, or fume cupboards to prevent toxic fumes from leaking into work-spaces.

• Special physical requirements. These are often found in industrial buildings where, for example, floors may have to be reinforced to withstand heavy loads from large manufacturing machines or point-loads for the upright frames of pallet storage. There may also be specific headroom or width requirements for fork-lift truck access, or the need for reinforced roof beams for overhead cranes.

• Cost and method of occupancy. For short-term needs, the best option is usually to look for rented premises where the arrangement is typically based on an annual contract, or perhaps a very short-term contract. The latter is often available in business incubation centres where the contract can be ended with perhaps up to three months’ notice. Such sites are ideal for start-ups as the licences issued to occupants by incubators often allow flexibility for expansion (or contraction) into an alternative space in the same incubator to meet the needs of the businesses. For medium- to long-term occupancy, the normal contract arrangement is a 10-, 15- or 25-year lease, with rents reviewed annually and payable quarterly in advance. This is particularly common with retail premises. If the business has substantial reserves or funding, it may be viable to buy the freehold of the premises either outright or through a commercial mortgage that would normally be spread over 10 to 15 years. Although purchasing premises ties-up capital, the premises would appear as an asset on the firm’s balance sheet and could be used as security for further borrowing, particularly if the premises grew in value over time.

• The availability and supply of public utilities, such as electricity, gas, telephone lines, water, and sewage/waste disposal services, not all of which may be readily available in all locations. It is usually possible to obtain competitive prices from suppliers, or a “bundled supply” where gas, electricity and telephone lines, for example, are supplied by a single provider. This situation will vary widely according to location, particularly in developing countries where options may be limited. It goes without saying that when buying plant and machinery etc, check first that the appropriate sources of power are readily available.
B. MACHINERY, EQUIPMENT, FIXTURES AND FITTINGS

Plant and Equipment

People tend to think of capital equipment in terms of plant and machinery used in manufacturing or industry such as heavy rolling or milling machines, printing presses, foundry equipment, steel presses and moulds. However, the label is much broader and includes items used in materials handling such as pallet or fork-lift trucks, weighing, packaging and labelling equipment, pumps, cranes, lifts and pulleys, conveyor belts and rollers, power tools and hand-held equipment. In a retail environment, it might include catering equipment and ovens; or in agriculture, it could be tractors, ploughs, harrows and combine harvesters. The term really relates to the type of purchase: a capital item is bought with the expectation of being used regularly over an extended period of time and, therefore, depreciated over that same period; a revenue purchase, on the other hand, is something that is only expected to be used or to last for the current financial year.

There are several questions to be considered here when planning resource requirements, all of which will have a financial implication for budgets and cash flow.

- What essential plant or machinery is required to manufacture your products or facilitate your processes? Do you already own any of this, or do you need to buy it?
- Is it essential, or more cost-effective over time, to buy the item new, or can it be bought second hand?
- If the item is very specialised, will there be a long lead time for delivery, or will it take time to install and commission before becoming fully operational?
- Will the premises need to be modified to accommodate it, e.g. reinforced floors or three-phase electricity? Are there any specific safety issues that need to be considered?
- Will it be necessary to maintain a supply of tools and spare parts for the machinery, and to train or employ staff to maintain it?
- What special training will the operators need, if any? Can that be delivered on site or will they need to go away for training?
- Are there any implications for insurance and the safe and secure storage of the equipment, particularly if it is valuable and easily moved (or removed)?
- What is the best way to finance the purchase? Will the company pay for it from reserves (not possible in start-up situations), by means of a bank loan, by hire purchase, or perhaps by leasing? Will it be necessary to make a substantial down payment when placing the order? How will the business finance the period between ordering and becoming fully operational – when the equipment may not yet be fully functional and able to generate income?
- Which is the most tax-efficient way of acquiring the equipment – e.g. leasing it from a third-party leasing company as opposed to hire purchase?

Fixtures and Fittings within the Premises

Fixtures and fittings within the premises are those items that are attached to the structure, or which are necessary to the production of the goods or services but are not directly involved in their creation or provision. Fittings include such things as lighting and heating systems,
electricity or water supply pipes, telephone or broadband cables, sinks, toilets, drainage and air-conditioning systems, which have been fitted to the premises to make them habitable and usable. There can sometimes be confusion between the terms “fixtures” and “fittings” as some items such as supply pipes or cables may have been built into the fabric of the premises. It may be that when moving into new premises the existing fittings are inadequate or need to be upgraded, replaced or repaired. Perhaps extra power supply points are needed in the office, or the water supply has to be extended, or new toilets built for additional staff. When considering these situations it is important to consider the installation cost as well as the purchase cost of the items.

When we talk of fixtures within the premises, we are usually referring to items such as safety rails, storage or racking systems, lifting equipment and mezzanine floors, which have been fitted or installed within the building to facilitate the operation of the business. Questions to ask here include the following.

- What fixtures are needed for immediate use, and what additions will be required as the business grows?
- Is it cheaper to install them all from the outset or is this beyond the capital currently available?
- Will deferring the installation result in higher costs and potential disruption to business operations?
- If a loan is used to pay for the additional installation requirements right from the start, will the savings on future installation costs and later disruption to your business outweigh the arrangement fee and interest payments on the loan?
- If the fittings include storage facilities, are they of adequate size or capacity to meet current and forthcoming needs, and are they capable of being used in such a way to ensure proper stock rotation to avoid waste and additional expense?
- Are any air-conditioning or humidity systems adequate to provide any specific environmental conditions that the business needs for goods in storage?
- Is there any known or forthcoming legislation that might require modifications to premises that would be cheaper and less disruptive to incorporate from the outset?

**Office Equipment and Furniture**

Office equipment and furniture includes those items within the building that are not used for production or storage, but which still count as capital equipment because of their cost and long-term usage. As well as the furniture, storage and ICT equipment within management or administrative offices, this category also includes any carpets, easy chairs and display materials located in a reception area for visiting customers and, of course, any tables, chairs, tea\coffee cups, kettles, toasters or microwave ovens for staff use.

Within an office space, we are talking about items such as desks, chairs, filing cabinets, storage cupboards, computers, safes or petty cash tins, telephones, fax machines, answering machines, franking machines, cleaning equipment, and the multitude of minor items such as staplers, hole punches, laminators, and even the favourite, but non-essential, gadgets used by the boss. These are the things that are most often taken for granted or underestimated when planning a new business: individually their costs are quite small, but when aggregated, the total costs can be very high, so they all need to be identified and costed for budget purposes.
Other Knowledge-based Capital Expenditure

It is also important to remember that for knowledge-based businesses, particularly those involved with early stage development of new innovations or technologies, the capital investment and expenditure may take the form of expensive laboratory or research equipment. For very specialised applications, the expenditure may not even be for the purchase of physical equipment: instead, it could be for the payments to buy fixed amounts of time to use highly specialist research equipment at a university or research establishment in a different country. This situation is quite common, especially in biotech and nanotechnology research, where there may only be one or two of the required machines worldwide, and where “user time” is sold to outsiders to help pay for the equipment. Strictly speaking, this is not capital expenditure in the conventional sense of buying an asset that the business will own; instead, it is capital outlay, as a development expense for the new technology. It does need to be properly budgeted for.

The costs of protecting and maintaining IP such as patents is another capital outlay that does not relate to a tangible capital item like a piece of production machinery, but it is still a key part of the product development process that needs to be costed for budgeting purposes. In the case of patents and patent licences, they can be shown on the annual balance sheet as “intangible assets” of the company.

ICT and Administrative Support Systems

There may be some overlap between the categories of ICT and administrative support systems and office furniture and equipment, as some businesses classify ICT equipment such as laptops as office furniture, especially if they are used solely in the office. Other businesses will classify those items as ICT equipment, particularly laptops, smart phones or media projectors that are used away from the main business location by sales people or staff working from home. Again, by virtue of the cost and duration of usage (more than one year), ICT office equipment is usually classed as capital expenditure.

As well as ICT hardware, admin support systems include other resources used by staff such as office telephone systems, fax machines, photocopiers, printers, and administrative software such as accounting packages, payroll systems, order-processing systems, databases and customer records. Depending on the nature of the business, there may also be a need for sector-specific software (e.g. room booking systems for hotels or secure online payment systems for internet sales) or bespoke software systems, perhaps for customer quotations.

When buying any items of furniture and equipment or any ICT and admin support systems, the same questions need to be asked as when making other capital purchases.

- What is essential as opposed to “nice to have”?
- Does it all have to be purchased from new or can we use or upgrade any existing equipment that the owners bring into the business?
- What is the most appropriate or cost-effective way of purchasing, e.g. through loans, hire purchase or leasing? Whilst hardware can be financed externally, software is usually purchased outright as it becomes outdated quickly and has little residual value, especially if it has been specially designed for the needs of the business.
• What training will staff require in order to use the systems effectively, and how long will this take?
• Which items of ICT and admin support are important for public appearance and visibility to customers, e.g. in the reception area, to create the right impression of the business?

Consumables and Miscellaneous Business Expenses

Consumables is the collective term for the various day to day minor purchases of things like cleaning materials, office stationery, printer inks, toiletries, tea and coffee for the staff kitchen, and water for the office or reception water-cooler. These are basic, small but regular expenses which are not directly associated with the supply or provision of goods and services, but which add to costs and reduce profit. If not watched carefully, they can easily get out of control, especially as some of the items can easily be misappropriated for personal use. Hence, they should be included as a budget item in the financial plan alongside the more substantial expenditure items so that they can be checked and monitored alongside the other business expenditure. In particular, relatively small but regular miscellaneous expenses, such as snacks and sandwiches for office meetings, business lunches or hotel meetings, can mount up to four-figure sums over the course of a year.

C. PURCHASING AND SUPPLIES

Any business that is manufacturing products, importing them for sale and distribution, or wholesaling or retailing products that are sold by other companies will need to establish formal arrangements for the supply of either the raw materials and components, or the finished goods. It is essential, therefore, to ensure that the sources and lines of supply (the supply chain) are sufficiently reliable and robust to avoid problems in subsequently providing reliable sales to the end user or next company on the supply chain. This process of establishing the supply chain raises a number of issues including sourcing supplies, the reliability of suppliers, relative costs, frequency of delivery and levels of stock-holding, bulk discounts, advance ordering arrangements, seasonal requirements, storage implications for premises, and not least the effect of stock levels on working capital and cash flow.

Finding and Negotiating with Suppliers

In the days before internet searches became available, finding suitable suppliers was frequently difficult, especially if they were located in distant countries. In established business sectors, there are usually trade associations or trade magazines that can assist with finding the right supplier; however, where, for example, components are needed for new innovative products, an imaginative internet search using a range of keywords may be the best solution, especially if that component needs to be designed and manufactured for the first time. Sometimes even just asking colleagues or contacts in other businesses or at networking meetings can help. One interesting example of this was a highly specialist small business in Sussex (UK) that manufactured high-precision nanotechnology equipment and needed a supplier to manufacture a component from a rare metal to very fine tolerances. The owner searched the internet and trade sources for several days and was telling his neighbour on the industrial estate where he was based about the problem – only to be told that there were two
such engineering firms in the UK that could do the work and that his neighbour was actually one of them. Problem solved!

One-off purchases aside, any longer-term arrangements need to be properly documented, ideally with formal contracts if substantial sums of money or regular supplies are involved. These documents should specify terms of trade between the two parties, including agreed prices, quantity-related discounts, credit terms, minimum order quantities, order lead times, delivery deadlines, and any penalties that might be incurred by default. These contracts can become very complex and can involve lots of clauses and conditions, so it may pay to get a lawyer to read through the draft contract before signing.

There are a few basic principles to be considered when negotiating and dealing with suppliers.

- Your suppliers are just as entitled to make a reasonable profit as you are. Don't be afraid to push them for a bit more credit or discount when the time is right, perhaps if your purchases from them are growing, but respect their position if they turn you down. They almost certainly still want your trade, but not always at any price. Sometimes when a customer pushes too hard, you just have to walk away from the business if it ceases to be worthwhile.

- The objective in dealing with suppliers should be to develop a long-term, honest and reliable relationship that will ensure continued supply of quality goods or services at a mutually acceptable price. Suppliers should be treated and respected as stakeholders in your business, just as you would treat your own customers, the bank manager or your accountant. They have an interest in the profitability and survival of your firm, just as you have in theirs, in that both businesses need each other as part of the supply chain to the end user. The cheapest price from a supplier is not always accompanied by the best quality and reliable products, and long-term continuity of supply can be just as important to your business. It also pays to keep in regular contact with suppliers, not only to find out about new products or opportunities, but to talk about any trends or changes in the market place that might affect you both.

- If you have cash flow problems, don’t lie to your suppliers or ignore their calls. They are not stupid and they can read the warning signs as well as you can. Be honest, contact them promptly and tell them about the problem, ask for their cooperation, give them a firm and realistic date for payment, then honour it. If you can, make a payment on account in the interim period, to show your goodwill. Sometime later, it may be your supplier that has a similar problem and asks for a prompt or early payment, in which case if you can afford it, return the favour. This is what building long-term business relationships is all about, and it will do you no harm at all when a bank or another supplier asks you for a trade reference from an existing supplier.

- Although price is important, it is not the only area for negotiation with suppliers. If the supplier is unwilling or unable to improve discounts or prices as the volume of your purchases increases, look for alternatives, and be imaginative. Can you get better payment terms, e.g. a longer period of credit, or a higher credit limit? Is there some advantage to you in varying delivery arrangements, such as weekly instead of fortnightly, to reduce the levels of stock that you need to hold? Will the supplier contribute to some of your marketing costs, e.g. by paying towards the cost of a trade exhibition, sharing advertising costs or by giving you some point of sale material or free samples for your customers? These are the sorts of possibilities that will benefit both you and the supplier in the long term.

- You should ensure that you have suitable monitoring systems in place to check on the quality of goods received, and that quantities, prices, and discounts are correct. Any discrepancies should be recorded and notified to the suppliers immediately. You cannot
realistically expect your suppliers to take responsibility for problems with goods that have been out of their hands for any length of time, so by reporting problems promptly you can avoid potential disputes. Again, be honest with them and don’t try to claim more than is properly due. If your suppliers regard you as being fair to them, they will tend to treat you fairly in future, and they will be more likely to respond to a request for help when you have a problem, or need an urgent delivery. However, if they do not respond reasonably, perhaps it is time to look around for a new supplier.

Planning and Managing Stock Levels

For providers of services, where the only stock which is held is likely to consist of stationery or consumables, stock control will probably not cause any major problems, but for manufacturers, wholesalers and retailers the situation can be totally different. Anyone involved in wholesaling or retailing will need to identify what stock has to be held at any one time. There will, of course, need to be a purchase of opening stock, and an ongoing holding of a reasonable level of core stock – those items that will be in constant demand. The costs of buying this opening and core stock have to be built in to the budgetary plan. As stock is sold, more is bought in to replace it and to replenish stock levels and as the business grows, the average level of stock held may need to be increased. This can have implications for storage space, equipment and the availability of adequate working capital to fund the additional stock-holding.

Stock-related problems can include:
- having inadequate volumes of raw materials to produce goods
- having inadequate volumes of completed goods to meet sales orders
- having the wrong type of goods in stock – often a problem with seasonal goods
- having too much money tied up in slow-moving stock, causing cash flow problems
- being unable to obtain stock from suppliers (particularly imported goods) on a regular or reliable basis
- having to handle a high proportion of returns of faulty or unsatisfactory stock
- being left with unsaleable or outdated goods
- careless storage or handling resulting in damaged stock
- inaccurate invoicing of stock sold or poor stock control, resulting in inaccurate stock records
- theft of stock, or slippage (e.g. removal of stock by staff for their own use).

Most of these problems are fundamentally concerned with operational issues, relating to the ordering processes and the physical storage and stock management systems used by the business. All of them, however, will have an impact on the profit margins of the business. Stock levels need to monitored carefully to ensure that they are sufficient to meet foreseeable demand, without tying up working capital unnecessarily for long periods of time. This will involve both regular liaison with sales and marketing staff to assess future levels of demand, and an efficient system of ordering replacement stock, e.g. by identifying both the minimum acceptable levels of stock, and the levels at which new stock must be ordered allowing for lead times etc. It is no good waiting until the stock reaches the minimum level before re-ordering, if the stock is likely to run out before the delivery is received. If the delivery takes two weeks to arrive, then the re-order level must be set at the minimum stock level plus the amount of stock that would typically be used during that two week lead time.
Many larger organisations, particularly in the automotive industry, use JIT ordering and stock delivery systems whereby stock can be ordered and delivered at short notice. This works well for them as it saves them the expense of holding large quantities of stock, but it often results in their smaller suppliers having to bear the cost of holding that stock on their behalf. To mitigate this problem, there must be close liaison between the customer and supplier (e.g. in the motor industry by sharing stock data via linked computer systems): as part of its forward-planning process, the customer will provide the supplier with estimates of its needs at regular intervals so the supplier can plan and adjust its own stock levels ahead of receiving the actual JIT orders.

Whilst the physical monitoring of stock is important – to detect any theft, damage resulting from storage or handling, and deterioration due to poor stock rotation – it is also important to monitor the financial aspects of stock control. When wholesalers and retailers handle a large number of stock lines, they have to deal with a constant stream of changing prices, discount structures, and special promotions, any and all of which will affect the purchase price of each of the stock lines. Unless these constantly changing costs are monitored on a regular basis (ideally on the receipt of each purchase invoice), profit margins can become eroded. The larger the range of stock lines, the more important it is to use some form of database or financial stock control system to record the cost prices, profit margins and selling prices, and to flag up any changes in the purchase price of the goods.

It is also useful to monitor the rate at which stock is being turned over. For example, if a business holds an average of £10,000 of stock and makes average sales of £60,000 per month, it is effectively turning that stock around six times per month, or every five days, which is excellent use of its working capital. If on the other hand, it holds the same level of stock but only makes sales of £20,000 per month, and is only turning the stock over once every 15 days, it is probably holding more in stock than is necessary and also has too much money tied up in stock, which is poor use of its working capital. Obviously the ideal turnover rate will vary from one industry to another – for example, fast-moving consumer goods such as foods will turn over far more quickly than retail furniture, which is held in stock for some time – but the basic principle remains the same in each case.

At the end of each financial year (and frequently at the half-year stage), it is necessary and usual to carry out a full and detailed inventory of all items of stock to determine the full value of the stock (at cost). The annual stock-take forms part of the process of preparing the annual balance sheet of the business, and there are a number of ways in which the stock values can be calculated. Under the Last In First Out (LIFO) method, stock is valued at the price pertaining to the oldest items held, which can be a complicated process if stock has been received at different prices over a period of time. Under the First In First Out (FIFO) method, stock is valued at the latest price, which is an easier method of calculation but risks overvaluing the stock, particularly if much of it is old. A more practical and realistic method is to divide the total value of all items of stock by the number of units. This gives what is called a weighted average cost, which reflects the true value of each line of stock. It is important to remember that the choice of method of valuation will influence the cost of goods sold in the profit and loss account, which in turn will affect the gross profit calculations, and subsequently the taxable profit of the business.

The frequency at which stock can be replenished and the minimum order or delivery size from suppliers may also impact on the need for storage space and on the required levels of working capital. For example, a supplier based at some distance may only make periodic deliveries so either larger volumes of the stock items have to be held, or the retailer may have to pay additional carriage costs for intermediate deliveries. This is typically the situation...
with the import of goods made in China or Taiwan into the UK or USA, where the suppliers normally insist on orders being sufficiently large to fill a container, or that a container is shared with another importer. The result is that if the importer wants the best price, the cost advantage is offset by the need for working capital to be tied up in stock that may take many months to sell. The alternative is to buy smaller quantities at a much higher unit price and transport cost.

Some suppliers only offer free delivery where the order is above a certain minimum value, and others relate discount levels to the size of the order. Here the savings from free delivery and better discount rates have to be weighed against having extra working capital tied up in stock, and the space which that stock is occupying. A related issue is the planning of re-order levels to ensure that enough time is allowed to for new stock to be delivered before the existing stock runs out. The problem is further complicated when there are multiple items coming from the same supplier, as the items needed urgently by a specific date may not be of sufficient quantity to be eligible for bulk delivery discounts or free delivery. The customer then has three options: to accept the small quantity at a higher price; to order more than is needed to make up the order to the minimum delivery quantity; or to face an interruption to production plans until the larger volume is needed.

**Purchasing Raw Materials**

Purchasing raw materials is similar to purchasing and holding stock for resale, except that:

- the initial purchase costs may be higher, particularly if credit is given to distributors or customers
- the time the stock is tied up, as either raw materials or work in progress until it can be sold, may be longer.

There is a need to buy an initial opening stock of raw materials and components, and whilst these are being turned into the finished product, further raw materials and components will need to be ordered to replace them. The wider the range of products offered, the greater the range of, and cost of buying, stock items will be. As the business expands, the average levels of stock-holding usually increase too. Depending on the source of raw materials and components, there could be implications for delivery lead times especially, as described earlier, if components have to be shipped from the Far Eastern countries that usually constitute one of the cheapest potential sources of supply.

Once again, the initial costs of buying the raw materials and components have to be realistically estimated and built into the budgetary plan and cash flow forecast for the business. The process normally includes identifying the various alternative suppliers, the range and quality of their respective products, and their costs, discount structures and terms and conditions of trade.

Given that the product quality and basic cost of a component are the same from each of two suppliers, it may be that the extra discount offered by one is more than offset by the credit offered by the other if working capital is freed for use elsewhere within the business. However, if the discount were larger, then it might pay the business to borrow from the bank and to pay cash for the components, as the costs of borrowing would be outweighed by the extra profit generated by the better profit margins. Consider the following example.

- Supplier A offers 60 days’ credit on monthly purchases of £10,000. The customer’s bank charges 12% per annum (= 1% per month) overdraft interest so the credit is worth £10,000 x 1% x 2 months = £200 to the customer.
• Supplier B offers zero credit, but a 2% cash-on-delivery discount. The customer could borrow the £10,000 at 1% per month for two months (total £200); however, as Supplier B’s discount is also worth £200, the customer would effectively be paying Supplier B the same as Supplier A, and would probably take the 60-day credit from Supplier A.
• If the customer negotiates a cash-on-delivery discount of 4% from Supplier B, although the customer still has to borrow the £10,000 at 1% per month for 2 months (total £200), Supplier B’s discount is now worth £400 giving a net contribution to trading profit of £200. This would justify borrowing from the bank to fund the cash-on-delivery payments. Also, the additional £200 per month of profit would gradually reduce the required overdraft costs, creating further profit.

This is the sort of cost–benefit analysis that a bank manager will understand and will normally be willing to accommodate. If adequate working capital is available, and interest rates are not excessive, then the benefits of cash discounts are usually better than extended credit terms.

D. TRANSPORT AND DISTRIBUTION

Vehicles and Transport Requirements

The process of selecting vehicles for company use will not only depend on the type of goods or services being produced, but also on the distribution channels and the relative locations of the customers. If the goods are being sold on to wholesalers who trade them on to a retail network, then large articulated delivery trucks might be the most appropriate form of transport. For the wholesalers themselves, a medium-sized truck (e.g. 7-tonne gross weight) might be more appropriate for accessing narrower roads to reach the retailers. This size of vehicle is popular because it is not regarded as being a full Heavy Goods Vehicle, and can be driven on an ordinary driving licence in the UK. If customers are concentrated in a fairly tight area, if access is a problem, or if the goods are small and not too heavy, vans with a payload of 1,000-1,800 kg are a better option, and unlike the 7-tonne options they do not need to have a tachograph fitted. For some companies, there may be requirements for specific adaptations to delivery vehicles such as the use of refrigeration, the addition of tail-lifts, vehicle-mounted cranes, or specialist containers for hazardous products.

The choice of the type of vehicle and its payload or size is basically an operational one but, like other options for capital expenditure, the decision to buy new or second-hand, or to lease or buy, will be determined by available working capital, the predominant interest rates on finance, any available tax allowances and the availability of the vehicles from suppliers – especially if the terms of supply are favourable.

The same applies to any cars required for sales purposes: the type of car (estate or saloon) will be determined by what it has to carry functionally; the engine size by the fuel consumption and type of driving involved (local or long distance); and the model of car by what the business can afford. For example, a mobile hairdresser working locally might need an estate car or hatchback for ease of transporting equipment and, being local, a small economical engine would be fine. It would not matter too much if the car was a few years old, so long as it was reliable. In contrast, if a company required a car for a sales person to drive long distances around the country on a regular basis, it would be more appropriate to choose something new or nearly new to ensure it was reliable. A saloon car might be appropriate, so that samples could be kept locked securely and out of sight in the back, and a 1.6, 1.8 or 2.0...
litre engine would give sufficient power for comfortable distance-driving, without excessive fuel consumption.

In Europe, there is a great deal of pressure on businesses to use vehicles that are not only economical, but also have low exhaust gas emission levels. This does mean, however, that firms that use cars with diesel engines for economy are penalised with higher taxes because of their higher exhaust emission levels, whereas petrol engines with lower gas emissions typically offer lower fuel economy.

As part of the purchasing decision process, vehicle operators also need to evaluate the capital expenditure costs alongside the other operating costs such as road tax, insurance, MOT tests, repairs and maintenance. These costs also need to be built into budgets.

**Vehicle Access to the Premises**

One aspect that is sometimes overlooked when making decisions about vehicle purchase is the practicalities of actually accessing the business premises. There are also practical issues regarding the ease of loading and unloading vehicles – not just in the early stages of the business, but when it starts to expand and grow. Here are some of the issues that must be considered.

- Are access points to loading bays and warehouse doors sufficiently wide and clear for vehicles to get in? This needs to be considered for both the vehicles that are owned by the business and those that are owned by external suppliers. Whilst the business may be able to use a number of small vans or trucks to deliver to its local customers, external suppliers may be located further away and may, therefore, make bulk deliveries using much larger vehicles which will need easy and safe access in order to unload. Otherwise, there may be extra labour costs incurred and extended time taken for unloading.

- When the vehicles get in to the premises, is there sufficient space for them to turn around easily to get out again?

- Is space needed for fork-lift trucks to access the vehicles for loading/unloading?

- Are there enough secure parking spaces for vehicles to be left safely overnight?

- Are there any parking restrictions in the proximity of the premises that would affect any vehicles waiting to load or unload?

- Is the height of the loading floor of the vehicles compatible with the height of the loading bays in the premises?

**Options for Outsourcing Distribution**

Consider the cost of running just one delivery vehicle for a year: capital outlay and depreciation, interest on finance, annual licences or taxes, road toll charges, emission charges, insurance, breakdown cover, fuel, tyres, repairs and maintenance, delays caused by traffic jams and breakdowns, hiring replacement vehicles, drivers’ wages and employment taxes, sickness and holiday pay, cover for lateness and absence, the cost of the supervisor who plans the deliveries and organises and administers the vehicles, etc. Once all of these costs are identified, it can be a valuable exercise to total them up and divide them by the number of packages or items delivered by that vehicle in a year. This provides a unit cost per item delivered, which can then be compared with the postal or contract delivery alternatives.
What are these alternatives? For small items and infrequent orders, mail order by conventional postal services is often the easiest method. For high-value or fragile items, contract courier delivery services (UK Mail, TNT, UPS, DHL, Amtrak), which use a network of international and local depots offering an overnight service throughout the country, are relatively cheap and efficient. By making prompt and efficient deliveries to your customers, these firms aim to retain you as one of their customers, so the interest in good reliable service is mutual.

Contracts can be set up with courier services for regular deliveries, just as with any other supplier, and it is possible to negotiate discounts on large volumes of transactions, or credit terms for weekly or monthly payments. Most courier firms also offer parcel collection services or operate delivery and collection points for non-regular customers who might want to send individual parcels to remotely located customers or across long distances, where the use of a delivery van is not cost-effective. Some of them also offer a network of local drop-off points for one-off parcels that also act as collection points for customers to collect when it is most convenient for them.

E. SECURITY

Risk Assessment

The first step towards implementing a business security system is to carry out a risk assessment. One of the easiest methods to use is the “onion-peeling process”, which examines the risks in three main areas of business: buildings, property and people. The process involves looking at these three layers and implementing appropriate security measures for each one. These measures are intended to:

- delay and deter criminals
- protect or remove any potential targets for crime
- reduce the potential rewards of crime
- eliminate any potential excuses for criminal behaviour.

It is important to remember that efficient security systems not only help to prevent crime, theft or damage to business property, they also offer the benefit of reducing the costs of business insurance. This can help offset the costs of implementing the security measures in the first place.

Before even considering acquiring new premises, it is good practice to carry out some basic checks, such as the following.

- Carry out a postcode check of the locality (e.g. via www.police.uk). These checks reveal both the volume and the types of crime in an area, such as theft, burglary, violence and anti-social behaviour.
- Find out if any local businesses have been victims of crime. This can be achieved by contacting and asking the owners of adjacent businesses, or local chambers of commerce.
- Find out if there are any business crime partnerships in the area, e.g. where shops collaborate with each other and the police by telephone to report any suspicious activity. These collaborations are often found in town centres, in shopping centres, or on small industrial estates where the businesses agree to share information with each other about actual or potential problems.
**External Security Issues**

Starting from the vicinity in which the premises are located, use a map of the area to identify both pedestrian and vehicle access routes to your premises – for criminals these are also potential escape routes.

- Think about the streets or alleyways that border your premises, and which of them might lead towards residential areas that have a reputation for crime.
- Think about the perimeter of the premises and how an intruder might gain access from an adjacent public space. Look for any weak areas in the boundary such as broken fences, holes, or walls and fences that could easily be climbed.
- Your insurers may insist on improvements to boundary security – perhaps the installation of steel fencing, railings or walls of at least 2.5 metres in height as a deterrent to intruders, and barbed or razor wire, rotating vanes or electric fence alarms on top of fences or walls. The application of anti-climb paint to walls or drain pipes also makes access more difficult.
- Moving inside the boundary, keep the area clean and tidy so that boundaries are visible and hiding places are minimised. Identify any bins or other objects that could be used for climbing or could be targets for arson. Check for poorly lit areas, blind-spots or other possible hiding places for criminals. Remove any ladders, tools or materials that could be used to break in. Remember, a clean and tidy environment also gives a good first impression and increases the feeling of security for staff and visitors.
- Consider whether security could be improved by the use of private security patrols at night, or remotely monitored CCTV. It may be possible to share the costs of this with adjacent businesses.

As part of broader company strategy, the security risk analysis should also consider the issue of business continuity: i.e. how will the business continue to operate if there is a major fire or other disaster at the premises, and what arrangements are in place for the use of temporary premises to maintain services to customers? Also, what back-up facilities exist for ICT systems – not just in case of a fire or damage to the premises, but in the event of external hacking into computers or databases?

**Providing Security for Premises and Contents**

Place yourself in the position of a potential thief or intruder, perhaps at night or when the business is closed. Consider first the shell of the building.

- Are there any weak spots in the structure itself? Key issues to consider include the roof, the loading bay, access via a cellar from an adjacent building, or through thin side or rear walls or an attached outbuilding.
- Are all entry points secure? Are there any unsecured doors or windows that could provide access to an intruder? Specialist security locks can help to secure access points but may be more effective, and may reduce insurance costs, if coupled with burglar alarms on doors that are activated when the business is closed.
- What improvements are needed to prevent or delay access by an intruder? These might include reinforcing walls or doors, and putting security bars on windows.
- Are there any fire hazards that need to be addressed?
Within the building, there are several practical security measures that can be used.

- Intruder detection or motion detection alarms triggered by movement (but beware if the building has rodents). Intruder alarms may need to be supported by other devices such as smoke alarms or chemical marker systems.
- CCTV cameras for monitoring internal and external spaces, with the more expensive option of live remote monitoring by external security companies (which can also monitor intruder alarms and fire detection alarms). These systems can also have wireless operation to prevent intruders from cutting alarm wires.
- The use of safes for storing cash or small valuable items. Any large sums of money should ideally be banked regularly, though, especially if the premises are not occupied at night.
- Secure reinforced storerooms for high-value items or explosives, and wire cages for hazardous materials.
- The use of overnight security staff located within the building to monitor the internal and external security systems.
- Speed dial telephone numbers for the police and fire services and private security companies.
- The use of externally hosted servers for data storage (ideally with duplicate system cover) if high volumes of confidential data are held as part of the business activities.

A number of these security options can be expensive, but the costs of security can be kept under control by planning the security requirements in conjunction with the firm’s insurance company and any approved or associated external private security businesses that work with the insurers.

**Staff Security Issues**

There are two totally different aspects to assessing the involvement of people as security risks.

- First, as an employer, the business has a duty of care to its staff not to expose them to any risk or hazard including aggravation or violence from visitors or intruders.
- Second, the need to ensure that the members of staff themselves are not able to commit any theft or breach of security against the business.

From the health and safety perspective, every company has a responsibility to protect its employees, visitors or customers from harm. It should, therefore, consider all areas of security including potential targets and the effects on them, such as financial loss or staff morale. In terms of security, this may consist of a combination of activities.

- The provision of one or more security guards on the premises to prevent unauthorised visitors or intruders during working hours.
- The use of security vehicles and guards to deliver or remove large amounts of cash or high-value articles.
- The use of security screens or glass to protect staff from the risk of attack, for example in banks or businesses that carry out a lot of cash transactions each day.
- The provision of personal alarms for staff (particularly women) who may be working or travelling alone at night.

The second aspect of security relating to staff is the need to prevent staff from actions that will have a negative effect on the business. This might include theft of stock items, embezzlement of cash, theft of IP by passing over company information to rivals, or poaching.
customers. Most of these breaches of security can be avoided, either by removing the incentive to steal or by removing the opportunity.

- Encourage an honest working culture, perhaps by educating staff about the potential costs of theft, or the consequences of being caught, but also by making staff feel valued by the business.
- Keep cash or high-value items out of sight, secure and restrict access to them to a very limited number of staff. Security firms can also provide cash collection services for large sums of money to be banked.
- Incorporate non-disclosure clauses in contracts of employment to prevent the theft of company “secrets”, such as technical specifications for new innovations, or the poaching of customers by a sales person who is leaving the business.
- Shred or incinerate confidential or sensitive documents that are no longer needed.
- When employing new staff, check the identity of the staff member and their references thoroughly. If there are gaps in a CV or doubts about previous work history, do not employ the person until these have been checked out. Some employment agencies offer staff checks and screening for potential staff.
- Carry out regular stock checks and maintain records of incoming and outgoing stock and any damaged or wasted stock. The administration and paperwork can be a distraction from core operations, but if regular checks are seen to be taking place, it can be a strong deterrent to theft. Staff should also be warned that the business reserves the right to check staff members’ personal bags and vehicles when they are leaving the premises – and don’t forget to check the security staff as well.
- Keep stock away from exit doors, and ideally in a place where it takes a noticeable action to reach it, such as collecting a key from a supervisor. Within these spaces, use mirrors or CCTV to keep stock and equipment monitored. If there is a major theft problem, use CCTV and security checks in staff car parks.
- Restrict access to warehouses and stockrooms so that only specified staff can use them. Regularly change or rotate staff who control stock to avoid collusion or bad practice.
Chapter 9

Planning and Managing Staff Resources

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INTRODUCTION

Some aspects of planning and managing staff overlap with other chapters in this study manual – for example with the coverage of personal business skills in Chapter 6 and the coverage of aspects of employment law in Chapter 12. However, the main focus of this chapter is to explore and identify the staff resources that will be needed to start and grow the proposed business during its early stages, along with their associated direct costs (e.g. wages or salaries, employment taxes and social insurance) and their indirect costs (e.g. recruitment and training), all of which must be included in the start-up budget. The second purpose of this chapter is to broadly identify and summarise some of the issues and associated problems with staff management that a potential entrepreneur needs to be aware of, and may have to contend with. On a personal level, this may be about developing a style of management and staff motivation that is appropriate to the size of business and the type of staff being employed. However, it is also about some of the broader issues that may be encountered as the business starts to grow, such as the recruitment process, conflicts between staff, dealing with discipline and grievance problems, and of course how to identify these problems in advance and to deal with them.

A. IDENTIFYING AND PLANNING STAFF REQUIREMENTS

Identifying Skills for Start-up, Survival and Growth

The first question to consider is what skills does the business need to make it successful – not just at the point of start-up, but also as the business becomes profitable and starts to grow? The answers are important to the person planning the business as the provision of these skills will have cost implications for the business, especially when people are employed to provide the skills.

Generally, the smaller the business, the wider the range of skills that the entrepreneur/owner-manager will need to operate it, particularly in the early stages of its development. It is important, therefore, to draw up a skills profile for the business to identify the range of expertise required, such as the following.

- Technical knowledge of, or expertise in, the goods or services that the business plans to offer, and how the customers will make use of them. From the customer’s perspective, the supplier is the specialist who is expected to answer all of the awkward questions about use and functionality.
- Marketing skills – to facilitate market research and to design a marketing plan to promote and distribute the goods or services. The importance of these activities to the business is covered in Chapters 7 and 10.
- Sales skills – these are often assumed to be the same as marketing skills, but there is a distinct difference. You may have an excellent product, and a market that is ready for it, but you still need the skills to persuade your customers or your distributors that they should use or retail your product, rather than one supplied by a competitor. In the early stages of developing the business, there may not be enough working capital to afford to employ a sales person.
- Organisational skills – the ability to plan and organise yourself and your business, to ensure that the staff, resources, materials and finished goods are in the right place at
the right time. With careful planning and attention to detail, you can make the most productive use of time and resources, and avoid costly waste.

- Decision-making – the facility to analyse problems, identify and evaluate options, and to make objective and rational decisions, including how they will be made to work effectively.

- Financial skills – keeping day to day accounts is not necessarily the best use of the owner-manager’s time, as a part-time book-keeper or accountant would probably be much more cost-effective and would free up the owner’s time to focus on other priorities. However, it is still important for the owner to be able to understand the accounting procedures and it is essential to have a basic understanding of budgetary planning and control in order to keep the business on track, and to spot any potential problems.

- Customer service skills – this is not just a case of keeping the customers satisfied by providing a consistently high standard of service. For small firms, one of the biggest headaches in dealing with customers is debt collection, and persuading customers to pay their bills on time without the risk of offending them or losing their business. This activity, although necessary, can be another distraction from business development activities.

- Staff management – the ability to supervise, delegate work, train and motivate staff to get the best out of them. The importance of this is often underestimated, and for new owner-managers who have never previously been involved with managing staff, one of the hardest aspects is delegation – trusting the staff to get on with their own jobs without constant close scrutiny, so that the owner can get on with the job of running the business.

- Management of information and computer literacy – word-processing, spreadsheets, databases, desktop publishing, accounting software, e-commerce and internet sales and marketing, project management, etc, plus the need for compliance with data protection regulations.

- Interim management – the process of hiring experienced managers for a fixed period of time to perhaps manage functional areas of the business, to guide the business if it is going through a period of change, or perhaps to help an innovator who has little business experience to commercialise the innovation.

The process of planning the staffing requirements involves a number of specific activities.

- Objectively analysing and identifying the skills needs of the business during the early stages, from start-up until the business reaches a profitable level of trading. This relates to the management, administrative and technical skills required and their relative importance to each stage of business development. They should be listed individually and quantified in terms of the amount of FTE staff time each activity requires per week, and the number of persons required to cover the various roles. Ideally at start-up stage, these persons need to be as multi-skilled as possible to keep the total wage bill low.

- Identifying the entrepreneur’s own personal goals and objectives, and accurately analysing and evaluating his or her own skills and resources in relation to them. Also, producing a realistic personal training and development plan for the owner, for example to manage the staff that will be employed to fill the other skills gaps. This is described in Chapter 6.

- Producing a skills gap analysis, which involves comparing the available people and the existing skills they share with the total needs of the business to identify the gaps between the two. The owner can then produce a strategy that will provide the right levels of expertise in the right quantities at the right time and at an affordable cost,
which may well involve several different types of employment contract covering both core and peripheral staff. The gaps might be filled by training or developing the owner or other staff members. However, there is often little spare time for training at the point of start-up so it may be easier and more convenient to buy in the skills, for example by using a part-time book-keeper, who is employed for a few hours per week, or perhaps a sales person who is paid commission against results.

- Monitoring and reviewing staff numbers and changing skills requirements at regular intervals. Once the business has achieved stability and profitability, it needs to revisit the skills gap analysis to start planning the requirements to support the future growth of the business. This includes skills development for the staff and for the entrepreneur and any managers who have been appointed as the business has become profitable.

Planning Staffing Requirements

The process of strategic HR management (more commonly called manpower or workforce planning) is all about getting the right people, with the right skills, in the right place, at the right time – and then providing the right structure and balance of motivation and reward to keep them there. This is hard enough to achieve in a large organisation that:

- has the resources to employ HR professionals
- can afford the necessary reward structures and opportunities for promotion or career development
- can make use of highly specialised skills.

However, as discussed previously, the average small firm does not have these luxuries: it often possesses only limited resources and relies on the limited personnel knowledge of the boss, combined with the willingness of staff to be flexible in their work.

At a strategic level, manpower planning involves matching the skills of the key executives or managers to the needs of the company’s strategic plan by identifying the management skills that are needed to achieve the long-term objectives of the business. For example, a policy of substantial growth that involves exporting would normally require the business to have someone at policy-making level who possesses substantial skills and experience in international marketing. The strategic aspects would also involve the monitoring and appraisal of performance to ensure that:

- managers are performing at a level that will enable the business to achieve its strategic targets
- skills are modified or developed on an ongoing basis in line with the changing needs of the business.

The reality of running a small business is that there are usually only one or two people in a position to define and implement strategy, and they are usually heavily involved with the day to day running of the business.

On a tactical level, manpower planning involves designing and creating a reward system that will provide and retain a stable and motivated workforce. It will involve anticipating future problems of surpluses or deficits of staff skills, possibly requiring the development of a more flexible workforce with a core of regular key staff supplemented by peripheral staff such as temps, agency staff, and part-time or seasonal workers. The tactical aspects are also concerned with medium-term staff development, career development and training plans, as a means of reducing the dependence on external recruitment when skills are in short supply.
Once again, reality dictates that expenditure on staff development in small firms during their early years is a luxury they can’t usually afford, and it takes place only when it is essential to the survival or growth of the business.

Figure 9.1: Workforce Planning Process

**SKILLS NEEDS AUDIT**
- Current skills needs
- Future requirements
- Quality and quantity
- Skills matrix/distribution
- Specialist skills needs

**STAFF SKILLS AUDIT**
- Matrix of current essential skills
- Evaluation of skills quality
- Spread of skills amongst staff
- Unused skills for future use

**SKILLS GAP ANALYSIS**
- Comparison of needs and available skills
- Quality and quantity
- Identification of gaps
- Job descriptions
- Person specifications
- Train or buy-in decisions

**DEVELOP INTERNAL STAFF**
- Internal promotion
- Training plans
- Mentoring and coaching
- National Vocational Qualifications/in-job training
- Formal training programmes
- Monitoring and evaluation

**EXTERNAL RECRUITMENT**
- Recruitment to replace natural wastage
- Recruitment to facilitate expansion
- Recruitment to facilitate changing skills requirements

On an operational level, manpower planning is about the day to day recruitment and selection process, induction, and staff training to facilitate immediate needs, create multi-skilled staff to provide more flexibility, and make the best (most productive) use of available human resources. It is also concerned with performance appraisal, administration, the monitoring of reward structures and ongoing motivation. Again, in practice most owners and directors of newly established businesses don’t have the expertise or time to devote to this, so real staff planning and appraisals only start to happen after two or three years when the business is established and has the resources to spare.
The workforce planning process is outlined in Figure 9.1. The staff skills audit and the audit of skills needed in the business are carried out and compared in the skills gap analysis. This paves the way for decisions to be made about whether or not to develop the skills of existing staff to plug the gaps or to recruit new skilled staff. In reality, where small firms are growing, the decisions usually involve a combination of both.

The first stage of the planning process is the skills audit which identifies precisely what skills are needed (the skills needs audit) and how they are currently covered by staff (staff skills audit) or where gaps exist, and the easiest way to make the comparison is by drawing up a skills matrix. On one axis, you need to establish the jobs that are already occupied, and those that will be needed to accommodate growth or diversification. Remember that these must relate to the jobs themselves, and not the persons who occupy them. On the other axis, you need to list the range of skills needed for each of these jobs. Table 9.1 is an example of an audit matrix of staff skills compared with the skills needs of a business.

Sources of information for the process of identifying existing staff skills include job descriptions for the essential and desirable qualifications and experience needed for each post; if that information doesn’t already exist, this might be the right time to remedy the situation. Even new start-ups may have standard operating procedures and product specifications prepared for product quality accreditations, and these can indicate the need for specific technical skills. Where part-time staff may be used, proposed work schedules or staff rotas can indicate potential gaps in skills, and can be used to ensure, for example, that there is adequate cover at all times for dealing with customer enquiries or adequate provision of first aid expertise.

The second stage is to produce the staff skills audit to identify exactly what skills exist amongst the people who will work in the business. In a small firm, this can easily be obtained by asking staff to look at the list of required skills and to identify those in which they think they have some experience – perhaps graded in terms of “basic knowledge”, “competent” or “very experienced”. CVs are also useful for identifying potential transferable skills that may have been learned in previous work but overlooked – for example, dealing with customers, handling money, record keeping or supervising other staff.
Table 9.1: Matrix of Staff Skills Versus Skills Needs of Business

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# = skill needed  
Y = training done  
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Skills Gap Analysis

The third stage of workforce planning uses the matrix shown in Table 9.1 to compare existing staff skills with the skills requirements of the business and to highlight the gaps between them that need to be filled. It also defines the skills required from potential applicants to fill any vacant posts and these requirements will form part of the job descriptions if or when new staff are recruited. The skills gap analysis is a useful tool for defining:

- the skills gaps that will have to be filled through training and development of proposed staff in a new start-up or, if the business has been trading for a few months, of existing staff
- the skill requirements of vacant posts or new posts to be created
- which existing staff might be suitable for being trained or promoted into the vacant posts
- the vacancies that will need to be filled by recruiting new staff from outside the business.

The gap analysis should not just focus on current staff and existing vacancies. It should also be carried out for all employment needs in the foreseeable future. This will mean looking closely at the resources that have been identified as essential to meet the organisation’s growth and development, and what staff will be needed to operate or support those resources. Furthermore, it must examine the various stages of phases of growth to ensure that the staff will be available in readiness for when they are needed. No business wants to have staff standing around waiting for work to come in; but, equally, no business can afford to be understaffed when that work does arrive. Irrespective of whether the staff are developed internally or recruited externally, there will inevitably be a lead time before they are fully operational, because both the training and development process and the recruitment and selection process can be extremely time consuming.

The gaps that are identified by the matching process will form the basis for the staff development strategy of the business – whether the business decides to plug the gaps by means of training and developing existing staff or by recruiting or buying in ready-trained staff from the labour market. Recruiting ready-trained staff can be very attractive to a growing business. The advertising and selection process does cost time and money, but there can be equally significant savings elsewhere. For example, training costs can be high, so recruiting ready-trained staff provides an immediate saving on the cost and time required for training; it can also enable the staff to quickly achieve a high level of efficiency or productivity in their jobs, whereas newly trained staff may have to work up to that level of efficiency over a period of time. It is also much more attractive from the owner’s perspective to buy in ready-trained staff rather than to train existing staff, which often raises their career expectations and results in them moving to a competitor a few months later. This approach is often argued for by small business owners who regard it as much better and cheaper to poach trained staff from a competitor rather than to face the costs and time involved in providing training. The counter-argument is that the approach is short-sighted: two or more firms competing for a limited number of skilled staff in a small locality can just end up creating a wages spiral for themselves.

Internal promotion can take time and cost money, but it also has its advantages in terms of the loyalty it can generate from promoted staff who appreciate the promotion or development opportunities they are offered. Internal development also has the advantage of familiarity, in
that existing staff are already comfortable with current systems within the business. The time needed to recruit externally can be particularly problematic if there is a fairly low level of local unemployment when local staff may be hard to find, or may cost above-average rates, or may have to be transported in from further away. This is where internal development scores much higher than external recruitment. Equally, when there is a shortage of skilled labour in the locality, there simply may be no alternative to developing current staff and then recruiting less-skilled replacements to fill the gaps at the bottom.

In practice, the manpower planning strategy will use an appropriate combination of selecting some staff for development, and recruiting others from outside. The key factor is to ensure that the chosen methods will enable the firm to get the right skills in the right place at the right time; and to enable it to meet its strategic targets and objectives whilst keeping costs down to an acceptable level.

B. MANAGEMENT STYLE

*Developing a Productive Management Style*

Management style is about the way in which managers get results through other people: how they motivate their staff to perform well in their roles, how they exercise authority over their staff, and how they make and implement decisions. The management style that is employed can have a major impact on staff performance and behaviour, both in localised sections of the firm and across the whole business.

Management style can impact on the following aspects of the organisational culture within the business.

- The level of formality or informality of relationships and transactions between staff, and between staff and customers. Also the respect shown to managers (or lack of), and the attitude of managers to each other.
- The unwritten rules, the expected norms of behaviour and the work ethic shared by staff, including standards of performance and acceptable or unacceptable behaviour.
- The loyalty and commitment staff show to the business and the attitude of staff to customers and to quality – for example, willingness to work beyond contracted hours without overtime pay, or to work flexibly when needed to meet customers’ orders.
- The entrepreneurial and innovative attitude of staff, and their willingness to propose new ideas or innovations without fear of embarrassment, or of blame if the new ideas don’t work out.
- The level of staff motivation within the business as demonstrated by their attitude and enthusiasm for work. This may be shown positively, by the effort put into their work and their positive attitudes to the job and the business as a whole, or demonstrated negatively by high levels of staff turnover, sickness and absenteeism, or problems recruiting staff because of a reputation of being a “bad” place to work.
- Staff attitudes to customers, and their willingness and flexibility regarding meeting customer orders.
- The performance of members of staff at work: meeting targets and required levels of production or output, and maintaining product or service quality; or, in contrast, missed targets, late customer deliveries, product failures and rejects, and customer complaints.
Planning and Managing Staff Resources

- Staff attitudes to managers and other staff: the levels of confidence and trust between staff and managers, the amount of cooperation and the efficiency of communications; or conversely, the resistance to new ideas and change, or the undermining of managers' authority.
- Whether staff feel they are valued and adequately rewarded, as opposed to just turning up to work because they need the money.
- The ways in which work is allocated and delegated: the efficiency of the delegation process, how clearly targets and objectives are explained, and staff awareness and understanding of what is expected of them.

Managers typically gain authority in three main ways.
- by nomination – by virtue of their position or role in the organisation
- through technical knowledge – by virtue of a specialist expertise
- by the consent of their peers – by gaining the respect of their colleagues over a period of time.

However, authority is only maintained by assuming a management style that will retain and enhance that authority: by demonstrating leadership, by encouraging a positive business and enterprising culture, by motivating staff, and by allocating and delegating work effectively.

This process requires a great deal of flexibility and understanding if it is to complement the essential aspects of directing work and maintaining order and discipline, and being firm and decisive when needed. It entails getting to know staff and their respective strengths and weaknesses, learning how they interface with each other, making full use of their existing skills and developing potential skills. It is also essential to lead by example, clearly define standards and targets along with individual responsibilities and lines of reporting, ensure good communications and involve staff in decisions when appropriate. It is also about effective delegation: assigning roles and responsibilities to complement individual strengths, setting clear objectives, monitoring progress, and acknowledging good results. Finally as a human being, it is about being aware of and sensitive to staff problems, creating an atmosphere of mutual respect, and being approachable so that staff can discuss issues before they turn into problems.

C. MOTIVATING STAFF

Three thoughts for consideration.
1. Motivation is getting people to do willingly that which they would not ordinarily do (General Schwartzkopf, US Army, Gulf War 1991).
2. Motivation is not just about what you do – it is just as much about what you don’t do!
3. Motivation is not just a one-off event; it is a constant and ongoing process.

Symptoms of Poor Staff Management or Inadequate Reward Structures

Problems with staff management or reward systems can be easily identified by monitoring levels of sickness and absenteeism and the annual rate of staff turnover within the business. There will always be some degree of natural staff turnover, resulting from retirement, staff moving to another area, health problems or family commitments, for example. The acceptable level of staff turnover will vary from one area to another, depending on the stability of the local population, the supply of labour and the competing demands for that
supply. In a rural area where people tend to be less mobile and jobs less available, the percentage may be low, say 4-5%. In an urban area where there are more jobs around and the population is probably more mobile, 10% may be nearer the norm. In either case, though, if the annual staff turnover (i.e. the number of leavers compared with the size of the total workforce) is above 15-20%, then there is a clear problem. This may be due to low levels of reward, poor working conditions or unpleasant or repetitive work. On the other hand, the problem might also lie elsewhere, perhaps in the recruitment policy of the business, resulting in the wrong type of staff being recruited for the work, or inappropriate methods of selection being used.

Typical symptoms of problems in reward structures or the way staff are being managed include: increased rates of sickness or absenteeism, regular patterns of staff absence (particularly at the start and end of the working week), poor motivation resulting in reduced output, disruption of output, industrial action and, in extreme cases, sabotage to equipment or machinery, and more arguments between staff, complaints to management and formal grievance procedures. Unfortunately these types of problem are usually the result of a combination of factors, which can make the real cause harder to identify. For example, employees on a very low wage may tolerate the work if there is no alternative local employment; however, if a second negative factor is introduced such as the removal of overtime work, a bullying supervisor, a work environment that is too hot or cold, or machines that break down resulting in the loss of productivity bonuses, they start to demonstrate their dissatisfaction through sickness or absence from work.

This brings us back to the importance of innovative and enterprising cultures within the business, as discussed in Section D of Chapter 4. Providing the right combination of leadership and management style, motivation, positive attitudes and appropriate reward structure will create a healthy culture.

**Theories of Motivation**

There are two main and contrasting views of how staff are motivated.

- **The Behaviourist** view is that problems in industrial relations occur because of conflicts between the aims of the organisation and the personalities of individual workers.
- In contrast, the **Organisational** view is that all individuals are basically lazy and idle, and will, therefore, only respond to reward or threat of punishment. They must be closely supervised, directed, and punished, as they actually prefer to be directed rather than given responsibility.

The following three theories explain the different approaches to understanding the motivation process.

**Maslow’s Hierarchy of Needs**

Maslow (1954) was a Behaviourist thinker who developed a Hierarchy of Needs (Figure 9.2) to explain the factors that affect people’s motivations, primarily in the work environment but also in their general lives. There are five needs, starting at the lowest level with the basic Physiological needs, and progressing through Security and Safety Needs, Social Needs, and the Need for Self-esteem, to the highest level which he calls Self-actualisation.
Maslow proposes that when, and only when, a lower need is satisfied does the next higher need become dominant, because only an unsatisfied need can motivate a person. In addition, as personal circumstances change, attention may focus back from a higher need to a lower one, until that lower need is satisfied again. For example, if a person with a highly satisfying job who is close to the top of the Hierarchy is suddenly made redundant, their immediate motivation may become dominated by the need to find new income to meet their Safety and Security Needs; only after this has been met, can they start to focus on the next higher need.

**Herzberg**

Herzberg (1959) proposed that man has two basic sets of needs in the working environment.

- **Maintenance Needs** – these are factors relating to the workers’ environment (also described by Herzberg as Hygiene Needs). They include pay and benefits, job security, physical comfort, relationships with co-workers and supervisors, and company policies. Attention to these needs does not create satisfaction for staff, it can only prevent or eliminate dissatisfaction; and as they are ongoing needs, the manager must constantly work on them to prevent staff from becoming dissatisfied. These Maintenance Needs really reflect the two lower needs defined in Maslow’s Hierarchy.

- **Motivational Needs** – these are the needs that can create positive satisfaction or happiness in people. They relate to the work role or task itself rather than to the working environment, and managers must aim for job enrichment or fulfilment to meet these needs. They include growth, achievement, responsibility, recognition, promotion,
acknowledgement or reward, and the job satisfaction gained from the work itself. In order to meet these needs, the work done must be meaningful and challenging as a lack of meaningful work will create apathy, detachment and a loss of interest for the staff. However, this raises the question of just how much effort the manager should put into creating job satisfaction as this is not always possible, particularly where repetitive manufacturing processes are involved. The Motivational Needs reflect the two highest factors in Maslow's Hierarchy, especially in the workplace context. Maslow's mid-range need (Social Needs) could arguably be included as part of Herzberg's Motivational Needs, although it is arguably more related to the general social environment than to the working environment.

**McGregor's X–Y Theory**

McGregor's theory (1960) is based around contrasting views of managers' attitudes and perceptions of their staff.

- **Theory X** – this is a classic example of the Organisational approach to management and the need for managers to employ “carrot and stick” methods to either entice and incentivise workers to do something, or to threaten them to do what is needed. People naturally dislike work and will avoid it where possible. They prefer direction to responsibility or authority and must be forced or bribed to achieve the right amount of effort; and because they are inherently lazy, they require high levels of coercion, supervision and control to produce a reasonable level of output. Creativity is only used to get around rules and procedures, as people are motivated primarily by money, which is their means of alleviating anxiety about personal security.

- **Theory Y** – this follows the Behaviourist approach and strongly reflects Maslow (1954) and the emphasis on self-achievement and job satisfaction as being of fundamental importance to people in the workplace. Work is essential to every person's psychological growth, and under the right conditions people will enjoy their work. Work provides intrinsic fulfilment and satisfies their desire to achieve and realise their personal potential. It also offers the opportunity for creativity and ingenuity. People welcome and direct themselves to targets, and they will happily seek and accept responsibility and authority, along with the accompanying discipline. Where there is a gap in discipline, they will impose discipline on themselves and their activities.

It is probably easiest to understand Theory X and Theory Y as two extremes of a spectrum (Figure 9.3), with reality somewhere in the middle but not fixed in any one point on the line.

![Figure 9.3: Theory X and Theory Y Spectrum](image)

There are times when work situations require managers to vary their management style, sometimes being consultative and engaging with staff, and sometimes more authoritarian and directive. Their specific position on the line will, therefore, vary according to what is needed at the time. That is precisely what the possession of a good management style is all about: only by realising that fact and adopting a flexible style of management that uses methods appropriate to each individual situation can a manager get the best from his or her staff.
**Effective Delegation**

Delegation (Figure 9.4) occurs when a manager gives a subordinate additional **responsibility** for a certain task, along with the **authority** and resources to get the job done, whilst retaining the **accountability** for the outcome.

![Figure 9.4: Delegation](image)

As a model of good practice, effective delegation:
- matches the person to the task – by identifying the people who: (a) have the right skills for the job or are willing to learn them; and (b) are willing to accept the responsibility they are being offered
- sets clear, achievable, measurable and realistic objectives – so the person knows what they must do and is capable of achieving them, and so the objectives can be measured in some way to confirm they have been achieved, and are realistic within the timescale and with the resources available
- gives full information and explanations, and checks understanding and communications
- monitors the progress of the delegated activity, and seeks feedback
- reviews the reasons for success or failure, and either rewards or acknowledges success and achievement, or accepts failure without blame – as accountability lies with the manager who has delegated the task, not with the person it was delegated to
- learns from failure and uses that to modify future practice.

When considering whether or not to delegate the responsibility for a task, there are a few simple questions to consider:
- Who has the competence and ability to take responsibility for the work now?
- Are their skills and standards adequate for what is needed or is further training or instruction needed?
- Are they ready for the responsibility, and do they actually want that responsibility?
- Do they understand the requirements of the job?
- Is there enough flexibility in their current workload to allow them to take on extra work without overloading them or impacting negatively on their other work?
- What resources will they need to perform the role properly?
• Could there be any personality problems or issues with other team members who might feel they should have been given the role?
• How will the process be monitored and controlled to ensure it stays on track (whilst still allowing the person to whom the task has been delegated enough autonomy) – for example, via daily briefings?
• What are the risks of failure and how can those risks be mitigated or avoided?
• If no-one is available to take delegated responsibility right now, who may be suitable in future?

D. POTENTIAL PROBLEMS AND PITFALLS IN STAFF MANAGEMENT

Costs of Employing Staff

When you buy a computer, a car, a van or a piece of production machinery for a business, you or your accountant can perform some simple calculations to identify the outputs or benefits you will gain from the investment, how long it should last, the cost per annum over its lifetime, and the payback or return you will achieve on the investment. A delivery van might be good for five years, or a production machine for ten. Either way, you can be fairly sure that if you make the right choice in the first place, you will get a return on your investment.

Unfortunately, people are not like that, and employing them can be both risky and expensive. For example, when you want to recruit a new skilled member of staff, you pay someone to draw up a job description and person specification and to design a suitable advertisement. You may then spend time ploughing through hundreds of applications to produce a short-list of applicants, carry out a series of time-consuming interviews, select the person you want, and wait until they have worked their notice from their current employment. When they start, you provide them with induction training, and perhaps product or job training. All the time this is going on, the business is running at less than optimum efficiency. Then three months later, just as your business is returning to full efficiency, the new member of staff decides to leave and you have to go through the whole time-consuming and expensive process all over again. People are expensive to find, expensive to train, expensive to replace, and inherently unreliable; that is, unless you have the right motivation and reward structure to retain them. This may appear to be a rather extreme example of the Organisational approach described earlier in this chapter, but it does actually happen and for early stage businesses it can have a significant cost implication and impact on their progress.

In addition to the basic salary or wages, the overhead costs of employing staff are a significant burden on business finances. In the UK, the on-costs of National Insurance, compulsory staff pensions, uniforms, annual leave, cover for sickness, absence or maternity leave etc can easily add another 30% to the annual wages cost for each member of staff. In EU countries such as France and Germany, the staff overhead costs are between 40% and 50% sometimes. There is also the added cost of administering the payroll systems, tax credits, pensions etc which small firms are now obliged to provide. It is easy to see why many modern businesses, particularly those involved in manufacturing, prefer to use robotic systems – they don’t argue with colleagues, demand pay increases or call in sick on a busy Monday morning, and you never hear of a robot claiming sexual harassment in the office! The moral of this is that it is imperative to make the right decisions about the recruitment and staff development policies, as mistakes can be very expensive.
Balancing Cost Control with Reward Structures

Good selection and carefully planned staff development policies are a pre-requisite for efficient business performance, but are still ineffective unless backed up by carefully designed reward systems. This is where many organisations go wrong: they put the recruitment and training in place, only to cut corners by offering minimal wages or very basic staff benefits, and subsequently experience high levels of staff turnover which push up recruitment and operating costs and reduce the efficiency of the business. A workable reward structure is the final link in the chain to ensure that skilled and experienced staff are retained. Rates of pay and other conditions of employment must be sufficient to attract staff, to retain them, and to motivate them to willingly contribute to meeting the objectives of the organisation. The system must be capable of influencing the internal culture of the business, to encourage initiative and innovation; and it must reward responsibility within the structure of the business.

There is no ideal formula for getting the reward structure right. Job-related pay with annual reviews, if set at the right levels, can encourage loyalty and stability in the workforce, but motivation and performance may be enhanced by team bonuses or profit share systems. An individual bonus or performance-related pay (PRP) is highly motivating for individuals and encourages initiative, but can be very difficult to administer when all staff are on different pay rates. PRP can also have a negative effect on less able staff, and can often encourage competition rather than cooperation between staff. Satisfactory financial reward can also be particularly important to staff where there are no opportunities for advancement due to a firm’s small size.

It is particularly important for the owner-manager to keep an eye on local wage rates and the supply and demand for skilled labour in the area. If these rates are high due to relatively low levels of local unemployment, then cost-cutting to reduce wages costs will only be counter-productive, and will result in staff leaving for better pay elsewhere. The costs of replacing staff may well outstrip the marginal extra cost of retaining them in the first place, plus the un-quantified cost of the disruption that high staff turnover can cause in achieving the firm’s strategic objectives. In summary, a sound reward structure is the key to successful manpower planning, and getting it right is just as important to the business as the recruitment, retention and staff development activities of the business.

Complying with Employment Law

This subject is addressed in more detail in Chapter 12. The legislation relating to employing staff will vary widely from one country to another but in Europe, for example, it is highly developed and quite complex, and can, therefore, be quite onerous for prospective entrepreneurs and small businesses. Here is an overview of some of the key issues.

- Discrimination – whether racial, religious, or gender related. In particular, this can occur when designing advertisements for staff, preparing terms and conditions of employment, making pay decisions, and in treating applicants equally and without bias during the recruitment process.
- Managing conflict situations between staff or between managers and staff. It is important to ensure that all people involved are treated equally and are given a fair
opportunity to state their perception of the issues, in order to avoid the potential for legal action at a later date.

- Disciplining or dismissing staff. Proper procedures must be followed, again to minimise the risk of subsequent litigation for unfair or constructive dismissal, or breach of equal opportunities legislation.
- Reviewing complaints and grievances from staff – particularly where complaints are made about unfair treatment or bullying by managers, who may not be aware of the effects of their actions or attitudes. This can impact significantly on staff motivation, and once again can raise the prospect of litigation.
- Statutory requirements. Businesses must comply with regulations relating to providing contracts of employment for staff, checking work permits, keeping proper records of employment and pay, making any required deductions from staff pay for tax or social insurance and remitting them to the authorities, etc.

**Recruitment and Selection**

The recruitment and selection of new staff can be a complex process for even the smallest business, and would normally merit a full chapter in its own right. However, for the purposes of preparing a business plan, it is sufficient to have a broad understanding of the stages of the recruitment process and where costs are likely to be incurred. The approximate costs can then be incorporated in the budgetary plan. The recruitment process is also full of potential pitfalls and legal risks for inexperienced entrepreneurs.

Once the staffing requirements have been identified via the skills gap analysis (as described in Section A of this chapter), the first stage in the recruitment process is to define precisely what the business needs. This is achieved via the job description, which defines precisely what work activities the role entails, and the person specification, which outlines the type of person required to fill that role – their expected skills and abilities, qualifications, previous training and experience, their personality and attitude etc. Then, the terms and conditions of employment that will form the basis of their legal contract of employment need to be confirmed. Most proficient managers should be capable of producing drafts to form the basis for these documents, but as they are legal documents that could perhaps be referred to in litigation, it is worth having them checked or reviewed by someone who is experienced and properly trained or qualified. As lawyers are expensive and may be inclined to make the documents more complex than is really needed, the obvious choice is to call in a specialist HR/personnel adviser. Of course, this has a cost implication for the business, but the cost must be balanced with the potential risk of getting the documents wrong, which at best might result in the wrong person being selected, and at worst could involve the business in an expensive legal action if they are deemed to be discriminatory in any way.

The second stage of recruitment involves choosing the appropriate form of media to advertise the vacancy. Local shop windows or local newspapers might be the best and cheapest way of advertising unskilled vacancies, and regional press or trade magazines the best for more specialised or skilled posts. Again, though, these come at a cost that must be budgeted, those with the broadest coverage being the more expensive. Against those costs must be balanced the risks of spending money to advertise via a media form that might be cheaper but not as effective in reaching the target audience. So rather than the cheapest paper, advertisements should be placed in the particular paper or trade journal that the type of person wanted for the job will be likely to read. Designing the advert and its wording is also something that might be a risk if it contravenes any advertising standards or equality regulations – this is something that can be passed by the HR specialist when the job
description is being drafted and checked. Recruitment agencies offer an easier option for recruitment, as they will advertise vacancies and carry out the sifting of applications and possibly an initial screening interview. However, there are two drawbacks to using recruitment agencies.

- The cost, which will typically be 15-20% of the first year’s salary.
- The fact that the ability of the agency to find the right people will be directly proportional to the quality of the job descriptions and person specifications supplied to them – weak or vague specifications will usually result in unsuitable candidates.

Sifting and selecting candidates for interview can be simple where numbers of applications are low, but extremely time consuming when they are high. This is where the job description and person specification come in so useful in defining precisely what is required: from them, a checklist of essential and desirable requirements can be prepared to help identify the strongest prospective candidates (the “probables”), those who might be used as reserves if the first group prove unsuitable (the “possibles”), and the others (the “unsuitables”). The checklist can also provide evidence that the process was properly managed if a candidate claims they were not properly considered.

If the sifting process has worked, there should be a short-list of perhaps four to six strong candidates to interview for each post. If a number of similar jobs are identified, that ratio may be reduced to two interviewees for each post. Interviewing is an expensive and time-consuming process, especially if it has to be repeated because the right candidate has not been identified. To avoid potential litigation from candidates who were rejected, it pays to have a second person at the interview to take notes – ideally a personnel professional (if affordable) to ensure legal compliance, but at least a person who can offer a competent and objective second opinion about the candidates. This is also the stage at which references can be checked, especially if the job role involves handling cash, valuables, documents or the secure storage of stock.

Finally, the offer of the job is made to the chosen candidate(s), and any terms and conditions are negotiated. Although the agreed wages/salaries and any on-costs such as employment taxes will probably have been included in the company budget, it pays to check for any additions or changes.

**Handling Conflict**

Conflict between staff can arise for a wide range of reasons – personal rivalry or antagonism, personal problems, arguments and disputes, inter-family arguments, differing values or beliefs, differences in language and social or racial backgrounds, arguments over money, and even affiliation to rival football teams. It can also occur where there is a breach of the accepted norms or behaviour in the workplace, such as someone not working as hard as the rest of the team, showing disrespect to colleagues, or a breach in the unofficial hierarchy of staff.

Conflict can also occur between members of staff and their managers where perhaps staff refuse to accept a manager’s authority, or question or challenge instructions given. Conversely, there may be issues of bullying or victimisation by a supervisor towards a member of staff, incorrect use of authority, or one manager countermanding another’s instructions, creating conflicting priorities for the staff.
Some conflict can actually be positive, generating discussion about new ideas and options, but most tends to be potentially disruptive or destructive to the business, reducing efficiency, creating tension and arguments (often lasting beyond the main dispute), reducing trust between colleagues or between staff and their managers, wasting time and energy and, in extreme cases, causing physical violence.

It should be the owner’s or manager’s role and responsibility to either prevent the conflict from breaking out in the first place, or dealing quickly and effectively with it where it cannot be avoided. In new and early stage businesses, the staff numbers are usually small enough to facilitate fairly direct communication between staff, and problems are identified quite quickly. However, problems can arise when entrepreneurs are so focused on running the business that they fail to deal with conflict, either because they lack the experience to do so, or because they overlook the issue as not being a priority to them personally.

In larger businesses, it is often possible to convert a conflict situation into positive energy by staff development – for example, via team-building activities, personal development or counselling staff. These are rarely practical options for new or small firms, and the most common responses from owners are as follows.

- Avoidance – ignoring the situation and hoping it will go away, or pretending nothing has happened. This can be a dangerous choice as not only may the problem persist and possibly grow, but the owner may become regarded by staff as weak, unfair or indecisive, so undermining his or her credibility and authority.
- Defusing – smoothing over the problem and calming down the antagonists. This may be an immediate solution but it fails to address the cause of the problem, which may blow up again in a more serious form at a later date.
- Confrontation – dealing with the problem promptly and in a balanced and rational fashion. This is the most productive approach. For the owner or entrepreneur, it may create a short-term diversion from their main focus, but it should resolve the situation and give a clear message to other staff that the owner or manager will not accept unnecessary conflict. There are two ways to confront conflict. The first is the power approach – to impose a decision on both parties. This resolves the problem quickly but it can also be risky in that it may create a “loser” in one of the antagonists, thus causing resentment. The second approach is to negotiate a solution between the parties by establishing the facts of the situation and by leading the antagonists to reach agreement. This is much harder to manage but is more likely to be accepted by both sides.

**Discipline and Grievance**

The management of discipline and grievance processes is closely linked to handling conflict: the issues raised within conflicts may result from personal grievances which, if not handled well, could lead to formal grievance procedures within the business. Similarly, conflict issues may reveal problems with staff behaviour or performance that should be the subject of discipline procedures such as verbal or written warnings or, in extreme cases, possible dismissal. Unfortunately, issues of discipline and grievance can cause major problems for early stage and small businesses as they are not only time consuming and disruptive, but entrepreneurs and owner-managers rarely have experience or training in managing them, obtaining proper advice and guidance can be expensive, and failure to manage the process properly can often result in even more expensive legal action by an employee.
Discipline Procedures

Discipline is defined as the process of managing compliance with the rules of the workplace, the purpose of which is to enable people to work together safely and effectively by regulating disruptive behaviour. In many Western countries, particularly in Europe, there are statutory guidelines about how the disciplinary process should be managed in order to keep within the law and to ensure fair and objective treatment of staff. If these rules are not followed, there are legal remedies that staff can seek if they feel they have been unfairly treated. In other countries, it will often be down to individual managers to handle the situation as they see fit, and there may be no guidelines for the process and no remedies if it is regarded as having been conducted unfairly. The following summary of the disciplinary process is based on the UK model defined by the UK’s Advisory, Conciliation and Arbitration Service (Acas), which has issued clear and precise guidelines in its document Code of Practice 1 – Disciplinary and Grievance Procedures. This can be accessed on its website (www.acas.org.uk).

The main principles that underpin good practice in the management of disciplinary problems are often described as the three basic principles of natural justice.

- Individuals should know the standards of performance they are expected to achieve and the rules to which they must conform. This implies that the onus is on the employer to ensure that the standards and rules are properly communicated to employees.
- Employees should be told clearly how and where they are breaking any rules or failing to achieve the required standards. It is the employer’s responsibility to communicate this to employees and to ensure that they understand what they have been doing wrong.
- Employees should be given adequate opportunity to improve before disciplinary action is taken, or dismissal is implemented. The employer must clearly define and explain what the employees need to do to improve their performance or behaviour and provide any necessary training where it is needed. The employer must also allow “reasonable” time and opportunity for the employee to demonstrate that they can perform at the required standard or behave correctly. The exception to this is where the employee is deemed to have committed "serious gross misconduct" such as fighting in the workplace, physical violence or damage, or the theft of goods, money or property.

It is the responsibility of the employer to ensure that any reviews of potential breaches of discipline are handled fairly, objectively and in a non-discriminatory manner. The employer must establish all of the relevant facts and then follow an appropriate process of enquiry and action within a defined timescale. In serious cases, the employee may be suspended from work (with or without pay), pending the outcome of the enquiry.

Where the employer has investigated the problem and found the employee to be in breach of the required behaviour or standards of work, it is normal good practice to follow a three-stage approach to discipline.

- For a minor transgression or first offence, the employee is given an informal verbal warning – describing what he or she has done wrong. Although this is “informal”, the details (the dates, times, nature of the problem and the remedial action) will be recorded on the employee’s file.
- For a more serious transgression or a repeated breach of performance or behaviour, a formal verbal warning is issued – specifying the breach and the remedial action needed, and the consequences of any further breaches in performance. It is normal for a witness to be present when the employee is being given the formal warning.
• For further occurrences, or in the event of serious breaches of behaviour or performance (that fall short of the serious gross misconduct mentioned earlier), a **formal written warning** is issued – notifying the employee that if a further breach of company rules occurs within a given period of time, he or she may be subject to suspension, dismissal or some other penalty (e.g. loss of pay or performance bonus). If the breach of rules has occurred after the expiry of a previous formal written warning, the employer also has the option to issue a **final written warning** that tells the employee that any future breaches of rules will result in dismissal. Each of these warnings would be witnessed by a third person and recorded on file.

This may seem like a laborious process when it would be much simpler just to dismiss the offending employee, but the three-stage process exists just as much to protect the employer from future litigation as to ensure that the employee has been treated fairly.

**Dismissal**

Dismissal is usually regarded as a last resort, except where a serious breach of company rules has occurred. It is deemed to have taken place where:

• employment is terminated with or without notice of termination
• the employee is unjustifiably demoted, or unreasonably transferred to a different working location (this is classed as constructive dismissal and in Europe, it is often used by employees as the basis for legal claims against their former employer)
• the employee resigns with or without giving notice of termination of employment due to the unreasonable behaviour of the employer (again, an example of constructive dismissal)
• the employee is working under a fixed-term contract (e.g. 12 months) which is not being renewed upon expiry
• the employee resigns whilst under notice to terminate their contract of employment
• (in Europe) the employee is unreasonably refused a return to work after pregnancy.

For legal purposes and to avoid potential of litigation by former employees, two key test questions are asked.

• Was there sufficient reason for the dismissal (i.e. was it fair or unfair)?
• Did the employer act reasonably in the circumstances?

Where the answer to either of these questions is “no”, the employer could face a potential legal action by the employee.

**Grievance**

Grievances or complaints by employees may be individual, for example about their work duties, pay, holidays, their colleagues, or bullying by a supervisor; or they may be collective (made by a group of employees) about issues that affect them all, such as pay, terms of employment, working conditions, or their treatment by supervisors.

The actual rights that an employee has within the workplace will vary substantially from one country to another and from one culture to another. Once again, we will look at the grievance procedures in the context of the rights that exist in the UK and EU, as examples of strong employee rights. Some employers might argue that they are in fact too strong, especially in small businesses, which can be disadvantaged by the burden of complying with obligations imposed under employment law that was essentially designed to protect employees in larger organisations. In the EU, for example, the good-practice model for dealing with complaints and grievances has several stages.
• Stage 1: Where employees (in the public or private sector) have a grievance or complaint against a colleague or against the employer, they are entitled to have that complaint heard and treated fairly by the employer. The initial complaint should normally be made to the employee’s immediate supervisor (or, where the complaint is about the supervisor, to the line manager above), and that person should attempt to resolve the complaint, ideally within 24-28 hours. Here is the first problem for very small businesses in that they rarely have such a defined management structure and if the owner is working away for a couple of days, the issue may not be addressed quickly.

• Stage 2: Where the employee feels that the complaint has not been resolved properly or has been handled in an unsatisfactory manner, he or she has the right to appeal to a higher level of management. The employee should request a meeting with the more senior manager, and this should take place within five working days of the request. The employee may be accompanied by a colleague or trade union representative, and a personnel officer should be present. Again, in the case of small businesses this higher-level manager may simply not exist within the business, and neither will a personnel officer.

• Stage 3: If the problem remains unresolved, the employee has the right to appeal at board of directors level, where the decision of the appropriate director will be final. Once again, this meeting should take place within five days and a colleague/trade union representative may be present. The director may request the supervisor and senior manager previously involved to attend, and a personnel officer should be present to take notes and advise on employment or legal issues. In the case of a small business, the director is very likely to be the person to whom the initial complaint was made so, in practical terms, this exercise is quite unrealistic.

REFERENCES


SOURCES OF INFORMATION

• Advisory, Conciliation and Arbitration Service (Acas) - www.acas.org.uk
• Chartered Institute of Personnel and Development – www.cipd.co.uk
• Chartered Management Institute – www.managers.org.uk
## Chapter 10

### Developing the Marketing Plan

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INTRODUCTION

Marketing is a very broad subject, so this chapter will focus on a small part of it that relates to the preparation of business plans. Other aspects such as market research and identifying potential customers are examined in Chapter 7, and a more expansive coverage of marketing is provided in the Introduction to Marketing Unit that is one of the four Units in the Level 4 Diploma in Business Start-up and Entrepreneurship.

The process of creating a marketing strategy has three main stages.

• Carrying out market research in order to understand the market itself, the competition and the barriers to market entry.
• Developing plans for market penetration, using the unique features and benefits of the proposed products or services to create competitive advantage.
• Planning the marketing mix that will make the strategy happen.

This process is then followed up by putting in place sales activities and customer service support. This ensures that the business is able to achieve sustainable growth by retaining its customers and allowing sales effort to focus on generating new business.

A. STRATEGIES FOR COMPETITIVE ADVANTAGE

Competitive Advantage

Some of the barriers to market entry are considered in Sections C and D of Chapter 3, in the context of starting and growing a new business, and in Section C of Chapter 7, in the context of the analysis of competitors and market forces using Porter’s Five Forces model. That model is also useful for identifying where there are opportunities in the target market to exploit the features and benefits of the products or services being offered to create an advantage over competitors in the market. This is particularly true where those features and benefits are significantly stronger than those of competitors’ direct alternatives or potential substitutes.

Competitive advantage is about defining what advantages one business has over another and how these can be sustained. Lasher (1999, p51) claims that “few firms have been able to achieve sustainable competitive advantage”, i.e. to stay at the head of their market for a long period of time. Certainly for new and small firms to achieve that situation is unrealistic, except in very rare cases where they have developed a totally revolutionary innovation. The importance of innovation breakthrough in creating step-changes in the market that will generate competitive advantage for the innovative company over it rivals is explained in Section B of Chapter 4.

There may be a great deal of prestige in being recognised as the market leader, particularly in major international markets; however, the average small business is simply not in that league – except where it has created the new market from the development of a new innovation. Even then, in the early stages its primary focus will be on achieving profitability rather than maximising market share; and its share is frequently at risk from rival companies with more substantial resources that may come along with a slightly improved and differentiated version of the innovation. In fact, it is sometimes claimed that there is a great
Developing the Marketing Plan

Adopting the second-to-market approach does not demean the value of creating competitive advantage, as its possession is still very relevant to achieving profitability. When attempting to create competitive advantage, a few basic questions need to be asked.

- What is it about my products and services that makes them stand out from the competition?
- What unique features do they have that make people want to buy them as opposed to the alternatives?
- How can I ensure that this uniqueness persists?
- If this is not possible, what else can I do to keep ahead of my rivals?
- What can I do to make my customers remember me and come back for more?

The answers to these questions will start to form the options for the strategic marketing plan.

Porter (2004) suggests that “holding a 100% market share is rarely, if ever, optimal. It is sometimes more sensible for firms to yield position and allow good competitors to occupy it than to maintain or increase share”. This pragmatic view is based on the idea that monopolising market share is impossibly hard to achieve, even if regulators allow it, so it is much better to share it with the safe and non-threatening competition: “A firm’s optimal share of the industry it is targeting should be high enough not to tempt a competitor to attack it. A firm must also have sufficient market share superiority (combined with other competitive advantages not related to share) to maintain equilibrium in the industry”.

Apart from market superiority, other competitive advantages identified by Porter include:
- possession of significant economies of scale that create cost advantages
- fewer industry segments from which competitive or substitute products might emerge
- buyers willing to purchase from a single supplier in the market, reducing pressure on the supplier’s prices
- a steep learning curve that is proprietary to the product or brand, that creates a barrier to entry for potential competitors
- no distribution channels stocking multiple brands (unless they are your own)
- other significant barriers to entry
- smaller competitors who can share value activities (“good” competitors).

In addition, the existence of a few competitors can actually be productive: it helps the overall size of the market to expand by raising customer awareness of the market. We can also add to this list the entrepreneurial culture that encourages constant development of new and “breakthrough” innovations to sustain competitive advantage.

Generic Strategies

Three primary generic strategies are identified by Porter (2004) in order to achieve competitive advantage; there is also a fourth hybrid of the first three that is often described alongside them.

- Cost leadership strategy. This is where competitive advantage is gained and maintained by planning and managing the cost structure (the relative price) of the goods or services compared with those of the competitors. This is essentially a proactive policy of maintaining a leading place in the market by using a keenly competitive pricing policy.
• Differentiation strategy. This is where competitive advantage is created by focusing on the difference or uniqueness of the products (in terms of product choice, quality, options, service, perceived value) in the eyes of the customer – i.e. by emphasising the points of difference and their value to the customers.

• Focus strategy. This is where the organisation concentrates on one or more specific niches in the market that have (typically) been unexploited by competitors. This particular strategy is popular with smaller firms that are competing against much larger rivals. The niche markets may not be sufficiently large to be of interest to the rivals initially – at least until the small firms have developed them into larger markets, at which point they may be targeted for acquisition so the larger firms can incorporate the niche markets into their mainstream market share.

• Best-cost provider strategy. This is the hybrid strategy and is offered as a variant of the previous three approaches – for example, to gain competitive advantage by combining cost leadership and differentiation to offer a high-quality product at a mid-range price.

B. DEVELOPING A COHERENT MARKETING PLAN

Planning the Market Penetration

Market penetration is about evaluating the market research that has been carried out and deciding on the strategy that will be used to penetrate that market, by employing any competitive advantages that the products or services might offer. Here are some examples.

• Lower production, distribution or other costs – where the business is able to achieve these, it might be appropriate to use the advantage they provide to offer lower prices in order to break into the market and establish a customer base. The downside of this approach is that once a company gains a reputation for offering low prices, it can be difficult to raise those prices back to the market norm without losing some customers. Ideally, therefore, the competitive pricing strategy needs to be linked with some other benefit to the customer.

• Clear difference in the quality of similarly priced goods – the higher quality becomes the differentiating and selling feature; this, if coupled with a price that is in line with the competitors’, could create a perception for customers that the product is better value for money.

• Niche market opportunities – these occur where there is a gap within a larger market for a specialised sub-market that is not currently being addressed. Niche market opportunities can be extremely profitable, especially in the short term, but unless the niche is very small and can be addressed by a single supplier, or protected by patents, then eventually competitors will be attracted to it. As mentioned earlier, the bigger the niche markets grow, the more likely they are to be targeted by the bigger players in the market. The companies that are most successful at exploiting niche markets move quickly to maximise market share but at the same time start looking for ways to keep their advantage – for example, through product innovation, or by looking for other niche opportunities.

• New markets – this is where there is currently no direct competition and where, until competitors can catch up, new products or services can command a premium price, like in a niche market. Markets for new or innovative products are ideal for first-to-market strategies, whereby the entrepreneur may positively choose not to go through the time-consuming and expensive process of protecting IP, but will just get the
Developing the Marketing Plan

product out to the customers and establish it as a market-leading brand before the competition realise what is happening. The competitors will invariably follow with their own similar new products, but unless they come up with a breakthrough innovation themselves, they will usually be following the market leader. This can create a situation where successful market leaders can become targets for acquisition by larger companies that want to break into that market. For some small firms, this situation may also be part of their pre-planned exit strategy.

- **Unique features** – these might differentiate a company’s products from those of its competitors for a period of time, especially if the IP for the unique features can be protected to prevent the competition from copying them or introducing similar features into their own products. Unlike the first-to-market advantages that can be gained in new markets (where protecting IPR may be less important), where innovative features are introduced to established markets the protection of the IPR associated with those features is a key element of maintaining the competitive advantage they create.

- **Loss-leaders** – this is the idea of selling the products very cheaply at first to get a foothold in the market and to buy or create a market share. This approach is frequently used by manufacturers and distributors of fast-moving consumer goods distributed through chains of retail shops or supermarket outlets. Typically, the suppliers pay the supermarkets a premium price to place their products in a prime position in the shops, and they combine this with a high-profile launch, often supported by TV advertising, or with in-shop free samples or product tastings, and frequently with discounts or special offers on multiple purchases. Once the customers have got into the habit of buying those products and they have become established alongside their rivals, the price is increased to the normal level. Another technique used by supermarkets is almost giving away products or selling them at an unprofitable price to create foot-fall. The idea is to get the shoppers into the retail outlet to buy the special offers, and then to get them to buy other products whilst they are there, rather than going to a competitor’s shop.

- **Acquiring competitors** – buying another business to get an established share of the market without the expense and effort of normal market entry. This approach is sometimes used by a large corporation that wants to establish a presence in a different market (or country) without the time and expense of setting up a totally new business structure and distribution network. On a different scale, it is also used by smaller companies in an emerging market – for example, buying an established competitor’s customer base to introduce their own product.

- **Merging or cooperating with competitors** – this involves using the competitors’ market position to launch complementary products. This is a situation that is quite common in wholesaling or distribution environments, where small rivals operating in overlapping geographical areas and selling similar products may collaborate. This might involve sharing deliveries to reduce costs, or selling each other’s products in the parts of the sales areas that don’t overlap. If that process works well, there may be scope for further collaboration to achieve further economies of scale, such as joint purchasing to achieve better prices or discounts. This, in turn, may eventually lead to a merger between the two companies to make them stronger in the face of their larger competitors. In the UK in the 1980s and 1990s, this tactic was used by a number of small regional brewers and wholesalers to resist the aggressive expansion and acquisition activities of the five big national breweries that dominated the market at that time.

A much different and more powerful form of cooperation and collaboration has led to what has quite recently been described as **collaborative advantage**. This is now often regarded as equally important for business growth as competitive advantage. Market penetration in its
most effective form employs the utilisation of any and all available network contacts to facilitate access to new markets. These could be personal or professional contacts within the market (if in related markets) to achieve introductions to potential distributors, retailers, suppliers or customers. It could also be the use of third-party support agencies that have knowledge of, or contacts in, overseas markets such as export agencies, trade attachés in international embassies or foreign inward investment agencies, or that may be able to identify potential collaborators or trading partners. On a technical level for product innovation, the collaboration may take the form of knowledge transfer (involving academic or specialist research institutions to help create the innovation breakthrough in the first place) or assistance with further product developments to sustain the competitive advantage in future. This leads on to the broader issues of accessing markets and distribution networks, which are covered in the next section.

**Accessing Markets and Distribution Networks**

One of the biggest problems facing small firms is that of accessing new markets. Their large rivals will typically have the staff and financial resources to spend on investigating new markets, not just through desk-based market research activities but by visiting and meeting potential distributors or customers. The process becomes even more important when the company is considering exporting or establishing an operating base in another country. The needs of market access, especially if the new business is proposing to export, will also have implications for the marketing strategy as defined in the marketing mix.

In the home country, the market research activities and sources of support and information are usually relatively straightforward to identify, although the process itself can still be time consuming. Depending on the country in which the company operates, there will usually be some form of business support service such as chambers of commerce or trade services in overseas embassies, although the range and quality of support may vary from one country to another.

Accessing markets in foreign countries can be a major challenge, however. As well as language and cultural barriers, communications systems may not be as well developed as the potential exporters are used to, and there may be legal restrictions or barriers to non-domestic firms. For example, in certain countries all products must be distributed through native-owned companies or networks, and any foreign-owned subsidiaries may have to have at least one director on the company board who comes from the country in question. There may also be import restrictions or tariffs limiting what can be exported to those countries, particularly if those products include pharmaceuticals or medical devices.

There are a number of ways potential exporters can tap into both public and private sector organisations that may be able to assist them with making contact with potential customers, distributors or sales agents in foreign countries.

- Most countries have foreign embassies or consulates abroad, usually with at least one member of staff in those locations – often called trade attachés – with responsibility for supporting companies that want to access overseas markets. Some countries also provide export advice and support, often through regional development agencies or chambers of commerce.
- Inward investment agencies are organisations that assist companies that want to set up trading operations in a new country by establishing a subsidiary form there. They will assist the companies to find suitable locations and premises, to set up banking facilities and access legal services and development funding, and to develop trading
partnerships and distribution networks. Their objective is to bring investment into the areas where they are located, and to create new employment opportunities, and for this reason they are often in competition with each other within a country. A number of the economic development organisations also have reciprocal “soft landings” support arrangements with each other, to support both incoming and outgoing companies in accessing new markets. They use their network of contacts to help companies to find similar agencies in the target countries that can assist with setting up overseas activities.

- There are a number of international organisations that provide support for international trade. The EU-funded European Business Incubator Network comprises over 150 business incubator operators across Europe and some associate members in North Africa and the Middle East, for example. The National Business Incubator Association, based in the USA, is a similar but much larger network with over 1,900 members in 60 countries around the world.

- There are a number of larger banks that operate on an international basis, such as HSBC, Standard Chartered and the National Australia Bank Group. They not only help with managing international payments, currency exchange and export guarantees but, because of their international or global coverage, they are able to provide businesses with support with export documentation, and specialist advice on trading in particular markets, especially in China and the Far East.

**Defining the Marketing Mix**

The marketing plan for any product or service is concerned with formulating the right mixture of product characteristics, along with the way in which the product is supplied and presented, in order to maximise its value and interest to the target groups of customers which have been identified through the market research process.

The marketing mix defines the tactics that will be employed in order to achieve market penetration, and it is traditionally expressed in marketing theory in terms of “the Four Ps”. These are the four key elements of the marketing mix.

- Product.
- Price.
- Promotion.
- Place.

It has been argued (Booms and Bitner 1981) that three further Ps should also be considered for service industries.

- People.
- Process.
- Physical.

The idea is that for each product or service being offered, there is an appropriate combination of these factors that will optimise the sales potential to the respective market segments. Where a product or service is relevant to more than one segment, the components of the marketing mix will be modified accordingly, to match the needs of the respective segments. In reality, it is a common sense problem-solving process applied to the needs of marketing, and its value and effectiveness is clearly proved by the fact that it has been in use without challenge or major modification for many years. The seven Ps of the marketing mix are outlined in the following sub-sections.
Product
The Product element of the marketing mix is concerned with customers’ perceptions and expectations of the goods or services. It covers a broad variety of aspects, such as the basic quality of the product, its primary and secondary uses (if any), its features and benefits, and its durability and whether or not it will be fit for the purpose for which it was intended. Also linked to this is the added value that can be created around the core product – for example, warranties and after-sales service in the event of there being faults or problems with the quality of the product or service.

The product may be of a very satisfactory or high quality, but there is also the question of its perception by the customer as giving value for money – i.e. whether or not the perceived quality corresponds to the cost. If the quality is seen as being low compared with the cost, it will constitute poor value for money; but if it is perceived as being high in relation to cost, it will be good value for money. This aspect becomes significant where the price is more sensitive, such as at times when money is tight, or at the lower or utility end of the market, and when there is an abundance of competitor products. Also related to value for money is the extendibility of the range of applications or uses of the product, and the uniqueness or relative usefulness of the goods or services. A good illustration of this is the range of gadgets or extras that is offered with goods such as food processors and electric drills to make them appear more versatile than competitors’ tools.

The Product part of the marketing mix is not just concerned with the quality and utility of the goods or services, however. It must also consider aspects of style and appearance as perceived by the potential customer. In particular, the packaging and presentation, the brand name and the image it creates, and of course the uniqueness of the product. This is especially true in premium markets where image and uniqueness, often coupled with restricted outlets or supply, can attract status value to a product, with commensurately higher prices and profit margins. This is why, for example, genuine Versace clothes and Gucci handbags are sold through exclusive shops, and not in local street markets – although you may well find some very good cheap imitations there and at much lower cost!

Price
In practical terms, price is concerned with finding out how much can be charged for goods or services to maximise profit margins without reducing the sales volume. This is an issue of customer perception, as the price level must be considered in terms of value for money, and in comparison with the prices of competitors’ products. It may be possible to charge a higher price than competitors, but only if the customers perceive the quality and value for money of the products as being substantially better than those offered by the competition. The less the quality differential between the products, the lower the price difference must be. An option is to choose to undercut the competition to buy market share through increased sales, but such a move can also adversely affect sales because a substantially lower price may prompt the customers to assume that the products are in some way inferior to those supplied by competitors.

When formulating the pricing policy for a product or service, it is important to factor in any discounts, and credit or payment terms offered alongside them, particularly if they are distributed via wholesale and/or retailer networks. Credit terms and discounts usually form part of the overall price in the mind of the customer and, if favourable, they can act as substantial incentives to stock or promote the products. Conversely, if poor, the terms and discounts may be a disincentive to sell the product, or result in the vendor selling it at an unfavourable price compared with competitors’ goods. Wholesalers and retailers are as concerned with their profit margins as the manufacturers are with their own profits.
Place
The Place aspect of the marketing mix is not just concerned with the physical locations of the business, with ensuring customer accessibility, or establishing where the customers can obtain the goods or services, it will also define the geographical areas in which the business will operate, and it may specify individual outlets and their locations within those areas. Place is also about defining the proposed distribution channels and coverage — for example, via wholesaler or retailer networks, by direct supply and delivery, or by mail order. The choice of distribution channels also has implications for the supply of the products in terms of transport and supply lines, and stock levels to be held, which raises a number of further questions. Will retailers be supplied through regular weekly deliveries, enabling them to hold relatively low stocks; or perhaps monthly so stock-holding will need to be higher, with consequential implications for the costs and payment terms of the distributors? Will wholesalers be used to hold regional stocks for the retailers, thus reducing distribution costs but also requiring the business to operate on a reduced profit margin? Will the distributors be allocated exclusive sales areas, or will they be competing against each other?

Promotion
Promotion encompasses the whole range of sales and advertising activities that could be used by a company. It may decide to employ a sales force to carry out direct personal selling to their potential customers, but that work could equally be carried out by sales agents, or by sales staff employed by distributors. Using distributors may be cheaper as there are fewer direct costs regarding the employment of staff, but it would not be as effective if those same sales people were selling competitors’ products as well.

The Promotion part of the marketing mix also involves identifying appropriate forms of advertising for the goods or services, for which there is a huge range of options!

- The internet.
- National TV.
- Local radio.
- Newspapers and magazines.
- Specialist trade journals.
- Mail shots.
- Advertising hoardings.
- Tethered balloons.
- Yellow Pages.
- Exhibitions.
- Trade fairs.
- County shows.
- Telesales calls.
- Sealed tenders for contracts.
- Click-and-pay adverts linked to internet search engines.
- Facebook pages.
- A stall in the local market.

Not only must a business identify the most appropriate forms of advertising for its product or service, it must select the ones that are affordable and likely to give the best return on investment. Word of mouth recommendation is very cheap and a superb form of promotion, but it is both slow and beyond direct control and, therefore, cannot be relied upon to produce consistent results. In contrast, trade fairs and exhibitions are expensive and time consuming — but, if chosen carefully, they can offer a captive audience with a potentially high level of
interest in the products and a good chance of achieving immediate orders, particularly at the launch stage of a new product.

An aspect linked to advertising is the use of special offers or sales promotions to generate interest in the products and to persuade potential customers to try them. As with loss-leaders (discussed earlier in this chapter), they are used frequently in supermarkets where new products are launched on the basis of “buy one, get one free” bargains, or tasting sessions for food items accompanied by money-off vouchers. These methods are clearly not appropriate to every type of goods or services, so the promotional activity must be designed to suit the product. Beauty and therapy treatments are often offered on a “five for the cost of four treatments” basis. Gyms and fitness clubs offer discounts for annual membership to encourage regular patronage, and magazines offer discounts for pre-paid subscriptions etc. Effective promotion is all about finding out what appeals to particular types of customer and then using a little imagination to trigger their interest in the product.

People
Where services rather than physical goods are being supplied, the People part of the marketing mix becomes a more important element, particularly in terms of the image which they project to prospective customers. This is more than just a question of the first impressions created by dress or physical appearance; it applies to knowledge, communication and behavioural aspects of the interaction with customers, including technical knowledge of products and services. If communicated properly, this knowledge can inspire or create customer confidence; if absent, though, it can destroy it. It is also about the attitude shown to customers through interpersonal behaviour, such as the friendliness of reception staff, the helpfulness of sales staff, a positive interest shown in solving customer problems and in building long-term customer–client relationships, which together reflect the overall customer-focused culture of the business. The issue becomes particularly critical in markets where customers are in contact or interact with each other in order to create growth in sales via customer recommendation. However, it is equally important to ensure that the reputation of the business is not damaged by the communication of any negative customer experiences they may have had with the attitudes or behaviour of employees of the business.

Physical
The Physical aspects include the sales environment and, in particular, the impression created by the parts of the premises that can be seen by the customers. Is the reception area clean and tidy, tastefully decorated and welcoming, or are the furnishings old and the space cluttered or dirty? Is the space comfortable to be in – not too hot, cold or noisy? Does the organisation project an image of being well organised and professional? In a retail environment, is the space well lit, clean, and are the goods clearly displayed and accessible to customers? For anyone managing a business, it should prompt the following questions.

- How would I feel about walking into this environment if it belonged to one of my suppliers?
- Would I feel comfortable, embarrassed or disgusted?

There is also the issue of health and safety compliance, to ensure a safe working and risk-free environment for staff, visitors and customers. A pleasant physical environment can also encourage staff who are engaging with the customers to be more positive.

Process
The Process part of the marketing mix is really related to the general provision of quality products and customer service. It involves ensuring that company policies and procedures are conducive to meeting the customers’ needs and to providing smooth and consistent
service. It can relate, for example, to the discretion given to employees to be flexible or to modify procedures in order to meet customers’ needs, or it can relate to involving customers in product development or in seeking ways to improve the standards of service for them. In a perfect situation, the processes operating within the business should be invisible to the customer as they should be designed to work for the benefit of the customer, rather than for the convenience of the firm or its staff. Above all, the process should facilitate smooth transactions and create a positive customer experience, and must not become a barrier that puts them off dealing with the business.

C. CUSTOMER SERVICE AND QUALITY POLICIES

Customer Retention

It is not sufficient just to carry out market research and to define a marketing policy, and the tactics to implement it. It is also essential to monitor the quality and efficiency of the service provision as the customers perceive it. This is the key to customer retention.

Replacing lost customers is expensive in terms of both sales effort and actual monetary costs, and all the time that sales effort is focused on replacing lost customers instead of gaining new ones, the firm’s potential for growth will be restricted. It is much more cost-effective, therefore, to develop a strategy to retain existing customers and focus the sales effort on generating new customers. The introduction and use of a long-term customer retention policy will enable the sales effort to focus on new business development, allowing the business to grow.

Consider a theoretical example that compares customer retention in two similar businesses.

At the start of Year 1, the Acme Manufacturing Company has 100 customers, each spending an average of $10,000 per year.

- The company employs a sales person who gains 50 new customers per year, but the company loses an average of 40 customers per year.
- The cost of sales activity to find each new customer is $1,000.
- Customer service activity is negligible apart from routine sales visits and emergency responses when things go badly wrong.

<table>
<thead>
<tr>
<th>Table 10.1: Acme Manufacturing Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>No of customers</td>
</tr>
<tr>
<td>Sales revenue $</td>
</tr>
<tr>
<td>Sales activity costs $</td>
</tr>
<tr>
<td>Net sales revenue $</td>
</tr>
</tbody>
</table>

Table 10.1 shows that the cumulative net sales revenue for the Acme Manufacturing Company over five years will be $6,250,000.

At the start of Year 1, the rival Remington Production Company also has 100 customers, each spending an average of $10,000 per year.

- It employs a sales person who gains 50 new customers per year.
• The cost of sales activity to find each new customer is $1,000.
• It also employs a customer service person to support and advise customers at a cost of $30,000 and, as a result of having the customer service support in place, it only loses an average of 20 customers per year.

Table 10.2: Remington Production Company

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>No of customers</td>
<td>130</td>
<td>160</td>
<td>190</td>
<td>220</td>
<td>250</td>
</tr>
<tr>
<td>Sales revenue $</td>
<td>1,300k</td>
<td>1,600k</td>
<td>1,900k</td>
<td>2,200k</td>
<td>2,500k</td>
</tr>
<tr>
<td>Sales activity costs $</td>
<td>50k</td>
<td>50k</td>
<td>50k</td>
<td>50k</td>
<td>50k</td>
</tr>
<tr>
<td>Customer service costs $</td>
<td>30k</td>
<td>30k</td>
<td>30k</td>
<td>30k</td>
<td>30k</td>
</tr>
<tr>
<td>Net sales revenue $</td>
<td>1,220k</td>
<td>1,520k</td>
<td>1,820k</td>
<td>2,120k</td>
<td>2,420k</td>
</tr>
</tbody>
</table>

Table 10.2 shows that as a result of the customer service support, the cumulative net sales revenue for the Remington Production Company over five years will be $9,100,000 – almost 46% more than its rival over the same period of time.

Managing Customer Relationships

Customers are usually lost because they are dissatisfied with the quality or functionality of the products or services themselves, the reliability of the supplier in delivering them on time, poor after-sales service, or because of a breakdown in the customer–supplier relationship. It is this relationship that is the most important: if the relationship is strong, it would normally be possible to sort out problems or complaints that the customer has experienced. The process of building long-term relationships with customers is, therefore, essential for customer retention. This might include:

• having named people to make regular contact with the customers, e.g. through regular telesales calls or account management. Having a specific contact person has several advantages: it makes the interaction much more personal when the customer can go to a person they know will help them; the one-to-one communication helps to develop a trusting relationship between the individuals; and it makes the customer feel valued and important – after all they are important to the business
• monitoring service provision and seeking regular feedback from the customers about the quality of goods or services. The customers’ perceptions may well be very different from those of the supplier but this will never be known unless the right questions are asked – or the customers have gone elsewhere, at which point it is too late
• responding promptly and positively to any negative feedback from the customer, and keeping the customer informed of what remedial action is proposed or is taking place
• establishing a quality and/or customer service policy that has defined standards that the company, its managers and staff, and the customers can use to evaluate the products or the services that are being provided
• always being totally honest and open with customers and not making promises that can’t be kept. Customers don’t like to be let down by suppliers but what they like even less is being lied to and let down. For example, if a delivery deadline is likely to be missed, it is better to warn the customer in advance so they can perhaps make contingency plans, rather than have staff and resources standing idle waiting for a delivery that is not going to happen.
Understanding Customers

A common mistake that businesses make is that they fail to try to understand what their customers’ perceptions are of their businesses – perhaps because they assume that customers will think just the same as they do, or possibly because they fail to understand that different people have different standards to others, and different expectations of them. This is why it is so important when developing customer service and quality policies to place yourself in the position of the customer and to explore just what they expect from the business and its products and services.

Think of yourself as a customer who is about to go into a shop or business for the first time. Ask yourself what factors are likely to impress you about the transaction, and what factors are likely to put you off dealing with the business again? Think in terms of:

- the business itself – does the firm appear to be professional in the way it conducts its business and deals with its customers? Does it have a good reputation? Does it give you confidence that your order will be handled efficiently and delivered on time?
- the business premises – are they clean and tidy, appropriately laid out and furnished, with good lighting, and do they appear to comply with health and safety requirements? Alternatively, are they scruffy, cluttered, gloomy or untidy? These questions must, of course, be taken in the context of the type of business that is being considered, as you would not expect a small bicycle repair shop to be as pristine as the reception area of a large corporate company
- the staff – do they greet you or acknowledge you as you enter; are they pleasant and polite; are they smartly dressed; do they appear to be interested in you; are they knowledgeable and helpful; and do they respond quickly? Or, do they ignore you and appear uninterested; fail to smile; fail to make eye contact; seem unwilling or unable to answer your questions; or keep you waiting?
- the products or services on offer – are they good quality, appropriately priced, fit for the purpose you want them for, and available when and where you need them?
- the business operations or service provision – how pleasant and efficient was the transaction; was it a positive or negative experience; would you want to deal with the business again? Would you recommend them to someone else?

The challenge is for entrepreneurs and business owners to use these perceptions of other businesses and apply them to their own business situation; this allows them to evaluate exactly what their customers’ perceptions and expectations might be about their own businesses.

Customer Care and Quality Standards

The primary objectives of customer care policies are as follows.

- To retain customers for repeat business. The use of sales staff and advertising to find new customers is expensive so – as explained earlier in this chapter – if customers can be retained or the rate of natural turnover of existing customers can be reduced, then – instead of chasing after replacements for the losses – sales effort can be invested in finding extra new customers. Overall, this will increase the sales revenues and profits of the business.
• To increase the level of trade with existing customers by improving their confidence in the business and its products or services. Dealing with the business should constitute a pleasant and problem-free experience.

• To enhance the reputation of the business and its product or service quality to increase customer loyalty and recommendations; this, in turn, generates extra sales revenue and profit in the longer term. Even customers who complain, but who are treated well in response to their complaints, tend to not only continue to buy in the future, but also to tell others about their positive experience. In contrast, poor service leads to loss of reputation and customers, and consequential reductions in turnover, or the need for extra sales effort to replace lost trade.

• To reduce the costs of business operations over the longer term. By using quality management systems and processes to eliminate faults or mistakes, it is possible to reduce the need for checking and inspection, leading to a reduction in the cost of quality control, as well as the associated costs of rectifying those faults. Similarly, a good customer care policy tends to reduce the occurrence of problems and to correct them before they get out of hand. Customers who don’t complain often tend to go elsewhere anyway, so the idea is to avoid complaints arising in the first place, to prevent the loss of customers.

• Within the business itself, to increase the job satisfaction of staff by positive interaction with their customers, and by avoiding the stress and aggravation that accompanies customer complaints.

The key to developing good practical quality standards is to ensure that they are both specific and measurable. By definition, if a standard cannot be measured in some way – by time, cost, shape or size, cost savings, performance or profitability – then it is not a standard at all. Quality standards do not have to be complex systems of standard operating procedures and technical specifications as are often seen in formal (and expensive) ISO/BSI/CE Mark accredited products or processes. They can in fact be quite simple and straightforward, although the process of breaking down the product into component parts and related tasks or the service into specific individual activities, is basically the same as for formal accreditations.

Specifying quality standards is probably easier for products than for services as products can be specified in terms of the type and quality of raw materials, the dimensions, shape or weight of each component, the assembly process and the functionality and durability of the assembled product. Specifying quality standards for services is basically the same process but may be more complex in that the criteria for assessing quality may be much broader – for example, using timescales, response times or deadlines, or standards of personal behaviour.

The process of identifying where standards are required is usually determined by asking the question: “What can possibly go wrong?” If something can potentially go wrong, there is a place for a quality standard to ensure that it either does not happen at all or, in the unlikely event that it does, that there is a defined procedure for remedying the situation. For this purpose, it often helps to break the service provision down into three parts, and to define standards for each of them.

• Pre-transaction processes – the standards required for the activities that will create the right first impressions, for greeting customers, responding to the initial contact or enquiry, preparing quotations for specific contracts etc.

• The transaction process itself – the standards required to cover the activities within the service delivery, ensuring the service is supplied to the specification, by trained and competent staff, at the right time and place, and at the correct price.
• Post-transaction processes – the standards required for the activities involved in after-sales service, support or warranty, correcting any faults or problems, seeking feedback and addressing any negative issues, and paving the way for repeat business.

Butler (2006) uses an example of a small mobile catering business providing wedding reception services to illustrate how customer care policies and quality standards can be developed using this three-stage process.

Pre-transactional standards.
• All enquiries will receive a telephone response within 24 hours.
• The owner will arrange an appointment to meet with the clients within seven days to discuss their needs, and will provide sample menus, photographs and references from previous functions.
• A written quotation will be posted to the client within 48 hours of the visit, giving a detailed schedule of services to be provided, any options available, a firm estimate of costs for those items, and a summary of payment terms. This will form the contract with the clients.
• On receipt of confirmation of the booking, a letter of acknowledgement will be sent to the clients requesting the agreed deposit or booking fee.
• Four weeks before the event, the client will be contacted to confirm any variations to the requirements, and an invoice will be raised for the balance.
• A week before the event, the client will be contacted again to finalise details of access arrangements, times and any special requirements, e.g. vegetarians, young children or wheelchair-users.
• All necessary food and sundries will be ordered five days before the event for delivery on the day before the event, or early the same morning.

Transactional standards.
• All food items will be fresh, of high quality and will be stored in suitable containers at safe temperatures prior to preparation and before they are served, in compliance with environmental health regulations.
• Food will be prepared as close as possible to the time of the event to ensure freshness and safety. It will be prepared in hygienic conditions, under the supervision of staff trained and qualified in food hygiene.
• Tables will be laid with clean cloths, crockery and cutlery, with decorations in the colours and designs prescribed by the customers.
• Waiting staff will be clean, tidy, polite and friendly. They will be dressed in a standard formal style appropriate to the event. Food will be served promptly and tables cleared quickly once the diners have finished eating.

Post-transactional standards.
• After the meal, all items will be cleared promptly, washed and removed from the site. Kitchen areas will be left in a clean and tidy condition, and all rubbish will be bagged for disposal.
• At the end of the event, the clients will be approached by the person in charge to check that there are no further requirements, and then thanked before departure.
• A week later, the clients will be sent a letter enclosing a brief questionnaire and pre-paid envelope, requesting their feedback on the service provision.
The last of the post-transactional standards is particularly important as there is little point in establishing a comprehensive list of standards and associated targets without monitoring them to ensure that they are being achieved. The feedback should be evaluated and used to modify the standards or to develop new standards. Above all, where the feedback reveals that customers are not satisfied with the quality of service provision, or that the standards are not being consistently achieved, it is essential that the business firstly addresses the problem, and secondly informs the customer that it is responding positively to the feedback.

D. SELLING THE PRODUCTS OR SERVICES

Marketing is concerned with identifying the level of demand for the goods or services, where potential customers might be found, the competition which exists, and creating a mixture of product features and means of delivery that will ensure the goods or services will be desirable. Sales is about actually persuading the customer to buy the goods, to pay the right price for them, and then to come back to you for more at a later date. It is quite possible to make excellent goods for which there is a potentially high demand in a ready-made market; however, without the sales skills to actually make the customer buy them, they will just sit on the shelves.

The Sales Plan

The Promotion section of the marketing mix should provide the basic structure for determining the most appropriate methods of sales activity for reaching the customer target groups. Typically, this includes several of the following methods of initiating the sales process.

- Internet advertising can, in its simplest form, comprise a simple website with keywords or phrases that will ensure a prominent position when any potential customers use the most popular search engines. On a more sophisticated basis, it may involve a secure interactive website through which customers can place orders and pay for them securely. This could be promoted via a pay-per-click facility with primary search engines to ensure prominence on the first page of any keyword search. A company website is really an imperative for any small business now that internet searches have largely replaced conventional directories such as Yellow Pages as the preferred method of researching sources for products or services.

- Cold-calling by telephone is basically a numbers game in which sales staff make a large number of unsolicited calls to contacts. The unit cost is relatively low, but cold-calling usually results in quite a low rate of positive interest or response, even when the targeted calls have been carefully pre-selected. The normal approach is to try to identify categories of businesses that might be interested in the product (often from Yellow Pages or Thompson Local listings, but also from customer contact or mailing lists that may have been purchased for the purpose), and then to make telephone contact to find the appropriate person or decision-maker within those organisations. The results largely depend on the skills of the individuals who are making the calls – they need to be both competent at doing the job and able to talk convincingly about the product if they get through to the right person. To achieve positive indications of interest from 5-10% of those called would generally be regarded as very good, and to subsequently convert 10% of those into an actual sale would be a high rate.

- Mail shots, like cold telephone calls, have seriously declined in value in recent years, simply due to the sheer proliferation of junk mail that falls through our letter boxes just
about every day of the year. Many people just treat circulars and junk as rubbish to be thrown away with no more than a cursory glance, and any obvious circular remains unopened in the envelope. Circulars containing personalised letters are sometimes read to the bottom of the first paragraph to determine any relevance or usefulness, before being discarded. Sadly, this constitutes a huge amount of wasted material, even if a proportion is recycled, and for businesses the cost of printing and posting all that waste material is huge. All too often, mail shots are used because business owners don’t make the effort to take a more proactive attitude towards other methods of sales or promotion.

- Cold-call visits by sales people are time consuming and costly and, therefore, need to be carefully planned to avoid wasted effort by calling on the wrong type of customer. They also need to be well organised to minimise the cost of travelling between calls and to optimise the use of the sales person’s time. For this reason, a good sales person will often fit them in between other booked appointments in a specific area, if only to gather information or contact names for future reference. Occasionally cold-calls do result in sales, but more often they serve other purposes: to maintain the profile of the company by regular contact, to seek information about future possible needs that will lead to subsequent sales, and to update or make new contacts that can be followed up at a later date. Cold-calling, therefore, is essentially a longer-term sales activity which is best used to complement other sales effort. Many people dislike having to sell by cold-calling: it is not easy to do, and it takes time, practice and quite a bit of nerve to do it well. However, as a long-term process, it can produce positive results.

- Planned sales activity involves a combination of the previous methods, and constitutes a much more professional approach, which results in better use of time and a higher proportion of positive results. For example, a cold telephone call might be used to do no more than to find the name of the key person or decision-maker in an organisation. This should be followed by a concise personal letter of no more than one page, which outlines the products or services offered, and tells the key person that they will be contacted within a few days to request an appointment for the sales person to meet them. After this, it is down to the skill of the sales person and the quality of goods or services on offer.

- Advertising on national or regional television or local radio is relatively expensive but does guarantee coverage of a wider audience. National TV is excellent for consumer products but highly expensive. Local radio stations are cheaper, but with lesser coverage, although they always seem to do quite well in promoting regional events.

- The national press is again expensive and often too broad to be of value to many businesses, although the travel industry always seems to find it productive. Local papers are good for local products and, in particular, local services, and are more reasonably priced. Most specialist products or services are advertised in trade journals or magazines where the cost is justified by the readership which will have been identified as a potential customer group.

Setting Targets and Measuring Achievement

The purpose of the sales plan is to define the range and combination of promotional activities that will be employed to persuade customers to buy the products. The part that many small firms find hardest is setting the actual targets for sales volumes and revenues. If the market research has been done properly, there should be some positive indications about the overall size of the market and the potential volume that can be achieved within that market. The next problem is to try to identify how much of that potential volume could realistically be achieved; this may be influenced not just by sales capacity, but also by restrictions imposed by the capacity of production and/or distribution facilities, or the time available for the provision of a
service. For example, a consultancy firm that employs three staff may be able to offer up to 120 hours of service per month per member of staff, giving an overall total of 4,320 hours per year; however, it could not meet a contract requiring 2,500 hours of work in just a three-month period without bringing in external help.

Monitoring of the sales and marketing performance can be carried out as part of the ongoing financial monitoring of the business, as described in Chapter 11, and by some fairly simple methods of evaluating the effectiveness of sales activities.

- In preparing the budgetary plan for the business, certain sales volumes will have been identified and formulated, and from them the forecast sales revenues will have been produced. These in effect establish the targets against which actual performance can be monitored on a monthly basis.
- The budget will also include forecasts of expenditure for advertising and promotion. The monitoring process will compare the actual expenditure with these forecasts to check that when money has been spent on promotional activities, the expenditure has resulted in the corresponding increase in sales that it was designed to generate.
- It is also important to monitor the response rates that are achieved by different sales activities – for example, in terms of the number of enquiries generated by each advertisement, and how many of them were converted into actual sales. Similarly, the response rates and achievement rates for cold telephone calls, cold sales calls, planned sales visits and mail shots can be measured against targets and monitored for changing trends. Where targets have been set for the various activities, they can be compared with the outcomes, and the results can be used to set more realistic targets for the coming year. If there were no initial targets, the analysis will provide real data to enable targets to be set for the future.
- From the expenditure figures, it is possible to calculate the relative costs of different sales activities such as cold-calls, telesales, mail shots and various forms of advertising. The figures showing response rates and rates of conversion into sales can then be applied to these various activities to identify, for example, the cost per enquiry for each advertisement, or the cost of each sale resulting from cold calling.
- Finally, the relative costs of the various sales activities can be compared with the revenues generated, to determine the most cost-effective methods. This will then feed into the marketing and sales plans for the forthcoming year.

Sales Skills and Basic Techniques of Selling

For a new or aspiring owner-manager with no previous sales experience, the most daunting prospect is that of having to sell their goods or services. Sales skills have to be learnt and practised if they are to achieve good results on a regular basis. The biggest mistake that most new sales people make is to try to push and sell to the client the range of products in their portfolio; someone with more experience, on the other hand, will listen carefully to the client, and probe to identify their specific problems and needs. Only then are the products revealed, and in such a way that they offer potential solutions to the customer’s needs. It is equally important to sell on quality and benefits rather than on lowest price. If nothing else, there is then still scope to negotiate on price at a later stage, but if a competitor can beat you on both price and quality, the sale is usually lost.

It is essential to be open and honest with the client, to establish credibility and to retain the opportunity of returning at a later date. It is foolish to promise what you can’t deliver, and there is no shame in admitting that you cannot meet the client’s requirements on this
particular occasion. Buyers are as much professionals as sales people, and they not only appreciate an honest answer that saves their valuable time, but they will usually be receptive to a later approach when your product might be the real answer to their problem.

Finally, it is also important to remember that not all business is good business, and it is perfectly reasonable to walk away from a contract or a sale if you are not happy about the terms of trade or the potential profit margins. Every supplier should expect to make a reasonable profit just as much as the customers to whom they are selling, and most professional buyers appreciate this fact. The sale should be treated as a potential starting point for a longer-term customer–supplier relationship and, as such, needs to be established on equitable terms.

The following list of tips will help less experienced entrepreneurs or new business owners to develop their personal sales skills and their ability to engage customers successfully.

Before the sales meeting.

- Rehearse your sales pitch so that you can deliver it fluently. It often pays to have what the Americans call an “elevator pitch” – a short succinct summary of your business or products that can be described in the time it takes for a lift to get from the ground floor to the tenth floor of a building.
- Research the target company – make sure that you understand what they do and the markets in which they operate or, in the case of public sector customers, the services they provide and the clients who use those services.
- Find the decision-maker(s) and get contact names and titles before asking for an appointment to see them. This can often be achieved by searching the company website or by a cold telephone call to reception, claiming that you need the name of the appropriate person so that you can send them some information.
- Arrange an appointment with the right person (the decision-maker or key influencer), allowing adequate time to talk. Book the appointment by telephone and then confirm it in writing or by email.
- Plan what you want to achieve from the meeting before you arrive, but be aware that these objectives may well change during the meeting, or may not be achieved in just one visit.
- Have suitable information/literature/website information available so that you can provide it if asked. Don’t hand it over too early, though, or your contact may well just read it instead of talking to you, or may just dismiss you with a promise to call you later if it is of interest.

The meeting itself.

- Dress appropriately for the type of organisation you are visiting and the level of the person you are meeting. Casual wear may be fine for an informal meeting in a social setting but not when presenting to a board of directors, even if they themselves are informally dressed.
- Arrive early – not just to avoid the stress or risk of being late, but also to allow time for exploratory conversations with reception staff, or to examine the visitor book to see if any competitors have been visiting and whom they have called to see. This can generate useful additional contact names.
- Introductions – take note of who is present and their roles and try to remember their names. Exchanging business cards at this point helps. Be wary if their roles are not explained at first as they may be the real decision-makers.
• **Briefly** outline what you are offering and why it will interest the potential customer (the elevator pitch); then **promptly** ask the customer an open question about their business to get them talking as soon as possible.
• Listen out and probe for problems or difficulties the customer is having and look for ways in which your offering will solve them. You may be able to sell them a solution for these problems.
• Avoid technical data unless the customer specifically asks for it – you can leave technical specifications with them at the end of the meeting. It is easy to get involved in technical data and, therefore, distracted from the sales focus of the conversation.
• Check to ensure that you have answered all of the customer’s questions, and remember that a response of “just put some information in the post” often indicates that the sales opportunity has already passed.

Closing the deal.
• In Section B of Chapter 7, we mentioned the most important principle of selling: “Don’t sell products or services – sell the features, benefits and solutions they offer to the customers”. It is also important to emphasise quality and value for money, rather than price.
• **Check** that the benefits and solutions you’ve outlined meet the customer’s need.
• Ask the customer if he/she agrees that your offering can provide what is needed, and **check** that he/she has no doubts or reservations about this. A “no” answer gives you the chance to address any doubts the customer may have, whilst a “yes” answer can lead into asking the customer for the order.
• **Talk** about costs and delivery times – **but don’t mention discounts**.
• **Most importantly, ask the customer for the order.**
• If the customer declines, ask why.
• If the customer places the order, you can discuss costs and delivery arrangements.
• At the end of the meeting, thank the customer for the order and for taking the time to see you.
• After the meeting, confirm details of the order and/or respond to any queries as soon as you return to your base.

Many people who are new to sales find it hard or embarrassing to close the deal, or to actually ask the client for an order. In fact, some buyers will make a point of waiting to be asked before committing themselves, particularly with young or new sales people. If you are uncomfortable about asking outright for an order – “Can I take your order today?” – then try: “When can I expect to receive our order?” or “When would you like us to deliver?” Another approach is to ask the question: “Can you see any reason why our products will not meet your needs?” If a reason is given, you have an open opportunity to answer and overcome it. If the client has no objections, you have a direct lead in to asking for the order.

**Using ICT and Social Networking for Sales and Marketing**

There are conflicting opinions about the value and importance of sales and marketing using ICT in the form of the internet and/or social networking. One school of thought suggests that internet selling is the only way forward, and that view is to some extent substantiated by the meteoric rise in the number of new websites, many of which do not actually sell anything but offer paid-for advertising space to businesses. The opposing view is that internet marketing is a very valuable additional option to existing and more traditional forms of marketing but should not be seen as the only alternative to them. This view is exemplified by the evidence.
that approximately two-thirds of websites with business models based on revenue derived from advertising are likely to fail in the first year of operation. That does not mean to say that internet marketing doesn’t work, but it does prove what has been known to newspaper and magazine publishers for many years: even with years of experience, selling advertising space is a very hard thing to do, and the proliferation of free advertising on the internet has made that sales process even harder in the past few years.

**Websites and Search Engines**

As described earlier in this chapter, internet advertising in its simplest form can comprise a basic website, with keywords or phrases that will ensure a prominent position when potential customers use the most popular search engines, and which provides information about the goods and services the business offers. For small businesses, this is a very cheap and cost-effective way of reaching a potentially huge audience. A company website has, therefore, become almost an imperative part of sales and marketing activities for small businesses now that internet searches have largely replaced conventional directories such as Yellow Pages as the preferred method of researching sources for products or services.

Interactive websites, through which customers can place orders and pay for them securely, can generate real sales revenue on a regular basis. However, when every other competitor is trying to do the same thing, the website has to be more sophisticated – using selected keywords and links to other sites in order to optimise its prominence on search engines. When keyword searches can produce two million results, and when most searchers rarely look at more than the first 20 or 30 of them, website optimisation becomes essential; but if everyone is optimising their websites, it is easy to get pushed back down the search list. The solution is to pay the search engine providers to push the website back to the top of the list, typically through banner sponsorship or Google Ads, where the website is displayed prominently at the top of the search results. You can also buy a prominent position on a pay-per-click basis, wherein you pay a small fee for each visitor that clicks on to visit the site. Sponsored listings and Google Ads can be costly but the cost is usually known up front. Pay-per-click, although it appears cheap, can become unexpectedly expensive if there are large numbers of visitors – particularly if they do not actually buy anything during their visits.

**Electronic Newsletters and E-zines**

Established companies with significant customer bases and mailing lists often circulate regular customer newsletters that also promote their products; or they may send them a regular electronic magazine (e-zine) containing editorial material, company news and product information.

A large number of magazine publishers now produce electronic versions of their printed magazines containing the same adverts as the printed versions. These are sometimes free, where the extra advertising revenue pays for the circulation (and potentially reduced sales of printed versions) or, like some specialist trade magazines, they are circulated on a subscription basis like their printed equivalents. Some more innovative independent magazine publishers are also now offering the electronic equivalent of the printed “reader enquiry card” that used to be found in most printed magazines, for which the advertisers pay an additional referral fee to the magazine.

**Social Networking**

Blogs were a very popular form of social communication for public sector, educational and business people to inform their friends, colleagues and networks of news, activities and opinions. They became very popular in 2006-08, but have been largely displaced (possibly because some bloggers were quite long-winded and dull?) by Twitter, which is a much more
concise means of spreading news or passing on opinions because there is a limit of 140 characters on each message. The Twitter website describes itself as “an online information network” that uses short bursts of information or “Tweets” that can be generated by businesses as well as individuals, in order to contact customers.

Social networks have proliferated since about 2005. Initially, they consisted of web-based organisations such as Friends Reunited, and individual college or university social websites for young people. However, several market leaders grew out of this including Facebook, which now has a huge international coverage across a broad range of age groups, and LinkedIn, which has become the international network for business and professional people. Businesses can set up Facebook pages to promote their products and services, and they can target their adverts at audiences based on age, location or interests.

When talking to individuals and businesses that are in or are linked with the ICT sector, it is frequently said that social networking is the way of the future and should be an integral part of the marketing plan (although at present its capacity may be limited to marketing rather than actual sales). Facebook and Twitter are particularly popular with people under the age of 30, but even with that potential audience of 800 million, they are still well below the capacity of the overall internet audience. There are still many people around who prefer not to engage in social networking; and its critics argue that it will never provide a better long-term alternative to websites and conventional methods of sales and marketing.

One of the factors that may sway the use of social networks for marketing is the development of dedicated applications for Facebook, Twitter, LinkedIn, etc, on smart phones, where access to a networked laptop or computer is not needed for online purchasing. However, at present these phone apps are primarily aimed at consumers rather than for business-to-business use.

**BIBLIOGRAPHY**

Chapter 11

Planning and Managing Business Finances

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INTRODUCTION

In a start-up situation, most lenders, banks or investors will base their decision to lend or invest on two main factors: the strength and realism of the financial projections, and the quality of the market research and proposed marketing strategy. In Section B of Chapter 5, we explored the general expectations of potential lenders and investors when they are reviewing a proposal for a new business. In summary, they expect to be presented with:

- a spreadsheet showing the first-year budgetary plan and cash flow forecast, and ideally a similar forecast for the second year
- if credit is given to customers or received from suppliers, a separate spreadsheet for each year showing the projected cash flow and reflecting the credit given or received
- a detailed explanation of the assumptions underlying the planned budget
- a personal survival budget – to determine the projected salaries or the drawings that the owners need to take from the business to pay themselves
- a break-even analysis to show when the business will reach a level of profitable trading
- profit forecasts for years one and two to demonstrate how profits will grow as the business becomes established
- the value of any capital available to the business, and any investment made by the owners to date, plus any tangible assets or resources that will be put into the business by the owners
- a breakdown of the additional finance required by the business, the phasing to show when it is needed, and the preferred options for raising the funds
- the proposed financial monitoring procedures that will be used within the business to ensure it remains on track.

The main purpose of this chapter is to explain how to compile and present the type of information that lenders and investors will be expecting in a format that will generally be acceptable to them. This includes budgetary plans, cash flow forecasts, explanations of the assumptions behind them, the profit forecasts for the first two years, and how the business will be funded in order to deliver the profits.

The second purpose of this chapter is to provide the prospective entrepreneur with the requisite knowledge and understanding to prepare the forecasts, and also an understanding of the broader aspects of small business finance that will enable the business to survive the start-up period, achieve its break-even level of trading and then move into profitability. This will require an understanding of the difference between mark-up and profit margins, the different ways of calculating break-even, how to monitor and control the working capital, cash flow, and how to manage the credit control issues that will inevitably occur at some stage.
A. BUDGETARY PLANNING AND PROFIT FORECASTS

Basic Principles of Accounting

There are four fundamental concepts that govern the way in which the financial accounting process is carried out.

1. Consistency concept: all items and entries in the company accounts should be treated consistently from one accounting period to the next. For example, if an item of expenditure is treated as an overhead cost in one year, it should be treated as the same in the following year. Similarly, if a vehicle is depreciated at 20% of its value in the first year, it should continue to be depreciated at 20% of its remaining value in future years.

2. Accruals concept: all income and expenditure costs must be accounted for in the period to which they relate (or in which they arise), rather than the period in which they are actually paid or paid for. If on the last day of the financial year, a company buys £5,000 of stock but does not pay for that stock until month one of the next financial year, then that stock must be shown as £5,000 of expenditure, and as £5,000 in the company’s creditors account. When the invoice is paid in the following month, the accounts will show the £5,000 payment from the bank account and an equivalent reduction in the creditors account.

3. Prudence concept: losses must be recognised at the earliest opportunity, but profits are only recognised when they are in a liquid (cash or near cash) form. This means that if a sum of money owing to the company is overdue or looks like it may not be paid, that sum must immediately be treated as a doubtful debt or a bad debt. Where customers pay by cash or where they pay regularly and reliably by monthly account, that money can be regarded as profit as it is reasonable to expect the reliable customers to continue to pay on time.

4. Going concern: the principle that a business will continue to trade in future, as at present, without significantly curtailing its scale of operations. The asset figures shown in a company balance sheet do not represent the potential sale value of those assets, just their “book” value to the company. In the event of a forced sale, if the company became insolvent they might be worth considerably less. However, unless the company is at risk of becoming insolvent or its sales levels are under serious threat, it is reasonable to assume that it will continue to trade as per normal and that its assets will continue to have value.

Budgetary Planning and Control

A budget is a financial plan for an organisation, detailing its income and expenditure over a fixed period of time – usually an accounting year. The primary purpose of setting a budget is to forecast the levels of income and expenditure over the coming year, in order to determine when and where the revenue will be coming in, and where and when it will need to be paid out. The ideal objective is to ensure that the revenue coming in is always sufficient to cover the expenditure going out, ensuring a positive flow of cash. In reality, this rarely happens as almost every company will have peaks and troughs in its income and expenditure. The budgeting process will enable those peaks and troughs to be
identified in advance so that any potential deficits between income and expenditure can be prepared for and managed.

**Historical and Zero-based Budgets**

There are two ways of preparing a budget: the historical or zero-based approach. The historical approach is the most popular, and involves taking the budget for the previous period and adjusting it for known or anticipated changes in revenue, costs or market trends. This is quite a simple and reliable process – assuming, of course, that the figures from the previous year have been prepared carefully and have turned out to be realistic. If not, errors can potentially be compounded year on year. Another problem is that any contingencies or slack that had previously been built into the budget can be compounded by the effects of inflation, leading to ever-increasing inaccuracies.

The alternative is zero-based budgeting where the budget is formulated from scratch, ignoring the figures from previous years and, thereby, forcing every single budget heading to be carefully analysed and individually justified. This process has tended to be unpopular, partly because it is time consuming if done properly and prone to error if guesswork and shortcuts are permitted to save time, and because very often the justification of parts of the budget will be historically based anyway. However, it is particularly good for evaluating the potential costs of R&D situations or where there is competition for limited resources.

Historical budgets can be too loose, leading to inefficiency, whilst zero-based budgets can be too tight, leading to inflexibility. However, apart from the first year when all budgets are by definition zero based, the historical approach is by far the most popular and practical.

**The Purpose of Budgets**

Budgets are a very useful and practical management tool, and they provide the basis of comparison for monitoring the financial performance of the business. They are used:

- to quantify the objectives of the business in financial terms
- to prioritise and allocate financial resources across the business
- to monitor and control activities and operations such as:
  - changing operating costs (labour, raw materials, production and distribution costs)
  - changing costs of overheads, management, sales and marketing, administration, finances and borrowing
  - the effectiveness of sales activities, changing market trends, fluctuations and changes in demand, the efficiency of advertising, the impact of advertising programmes and special promotions on sales, and the consequential increases or fluctuations in sales revenue
- to evaluate the performance of functional areas within the business – sales, production and distribution – as well as financial performance
- to plan and monitor cash flow
- to identify financial needs and working capital requirements – the potential need for additional financing, loans, short-term overdrafts to ensure adequate cash flow
- to identify potential profits/losses for an organisation or its individual products or services, or its internal departments or operational locations
- to monitor the effects of changes in interest rates on costs of borrowing, or changes in exchange rates on the profitability of export sales.
Preparing Budgetary Plans and Cash Flow Forecasts

The preparation of the budgetary plan normally involves using a spreadsheet, which is basically a grid containing row and column calculations. If the rows and columns have been prepared correctly, then all of the totals across and all of the totals down should correspond when carried to the bottom right-hand corner. However, even with computerised spreadsheets, the budgetary plan rarely works out first time around, and will invariably require tweaking or adjustment to achieve a realistic and acceptable result.

Table 11.1 shows an example of a budget spreadsheet for a market trader.

The first stage of preparing the budget is to identify the key areas of income, distinguishing between income generated by sales of goods or services and non-trading income, e.g. rent from sub-letting space. If required, the sales income can also be sub-divided to show the revenue from different product groups, from different types of customer, or carrying different profit margins. For example, a food and drinks wholesaler would want to distinguish between those two major product areas, but the budget headings may also differentiate between sales to retail outlets where a 20% profit margin is expected, and sales to other wholesalers at a 10% profit margin. The revenue figures throughout the year also need to reflect seasonal trends. In the case of the wholesaler, this might involve peaks over the summer months and at Christmas, and much quieter periods from February to March and October to November. Any other sources of income are identified and included under a separate heading, e.g. capital input or receipts of loans. Then all items of income are totalled.

The next stage is to carry out a similar exercise for all known areas of expenditure, including overheads, operating costs, stock purchases (which should reflect sales levels), distributions costs, capital expenditure and loan repayments. As with income, these are totalled for each month and for the year as a whole.

The third stage is to calculate the net income or expenditure for each month and for the year as a whole. If done correctly, this can be quite a complicated and time-consuming exercise the first time around. It is particularly important, therefore, that the time invested is not wasted once the bank manager has seen it, by simply filing the budget away and forgetting it until next year. The budget should be used as a working document to monitor and control the finances of the business throughout the financial year, but it will only work if it is used properly. The monthly figures against each item of income and expenditure are the forecasts against which the actual monthly income and expenditure can be compared to identify any discrepancies. Where those occur, by investigating the reasons behind the discrepancies it will hopefully be possible to deal with any problems before they cause harm to the business, but without regular monitoring the problems may continue to grow unnoticed, until it is too late to rectify them.

The sample budgetary plan in Table 11.1 uses the example of a sole trader who has set up a new business part way through the previous year to sell clothes from a stall in a local street market. The spreadsheet shows the sole trader’s budget forecast for the next 12 months. As it is a cash-based business with no credit given or taken, it also includes the cumulative cash flow forecast at the bottom. Its structure and content illustrate the range and depth of detail that lenders or investors would normally expect to see in a business plan.
Table 11.1: Sample Budgetary Plan for a Small Business

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<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
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</tr>
<tr>
<td>Bank charges</td>
<td>–</td>
<td>–</td>
<td>300</td>
<td>–</td>
<td>–</td>
<td>250</td>
<td>–</td>
<td>–</td>
<td>250</td>
<td>–</td>
<td>–</td>
<td>250</td>
<td>1,050</td>
</tr>
<tr>
<td>Personal drawings</td>
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<td>1,200</td>
<td>1,500</td>
<td>1,200</td>
<td>1,500</td>
<td>1,200</td>
<td>1,500</td>
<td>1,200</td>
<td>1,500</td>
<td>1,200</td>
<td>1,200</td>
<td>15,600</td>
</tr>
<tr>
<td><strong>Total Expenditure</strong></td>
<td>11,250</td>
<td>9,440</td>
<td>9,010</td>
<td>8,350</td>
<td>8,070</td>
<td>8,640</td>
<td>9,250</td>
<td>8,070</td>
<td>8,690</td>
<td>9,870</td>
<td>10,840</td>
<td>13,140</td>
<td>114,620</td>
</tr>
<tr>
<td><strong>NET INCOME</strong></td>
<td>7,550</td>
<td>2,560</td>
<td>(2,010)</td>
<td>650</td>
<td>(70)</td>
<td>1,360</td>
<td>(250)</td>
<td>(70)</td>
<td>1,310</td>
<td>1,130</td>
<td>4,160</td>
<td>3,860</td>
<td>20,180</td>
</tr>
<tr>
<td>Cumulative Cash Flow</td>
<td>7,550</td>
<td>10,110</td>
<td>8,100</td>
<td>8,750</td>
<td>8,680</td>
<td>10,040</td>
<td>9,790</td>
<td>9,720</td>
<td>11,030</td>
<td>12,160</td>
<td>16,320</td>
<td>20,180</td>
<td></td>
</tr>
</tbody>
</table>
In larger businesses, or in small firms where credit is given to customers and/or received from suppliers, it is normal to split the budgetary plan and cash flow forecast, in order to reflect the fact that payments made to suppliers or received from customers will frequently occur in different periods (months) to the ones in which they are incurred or invoiced. Apart from the practicality of being able to see just when the cash movements will occur, this reflects the accruals concept described earlier. The cash flow forecast document is very similar to the budgetary plan, and the process and content are explained in Section B of this chapter.

Personal Survival Budgets
Some lending banks request that a personal survival budget is included in the finance section of the business plan. The purpose is to allow the potential entrepreneur to identify how much money he or she needs to live reasonably comfortably (but not in luxury) and which will need to be drawn from the business.

The personal survival budget will include the costs of accommodation, heating, electricity, water and sewage bills, plus the costs of food and clothing for the family, operating a private vehicle, travel expenses, school fees for children, health and medication costs, leisure activities, holidays, and gifts for family on special occasions. In addition, the total cost must be treated as a net income figure after any taxes have been paid, and must be grossed upwards to reflect the total pre-tax wages cost to the business. Invariably, most people who undertake this exercise are amazed to discover their true cost of living.

Once a reasonable figure for total wages is established, this will feed into the budgetary plan as part of the operating costs of the business. In many cases, entrepreneurs will draw the absolute minimum from the business for wages in the early stages, and then gradually increase the amount as the business becomes more profitable. It must be remembered, however, that no entrepreneur should expect to live on a minimum wage for an extended period of time: if that is necessary, the whole viability of the business must be questioned.

Profit Forecasts
The inclusion of profit forecasts in the business plan is absolutely essential as potential investors want to see that they will be able to get a financial return on their investment, and potential lenders want to see that their money can comfortably be repaid from the profits of the business. It is normal to include profit forecasts for at least two years because the first year of trading may include substantial start-up costs so the business will not be trading at full capacity in the initial months; hence, its profits (if any) will not reflect a normal full year’s trading activities.

A common mistake in business plans is the failure to differentiate between the end-of-year cash balance shown in the budgetary plan, and the actual profit. The budgetary plan includes balances brought forward from the previous year, and possibly tax payments due, plus the owners’ drawings which are an after-tax expense for sole traders and partnerships, and loan repayments for which only the interest component can be treated as an expense to be offset against profits for tax purposes.

Table 11.2 illustrates a two-year profit forecast, using the financial data shown in the sample budgetary plan (Table 11.1). It also shows that the presentation of the summary of profit forecasts for each year differs from the totals shown in the budget and cash flow forecast, because certain items of expenditure such as loan repayments and tax payments
are not included in the profit forecasts as they do not form part of the operational expenses.

Table 11.2: Sample Two-year Profit Forecast

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market stall</td>
<td>£125,000</td>
<td>£137,500</td>
</tr>
<tr>
<td><strong>Expenditure</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stall rent</td>
<td>£7,800</td>
<td>£7,800</td>
</tr>
<tr>
<td>Stall wages</td>
<td>£5,500</td>
<td>£5,500</td>
</tr>
<tr>
<td>Stall stock</td>
<td>£74,900</td>
<td>£82,500</td>
</tr>
<tr>
<td>Bags and wrappings</td>
<td>£1,250</td>
<td>£1,375</td>
</tr>
<tr>
<td>Stall fittings</td>
<td>£100</td>
<td>£100</td>
</tr>
<tr>
<td>Book-keeper</td>
<td>£360</td>
<td>£360</td>
</tr>
<tr>
<td>Admin and expenses</td>
<td>£1,040</td>
<td>£1,200</td>
</tr>
<tr>
<td>Advertising</td>
<td>£420</td>
<td>£500</td>
</tr>
<tr>
<td>Insurance</td>
<td>£600</td>
<td>£600</td>
</tr>
<tr>
<td>Transport – running costs</td>
<td>£3,000</td>
<td>£3,000</td>
</tr>
<tr>
<td>Transport – hire purchase</td>
<td>£1,800</td>
<td>£1,800</td>
</tr>
<tr>
<td>Loan repayment interest</td>
<td>£200</td>
<td>£200</td>
</tr>
<tr>
<td>Bank charges</td>
<td>£1,050</td>
<td>£1,200</td>
</tr>
<tr>
<td><strong>Total expenditure</strong></td>
<td><strong>£98,020</strong></td>
<td><strong>£106,135</strong></td>
</tr>
<tr>
<td><strong>Net profit before tax</strong></td>
<td>£26,980</td>
<td>£31,365</td>
</tr>
<tr>
<td><strong>Tax due @ 10%</strong></td>
<td>£2,683</td>
<td>£3,137</td>
</tr>
<tr>
<td><strong>Net profit after tax</strong></td>
<td><strong>£24,297</strong></td>
<td><strong>£28,228</strong></td>
</tr>
<tr>
<td>Owners’ drawings</td>
<td>£15,600</td>
<td>£18,000</td>
</tr>
<tr>
<td>Loan repayment capital</td>
<td>£1,000</td>
<td>£1,000</td>
</tr>
<tr>
<td><strong>Payments after tax</strong></td>
<td><strong>£16,600</strong></td>
<td><strong>£19,000</strong></td>
</tr>
<tr>
<td><strong>Retained profit</strong></td>
<td>£7,697</td>
<td>£9,228</td>
</tr>
</tbody>
</table>

B. WORKING CAPITAL, CASH FLOW AND CREDIT CONTROL

Managing Cash Flow and Working Capital

The importance of producing detailed cash flow forecasts and budgetary plans was examined in the previous section of this chapter, but apart from keeping the bank manager happy, they are of little value to the business if they are not actively monitored on a regular basis. At least once a month, and preferably as soon as possible after the end of each month, the actual sales volumes and revenues and the actual expenditure incurred in each area of the business need to be compared with the forecast figures to identify any significant discrepancies. Where such discrepancies occur, they need to be analysed to determine the cause, and to identify whether or not they constitute a one-off situation or
part of a developing trend that might adversely affect the longer-term prospects of the business. Having identified the discrepancies, it is then necessary to assess the impact they will have on business operations and profit. If the budgetary plan has been prepared on a computerised spreadsheet, this is a relatively simple process as the actual data can be entered into a copy of the original budget to produce revised out-turn figures.

This process is even more important when forecasting cash flow, as relatively small changes in sales revenue or credit terms can, over a period of time, compound to create a major cash flow problem. However if the problems are spotted in time, it is often possible to address them before they become too great, for example by arranging a short-term overdraft, by tightening credit limits or the length of credit given to customers, or by extending the credit received from suppliers – ideally, after consulting them first, of course!

The cash flow of a business can be likened to an old rusty zinc bucket with holes in the bottom that leak water as fast as it can be poured in at the top of the bucket. If the inflow of water slows down or the holes get bigger, the level of water falls; if the inflow increases or the holes are plugged, the water level rises.

Using this bucket analogy, cash receipts pour in to the business through the top, and leak out as expenditure through the holes in the bottom. There are ways in which the rate of flow can be increased, to top up the level in the bucket, and there are factors that cause a faster outflow, thus reducing the level of working capital in the bucket.

- Increased profits or net receipts from trading improve working capital. As trading profits increase, the net profit from trading will increase the amount of working capital available (assuming, of course, that all debtors pay on time); however, any losses or net reductions in receipts from trading will diminish working capital.
- Raising of loans, and repayment of those loans. The receipt of loans increases working capital. When a long-term loan is taken out (or any other long-term liability), the working capital pot is increased; however, any regular repayments of loan capital and interest will progressively diminish the available balance. Similarly, the repayment of loans reduces the available cash and working capital.
- Injections of capital from investors will increase the availability of working capital but the redemption of capital or the payment of dividends, profit shares and taxation will reduce the available cash.
- Changes in the average balance of debtors and creditors are major influences on the available working capital. Increased creditors (more credit from suppliers) and decreased debtors (faster payment by customers) will both improve the cash flow, whilst conversely a reduction in creditors and any increase in debtors will worsen cash flow. The latter is one of the inevitable effects of any growth in trading.
- Sale or purchase of fixed assets (e.g. land and buildings) or investments releases cash. The sale of fixed assets will increase the cash available to run the business, but any corresponding or subsequent purchase of fixed assets will reduce that sum. When a vehicle is sold at the end of its practical working life, the residual value will be added to the working capital pot. However, any replacement vehicle (which will inevitably cost more on account of inflation over the intervening years) will probably result in a larger sum being taken out of the working capital pot, unless other financial provisions are made.
- The reduction of stock levels can free up cash previously tied up, but increasing stock levels tie up cash. Often the increased stock-holding is a response to expansion of sales, which, if coupled with an increase in credit customers, can
reduce available working capital quite quickly and severely, possibly leading to an over-trading situation.

**Cash Flow Forecasts**

As explained earlier in this chapter, for simple businesses operating on a cash or non-credit basis, the budgetary plan can incorporate the cash flow forecast by using an additional row at the bottom of the spreadsheet (as shown in Table 11.1) to reflect the cumulative cash flow, i.e. showing a running balance of the positive and negative net income/expenditure figures for each month. However, where the business receives credit from its suppliers, or gives credit to its customers, it is necessary to split the budget and cash flow forecasts into two separate sheets to reflect the difference between the budgeted figures (dates of sales and purchases) and the actual cash movements arising from payments to suppliers and receipts from customers.

The preparation of a cash flow forecast is very similar to the process of preparing a budget spreadsheet, as the format and calculations are basically the same; however, the purpose of cash flow forecasts is different. Whereas the budget is concerned with identifying levels of income and expenditure that are incurred in each part (e.g. month) of the budgetary period, the cash flow forecast is concerned with when that income is received, and when payments are made for expenditure incurred. In order to achieve this, the cash flow forecast will need to reflect:

- cash balances brought forward from the previous period (e.g. month)
- payments due to suppliers (creditors) incurred in the previous period
- payments due from customers (debtors) owing from the previous period, and adjustments for bad debts
- ongoing credit given and received during the year
- receipts of loan income or capital
- capital purchases, lease payments, loan repayments etc
- in the case of sole traders and partnerships, the income tax liability for the business in the previous year; or in the case of limited companies, the corporation tax liability for the previous period.

It is important to remember that whilst receiving credit from suppliers can be very positive for the cash flow of a business, giving credit to customers can have a very negative effect on cash flow. Where the total credit given exceeds the total credit received the net difference has to be funded from working capital. This situation may require extra funding to be found (perhaps additional investment, a bank loan or an overdraft) to prevent cash flow difficulties (called over-trading). This is a common problem in rapidly growing companies that can cause them to become insolvent and go out of business, even though they are actually generating substantial profit margins.

Table 11.3 uses the same data as the budgetary plan spreadsheet in Table 11.1 (Section A of this chapter), but with adjustments to reflect the impact on cash flow of:

- the receipt of 30 days’ credit from suppliers commencing on 1 January
- the provision of credit terms to 10% of customers from 1 January (e.g. via credit card payments or on account for regular customers).

By comparing the sample budgetary plan with the sample cash flow forecast, we can see that the net effect of the credit received from suppliers and given to customers is to
### Table 11.3: Sample Cash Flow Forecast for a Small Business

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>INCOME:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market stall</td>
<td>8,100</td>
<td>11,700</td>
<td>7,500</td>
<td>8,800</td>
<td>8,100</td>
<td>9,800</td>
<td>9,100</td>
<td>8,100</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>9,800</td>
</tr>
<tr>
<td><strong>Total Income</strong></td>
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<td>8,100</td>
<td>9,800</td>
<td>9,100</td>
<td>8,100</td>
<td>9,800</td>
<td>10,900</td>
<td>14,600</td>
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<td>133,100</td>
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<td><strong>EXPENDITURE:</strong></td>
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<td></td>
<td></td>
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<td>600</td>
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<td>600</td>
<td>600</td>
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</tr>
<tr>
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<td>500</td>
<td>400</td>
<td>400</td>
<td>500</td>
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<td>5,400</td>
<td>6,300</td>
<td>7,800</td>
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<td>–</td>
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<td>50</td>
<td>–</td>
<td>–</td>
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</tr>
<tr>
<td>Book-keeper</td>
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<td>250</td>
<td>250</td>
<td>3,000</td>
</tr>
<tr>
<td>Transport – hire purchase</td>
<td>150</td>
<td>150</td>
<td>150</td>
<td>150</td>
<td>150</td>
<td>150</td>
<td>150</td>
<td>150</td>
<td>150</td>
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<td>100</td>
<td>1,200</td>
</tr>
<tr>
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<td>–</td>
<td>–</td>
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<td>–</td>
<td>–</td>
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<td>–</td>
<td>–</td>
<td>250</td>
<td>–</td>
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<tr>
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<td>1,200</td>
<td>1,500</td>
<td>1,200</td>
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<td>1,200</td>
<td>1,200</td>
<td>1,200</td>
<td>15,600</td>
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<tr>
<td><strong>Total Expenditure</strong></td>
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<td>10,840</td>
<td>9,610</td>
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<td>7,770</td>
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<td>8,950</td>
<td>8,670</td>
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<td>8,970</td>
<td>9,340</td>
<td>11,340</td>
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</tr>
<tr>
<td><strong>NET INCOME</strong></td>
<td>14,350</td>
<td>860</td>
<td>(2,110)</td>
<td>(450)</td>
<td>330</td>
<td>1,460</td>
<td>150</td>
<td>(570)</td>
<td>1,410</td>
<td>1,930</td>
<td>5,260</td>
<td>5,460</td>
<td>28,080</td>
</tr>
<tr>
<td>Cumulative cash flow</td>
<td>14,350</td>
<td>15,010</td>
<td>13,100</td>
<td>12,650</td>
<td>12,980</td>
<td>14,440</td>
<td>14,590</td>
<td>14,020</td>
<td>15,430</td>
<td>17,360</td>
<td>22,620</td>
<td>28,080</td>
<td></td>
</tr>
</tbody>
</table>
improve the cash flow throughout the year, and increase the end of year cash balance by £7,900.

**Credit Control**

If it is becoming obvious that some of a company’s customers are either unable to pay their bills, or are unwilling to pay them on time, there are a number of options available for pursuing those debts.

- Call them by telephone or send a reminder letter. This is always worth trying as the non-payment may simply be the result of an oversight. However, if the customer regularly pays late this is likely to have no effect at all, as reminders will simply be ignored.

- If there is no further response within 7-14 days, try again, preferably more firmly. Contact the decision-maker or person responsible for payment. Check that the payment is not in dispute. Ask outright if there is a cash flow problem and ask for a firm date by which payment (or at least part-payment) can be expected. Again, a serial bad-payer will probably just make empty promises at this stage, and will stretch their credit to the limit until forced to pay. There are unfortunately still a few people in business who regard this process as a game and seem to enjoy testing the patience of their suppliers to the limit.

- Once the payment becomes 30 days overdue, then – unless there are special circumstances that the company is prepared to accept, or the customer has negotiated an agreement for repayment – it is time to seriously consider stopping further supplies. Some small firms find this a hard step to take, as they run the risk of the customer going to another supplier. But what is there to lose? A sale is not a sale until it is paid for, and if the customer is slow in paying your business, then the same will probably apply to his or her next supplier. You will be better off without that customer in the long term. It may come as a surprise, but some customers even respect this firm approach.

- If the customer is in difficulty, then it may be possible to negotiate a structured programme of repayment without a loss of trade. This can result in a positive outcome for both sides where, for example, the customer pays cash on delivery for the regular weekly supply of goods plus an agreed minimum figure to reduce the outstanding balance. This can sometimes also form the basis for a stronger long-term trading relationship as once the customer has overcome their current problems, they remain loyal to the suppliers who worked with them during the difficult period. However, it is imperative that if you do agree to take this route, you must not allow the outstanding balance to increase at any stage until the debt has been cleared and normal trading terms have been re-established.

- Once you get beyond the 90-day stage, there is little option but to take formal debt recovery action. Most owner-managers are very busy people, and have little time to chase bad-payers. Solicitors are one alternative, although expensive to employ, and often laboriously slow in getting results. Professional debt collection agencies are often a better alternative: apart from an initial assignment fee and the reimbursement of their legal expenses, they work on the basis of taking an agreed percentage of the money they recover. They also tend to inform their clients up front when faced with a hopeless situation, whereas a solicitor might run up expensive bills before reaching the same conclusion.

- There are also illegal options for debt collection that go on around the world, particularly in more deprived areas or where the law is hard to enforce, and this
may involve the use of threats of physical violence or injury to collect debts. Obviously, this method is strictly illegal and comes with the risk of legal and/or physical reprisals, so it should not be the chosen option for a respectable growing business. It also occurs particularly in the field of unlicensed credit. New businesses should also be aware that dealing with disreputable suppliers can sometimes leave them open to this approach.

- In the UK, the Small Claims Court is supposed to offer a quick and inexpensive form of redress for sums under £5,000, without involving solicitors. However, the sheer volume of small claims that the courts have to deal with means that the process can still take some months, even if uncontested. For larger debts, it is possible to take action by issuing a High Court writ against the debtor, although the cost of doing so is quite high. The High Court tends to move faster than the County Court, particularly when applications are made for Compulsory Winding-up Orders; but once again, the cost of action must be measured against the likelihood of recovering the debt.

- As part of the UK Insolvency Act 1986, the facility was created to issue a Statutory Demand for Payment, whereby if payment for a debt was not made within 21 days of the issue of the Statutory Demand, the plaintiff could automatically apply for the business to be wound up or declared bankrupt. This works in principle if the business has any assets that could be liquidated in the event of bankruptcy, although, if that were the case, the company could probably raise the money to pay the bill anyway. Realistically, it is only worth issuing a Statutory Demand if you are willing to go to the next stage of enforcing it – i.e. applying to have the debtor declared bankrupt or insolvent, which will incur further legal costs. Also, bear in mind that if there are no tangible assets against which to claim, the business owners could simply incur more legal expenses in pursuing the claim, only to find themselves alongside a whole host of other unsecured creditors.

- Where goods are supplied to customers, it is possible to write the terms of trade (which appear on the reverse side of business invoices) to include retention of title to the goods supplied until such time as full payment is made for them. The owner, then, has the right to reclaim the goods if payment is not made. However, this does not confer rights of entry to premises to recover the goods, or help if the goods have already been sold. It can sometimes be of use when goods are confiscated by bailiffs or receivers in bankruptcy, as those goods cannot be subsequently sold and have to be returned to the supplier once proof of title has been demonstrated.

**Aged Debtors Analysis**

An aged debtors analysis is a simple monthly report which is readily available from computerised accounting systems, or which can be compiled from customer’s account records. Unfortunately many small businesses overlook this analysis unless prompted to produce one by their bank manager. It does require more effort to produce one from a manual accounting system, but if credit facilities are given to customers it is essential to monitor the effectiveness of credit control at the individual customer level and to gain an overall picture of the debtors and the periods of outstanding debt.

The aged debtors analysis, an example of which is shown in Table 11.4, is used to assess the performance of customers in paying their bills (and the performance of the business in collecting the debts). Each unpaid invoice for each credit customer is allocated to the 30-day period in which it was issued, so taking the fairly standard business credit terms
wherein payment is required within 30 days of the end of the month in which the invoice was issued:

- any invoices issued within the current month are not yet due, and are regarded as current, unless of course they should have been paid cash on delivery
- those falling due at the end of next month are classed as 0-30 days old, and are within the terms of credit
- those which are 31-60 days old should have been paid by now, and so are in need of chasing for collection unless they have been granted extended credit
- those which are 61-90 days old are of major concern and, unless they are part of an ongoing dispute, must be regarded as being at risk or, in accountancy terms, a “doubtful debt”
- the 90 days+ category is a definite sign of a “bad debt” and debt recovery action should have been taken long before it reached this stage.

### Table 11.4: Aged Debtors Analysis

<table>
<thead>
<tr>
<th>Customer</th>
<th>Current</th>
<th>0-30 days</th>
<th>31-60 days</th>
<th>61-90 days</th>
<th>90+ days</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ardup and Appie Ltd</td>
<td>2,000</td>
<td>2,000</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>4,000</td>
</tr>
<tr>
<td>Bodger and Lashit Ltd</td>
<td>1,500</td>
<td>1,500</td>
<td>1,500</td>
<td>–</td>
<td>–</td>
<td>4,500</td>
</tr>
<tr>
<td>Ben Dover and Co.</td>
<td>3,000</td>
<td>3,000</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>6,000</td>
</tr>
<tr>
<td>Evan Elpus and Partners</td>
<td>1,500</td>
<td>3,500</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>5,000</td>
</tr>
<tr>
<td>Gerry Hatrick and Co.</td>
<td>2,400</td>
<td>3,600</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>6,000</td>
</tr>
<tr>
<td>Grabbit and Run, Solicitors</td>
<td>1,000</td>
<td>1,500</td>
<td>1,000</td>
<td>500</td>
<td>1,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Helen Highwater and Co.</td>
<td>2,500</td>
<td>3,000</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>5,500</td>
</tr>
<tr>
<td>Major Isewater</td>
<td>1,600</td>
<td>1,400</td>
<td>500</td>
<td>1,700</td>
<td>1,500</td>
<td>6,500</td>
</tr>
<tr>
<td>Mick Sturbs and Sons</td>
<td>–</td>
<td>1,000</td>
<td>2,300</td>
<td>1,400</td>
<td>–</td>
<td>5,000</td>
</tr>
<tr>
<td>Mustapha Napple Ltd</td>
<td>2,500</td>
<td>1,500</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>4,000</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>18,000</td>
<td>22,000</td>
<td>5,300</td>
<td>2,200</td>
<td>2,500</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>% of outstanding debt</strong></td>
<td>36.0%</td>
<td>44.0%</td>
<td>10.6%</td>
<td>4.4%</td>
<td>5%</td>
<td>–</td>
</tr>
</tbody>
</table>

Looking at this example, there are two customers whose accounts must be treated as bad or doubtful debts, one of which (Mick Sturbs and Sons) already seems to have had its supplies stopped. Two other customers have debts in the 31-60 days range but it may be that their credit has been extended to 60 days, or that they are reliable payers who are just a few days late.

It is also important to consider the relative proportion of bad and/or doubtful debt in the context of the total average monthly debt. For example, if the total bad debt (over 90 days) is just 1% of the average monthly debt, then although it still needs to be addressed, the overall impact on cash flow and working capital may be manageable. However, if the bad debt figure constitutes 10% or more of the average monthly debt figure, the business could be facing major cash flow problems. In the example in Table 11.4, 80% of debt is either current or within 30 days, but 9.4% is in the bad or doubtful category which could cause significant cash flow difficulties. However, if the business has a lot of cash sales (e.g. another £50,000 per month in addition to credit sales), that debt may not be a major problem.

The prudence concept outlined earlier in this chapter requires that profits are not classed as such until they are in cash or near-cash form. Similarly, any doubtful or bad debts must be acknowledged as such at the earliest opportunity. In Table 11.4, everything over 30
days should realistically be regarded as a bad or doubtful debt, and as this is 16% of the outstanding balance, this company has a problem.

C. MARK-UP, PROFIT MARGINS AND BREAK-EVEN ANALYSIS

Profit Margins and Mark-up

Understanding the difference between profit margins (as a percentage of selling price) and mark-up (as a percentage of cost price) is a pre-requisite for calculating the break-even point. However, it is also a subject that small business owners frequently find confusing, sometimes with catastrophic results.

When we talk of **profit margin**, we mean the difference between the selling price and the cost price. For example, if we buy an item for £60 and sell it for £100, the profit margin is £40. This also constitutes 40% of the selling price.

When we talk of **mark-up**, we mean the percentage amount by which the cost price is increased to produce the selling price. Using the same example, if we buy an item for £60 and mark it up by £40, it will sell for £100. However, the mark-up as a percentage of the cost price is 66.7% – and although that figure may look good, it still only constitutes a profit margin of 40%

Hence:
- a mark-up of 100% will produce a profit margin of 50%
- a mark-up of 67% will produce a profit margin of 40%
- a mark-up of 50% will produce a profit margin of 33%
- a mark-up of 33% will produce a profit margin of 25%
- a mark-up of 25% will produce a profit margin of 20%

Failing to distinguish between these two is probably the commonest and most significant mistake made by people who are new to business. If an anticipated 50% gross profit is in reality only 33%, and adding in a few unexpected expenses, some increased costs during the year, and a small drop in sales revenue, an original forecast of 10% net profit on sales turnover for the year can suddenly become a 15% net loss, and there may no longer be any spare cash for bills that are due to be paid.

Break-even Analysis

Although the provision of a break-even analysis is not one of the required items of financial information requested by many lending banks in Western countries, it is something that most private investors would expect to see.

More importantly, it is an absolutely essential piece of information for any potential entrepreneur. Without being able to identify the stage at which a start-up business will reach the break-even level of trading and subsequently move into profit, it is impossible to calculate the amount of working capital that will be required to finance the business up to that point. If the business runs out of working capital before it reaches a profitable level of
trading, it will fail in spite of the fact that it may have the potential to become very profitable in the longer term.

Break-even can be expressed in several ways.

- The period of time (weeks or months) it will take to reach a break-even level of trading.
- The number of product units that must be sold per month to break even.
- The value of the revenue from products or services each month that is required to trade at break-even level.

**Methods of Calculating Break-even Levels**

In order to define what we mean by “break-even”, we must distinguish between fixed costs and variable costs. Fixed costs are generally regarded as overhead costs, and are defined as “fixed” because they do not change in relation to changes in the level of sales or output. Typically, they would include things like rent or lease payments, local premises taxes, management and administration costs (including the owner-manager’s own drawings) and insurance. In contrast, variable costs are defined as those costs which vary directly in relation to changes in sales or output. This would include the costs of raw materials, components, labour production costs (particularly bonus pay or overtime), invoicing, packaging and distribution. The break-even point, then, is the point at which the revenue from sales equates to the variable costs incurred in achieving that level of sales, plus the full overhead cost, or as an equation:

\[
\text{Sales revenue} = \text{variable costs} + \text{fixed costs} + \text{profit}
\]

By definition, at break-even point there is no profit, and at this point the sales revenue must match the fixed or overhead costs, plus what it costs to buy or make the goods that have been sold, i.e.:

\[
\text{Profit} = 0, \text{ therefore sales revenue} = \text{variable costs} + \text{fixed costs}.
\]

Another related concept is that of contribution, which is defined as follows.

\[
\text{Contribution (to profit and overheads)} = \text{selling price} - \text{variable cost}
\]

This means that the difference between the selling price and the variable cost of an item makes a contribution towards the profit and overheads of the business. For example, if a car dealer buys a second-hand car for £1,000 (variable cost) and sells it for £1,500 (selling price) then the difference of £500 makes a contribution to the dealer’s overhead costs and profits.

There are several ways of calculating the break-even point, including a graphical break-even chart, but the two most accurate methods involve fairly simple calculations based on the sales revenue and contribution equations. To illustrate this, we will use an example where: selling price = £10 per unit, variable cost = £4 per unit, fixed costs = £150,000 per annum, and the break-even sales level = Y units.
a) The equation method uses the simple formula mentioned earlier.

Sales revenue = variable costs + fixed costs + profit.

\[
10Y = 4Y + 150,000 + 0 \\
10Y - 4Y = 150,000 \\
6Y = 150,000 \\
Y = 150,000/6 \\
Y = 25,000 units
\]

So we see that when sales levels reach 25,000 units, the income is sufficient to cover the variable costs incurred, plus the total overhead costs. However, it is only when sales start to exceed this level that the revenue will make a contribution towards the profit of the business.

b) The contribution margin method uses a different formula.

\[
\text{Break-even level} = \frac{\text{fixed costs} + \text{net profit}}{\text{contribution}}
\]

\[
Y = \frac{150,000 + 0}{10 - 4} \\
Y = \frac{150,000}{6} \\
Y = 25,000
\]

c) Some businesses work on a standard mark-up of goods and services to give a standard percentage profit figure, for example where the contribution equals 40% across all products or services. In these cases, the calculation is simply a case of dividing the annual overhead figure by the percentage profit: with annual overheads of £100,000 and a profit margin of 40%, we would divide £100,000 by 0.4 to give a break-even sales level of £250,000.

When calculating profit margins and setting prices, it is important to remember the effect that small changes can have on break-even level. Using the same example, let us assume that our marketing specialists have advised that reducing the selling price from £10 to £9 per unit would generate an increase in sales of 10%. This sounds good, but is it worthwhile? Using the equation method – 9Y = 4Y + 150,000 – we find that the break-even point Y calculates out at 30,000 units. Unfortunately, the increase of 10% in sales volume will only result in a total of 27,500 units, so the business will be worse off than before. It would actually need a 20% increase in sales to break even at £9 per unit.

D. SOURCING FINANCE FOR START-UPS

There are many different types of finance available for business start-up and expansion, and they come from a broad range of different sources. However, not all of them will be available to all businesses in all countries, and some may simply be unsuitable or inappropriate, perhaps because they are too costly to be affordable, or because they are more appropriate to businesses that have reached a different stage in their development.
When seeking finance, the entrepreneur must identify a source of funding that is:

- appropriate to the type of funds required (e.g. for start-up, growth, short-term working capital or long-term capital investment)
- interested in providing the funds that the entrepreneur needs: for example, banks will provide funding for working capital for expansion and growth, but would not normally consider funding pre-revenue R&D needs. Similarly, commercial bonds are suitable for large blue chip companies to raise substantial long-term funding but are totally inappropriate for SMEs.

The following list gives examples of the most suitable sources of funding for small firms.

- **Equity or investment capital.**
  - This is put in mainly by the owners of the business, their friends, or families (or sometimes “fools”) – and for that reason it is often referred to as “3Fs funding”.
  - It is usually in the form of cash but can also be fixed assets (equipment, furniture, computers or vehicles) or stock.
  - Borrowing capacity may be limited by the size of the equity of the business, as lending banks will expect to see an equity investment in place that is at least as large as any required lending.
  - Business angels (private investors) are useful sources of equity funding, especially for start-up or early stage investment, and they will often have sector expertise or be willing to act as unpaid advisers to start-ups.
  - Reserves or retained profits are generally regarded as the cheapest and best way to fund growth – but, of course, those profits have to be made first.
  - One of the more recent developments in SME funding is the formation of funding forums or circles. These started in 2010 and enable private individuals to invest small unsecured amounts of money in, or lend the money to, start-ups or small firms of their choice as part of a funding pool. The risks are high for the investors but the rates of return are generally good, often 8-10% on average. The company wanting to raise funds registers with the forum of its choice and posts a prospectus or business plan on the forum’s website. Potential investors can review the proposals and select a business to invest in, and bid for the interest rate they want for their loan to the company. Essentially, the businesses get the loans they want quite quickly at rates of interest that are cheaper than commercial banks, whilst investors can spread their money across a wide range of companies, reducing the overall risk, and getting a better rate of return than they could achieve through savings accounts or investment bonds.

- **Share capital.**
  - This is capital raised by the issue and sale of shares by private limited companies, limited partnerships, or public limited companies.
  - Ordinary shares: these carry voting rights and pay dividends based on profits. They are the most common form of equity.
  - Preference shares: these are non-voting shares with preferential claims on dividends (and assets in the event of liquidation).
  - In order to avoid surrendering too much equity and diluting the control of the business through the issue of voting shares, some companies offer potential investors a combination of ordinary and preference shares.
  - There is always a potential difficulty with share trading in private limited companies, as they cannot be traded on a public market. Often when shares are issued, they carry a condition that if the owner wishes to sell, the original investors (or possibly all other current investors) must be given first option to buy the shares before any outsiders are involved.
Debentures.
- A debenture is a long-term loan, on which the interest is paid at agreed dates, e.g. quarterly, and the capital is repaid at the end of the loan period. The rate of interest is normally pre-agreed as fixed for the duration of the debenture.
- Debentures are sometimes linked to share conversion options, whereby the debenture holders can choose to convert them into company shares at a pre-agreed value.
- They are mainly for public or private limited companies.
- They sometimes involve “peer” investment between suppliers and customers, e.g. when a supplier provides a debenture to its customer to facilitate expansion in exchange for a commitment to purchase specific volumes from the supplier for the duration of the debenture. For small firms that want to grow, this can be a very useful and attractive option to consider.

- Mortgage debenture.
  - This is basically the same as a debenture but is secured against specific fixed assets of the business.

- Commercial mortgage.
  - This is usually provided to purchase land or buildings, typically over a period of 10-15 years, with monthly repayments of interest and capital. These mortgages are normally arranged with banks or commercial lenders.

- Loans from a bank or financial institution.
  - Loans are either short term (1-3 years), medium term (3-5 years) or long term (5-10 years), with monthly capital and interest repayment, which is typically at least 5-7% over the bank’s base rate for SMEs, but can often be as high as 10% if the business does not have a track record of profitable trading, or sufficient security to support the loan. This issue was discussed in Section B of Chapter 5.
  - All but the smallest of loans are normally secured by directors’ assets (property or shares) and/or fixed and floating charges on the assets and book-debts of the business. Some loans to well-established, growth-potential businesses may be secured under the Government Loan Guarantee Schemes, but the lending criteria are often very restrictive and interest rates and government charges make them relatively expensive.

- Unsecured loan.
  - Apart from short-term loans for small amounts to long-standing customers, banks will very rarely provide unsecured loans. They come more frequently from family sources or friends.
  - In some developing countries, special social banks have been established to lend small amounts of money to people to start a small local business. These banks are often funded on a philanthropic basis and are, therefore, able to take the risk of unsecured lending to poorer people who would be classed as too “high risk” to access funds from conventional banks.

- Overdrafts.
  - This is essentially a short-term borrowing arrangement to cover seasonal peaks and troughs in trading levels. If it is needed for more than 12 consecutive months, a bank loan is more appropriate.
  - Overdrafts incur high interest rates (typically 10-12% over base rate), but interest is only charged when the overdraft is used.
They usually incur arrangement fees and annual renewal fees of about 2.5% of the value of the overdraft facility.

- **Hire purchase.**
  - This is used for the purchase of fixed assets, and can be shown as an asset on the company balance sheet.
  - Hire purchase agreements normally require a 20-25% deposit plus (in Europe) the full amount of VAT (which is reclaimable); the balance is paid over 2-5 years, after which the firm owns the asset outright.
  - A proportion of the capital value and the full amount of interest paid can normally be offset against company tax liabilities.

- **Lease or lease purchase.**
  - This requires a relatively low upfront deposit payment, typically three months’ payment in advance; for some assets, e.g. vehicles, maintenance costs can be included in the leasing charge.
  - Fixed monthly payments are made for the duration of the lease contract, after which the contract is terminated and the asset returned to the lessor; the lessee may be able to purchase it for a small one-off payment, though.
  - A lease purchase agreement can be very tax efficient as monthly payments are tax deductible as a business expense.
  - Leased items cannot be shown as assets on the company balance sheet as they are owned by a third party.

- **Grants or business incentives.**
  - Grants or business incentives may be available in some countries or regions and are usually provided by governments or regional aid sources. They may also be restricted to certain types of business, e.g. for agricultural improvement or tourism development.
  - Inward investment grants are sometimes available as an incentive for businesses to relocate from one country to another, and non-cash support (from professional services) or subsidised premises costs are also frequently provided.
  - The most common form of grant aid for businesses is for R&D for technological innovation, but this is usually only relevant to a very small proportion of start-up businesses.
Chapter 12

Legal and Financial Compliance

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Useful Sources of Information

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INTRODUCTION

Irrespective of the country in which a business is located, there will always be legislation and regulations with which the business must comply. In some countries, though, ensuring that the business remains in compliance can be a bigger problem than in others. Generally, it seems that the more Westernised the location (e.g. Europe and the USA), the more complex that compliance becomes.

In the past 20 or 30 years, more and more European and US companies have moved out of manufacturing and are having their goods produced in countries such as China, India, Korea and Taiwan where the cost of labour is much cheaper and where there are fewer regulations and trade unions. More recently, this same trend has been applied to the outsourcing of software development, particularly in India, Sri Lanka and Malaysia where levels of technical expertise are as high as anywhere in the West, but labour costs are lower and regulatory control is much simpler, particularly when it comes to employing staff.

There are two main challenges facing start-ups and early stage companies relating to legal compliance. The first is the issue of identifying which of the many laws and regulations directly apply to the proposed business. Some regulations, such as health and safety at work and aspects of employment law, relate to most businesses in many countries, but there are others that are sector specific (such as food storage and handling hygiene) and only apply to businesses providing certain products or services. This means that prospective entrepreneurs or business owners who operate in specific business sectors must understand and comply with the relevant rules and regulations. Fortunately, many new businesses are started by an owner or employ an experienced manager with sector expertise, which usually incorporates a basic knowledge of the legislation that relates to the sector.

The second issue is the problem of keeping up to date with constant changes in the law. This can be particularly challenging for new or early stage firms, which have very limited staff resources, are more focused on internal business operations, and have little time for searching for possible changes in legislation at national level. Fortunately, forthcoming changes in sector-based legislation (e.g. food labelling or electrical appliance standards) are normally well publicised within the sector, and more general changes are often publicised through chambers of commerce or accountants’ newsletters. However, minor amendments to more generic legislation, such as the frequent Directives issued by the EU, can easily be overlooked.

One of the problems faced by small firms is changes to regulations that don’t actually require direct compliance but which can have an adverse effect on profitability if they go unnoticed. For example, changes in UK tax regulations in 2011 substantially reduced the capital allowance limits that small firms could use to claim tax relief on the purchase of fixed assets. As a result, the net cost of a truck or a piece of heavy machinery purchased in March 2012 was significantly less than the same purchase made just one month later.

This chapter will examine four important areas of legislation and compliance that affect small businesses: their legal operating status; the main areas of legislation with which they would typically have to comply; issues of business insurance cover, which are a legal requirement in many countries; and a summary of some of the key aspects of protecting IP.
Whilst it is fully appreciated that these legal requirements will vary substantially from one country to another, for consistency, examples of legislation described are based on UK legislation, except where stated otherwise.

A. TRADING STATUS OPTIONS

The trading status of a business is the legal format under which it chooses to operate. It is normally selected to be appropriate to the size and scope of the trading activity and the simplicity or complexity of its needs. A small part-time family business with a modest sales turnover can operate quite comfortably with sole trader or partnership status and does not require the protection of limited liability status. In contrast, a company with substantial assets, and with sales revenues from international markets, needs a more robust and formal operating status, especially if it needs to raise finance from the money markets to expand its activities.

Sole Traders

Being a sole trader is not simply a case of operating as a one-person business, as many sole traders often employ quite a few staff. Sole trader status means that the person who owns and runs the business is solely responsible for its profits, losses, legal and statutory obligations, and liabilities.

On the positive side, this means that the sole trader does not have to answer to anyone else (apart from lenders or investors) and is solely responsible for decision-making. It is easy to start trading as a sole trader: all that is necessary is to inform the local office of HM Revenue and Customs by completing a standard form, which is available on the internet. All profits are retained by the sole trader, and he or she can determine the hours worked, duration of holidays, etc. With the aid of a good accountant, a sole trader can minimise tax liabilities, as tax is based on the profits of the business rather than the wages or drawings taken from the business. In fact, the overall operation of the business can be quite simple.

This sounds very attractive, but there is also a downside. As well as retaining all profits, the sole trader is directly liable for all losses, without any limit to that liability. If the business folds, then creditors can pursue the sole trader’s own personal assets: home, car, jewellery, savings, and all but the very basic possessions. Attachment Orders can also be made against future earnings. Unless the business is large enough to employ staff, working hours can be long and holidays rare, and there is often no back-up in case of illness or accident. It can also be lonely having to make decisions without anyone with whom problems can be discussed, or from whom an objective and honest opinion can be sought. Capital is hard to raise without security, although this is also true for most new businesses.

Legally, unless they are subject to special registration or reporting requirements for a particular trade or industry (e.g. environmental health registration for caterers), the statutory reporting requirements for sole traders are quite simple. If sales turnover is less than £73,000 per annum, then a short tax return is sufficient; above that level, the sole trader only needs to complete the appropriate parts of the annual self-assessment form for tax purposes, providing profit and loss account details etc. Once sales turnover reaches £78,000 per annum, then like any other business it is necessary to register for VAT with HM Revenue and Customs, and to make the appropriate quarterly returns and payments.
Also, if staff are employed, Income Tax and National Insurance must be deducted from their wages or salaries under the UK’s Pay As You Earn (PAYE) system. Sole trader accounts do not have to be audited by a chartered accountant, but all records do have to be retained for a period of six years. Profits, minus legitimate business expenses and personal allowances, are liable to Income Tax payments; and every sole trader must pay Class 2 and Class 4 National Insurance Contributions (NICs; employment taxes).

**Partnerships**

A partnership is a business involving two or more partners who trade together as a single business. Typically, the business relationship will be formalised under a legally constituted and legally binding Partnership Agreement under the Partnership Act 1890. A partnership must be registered with HM Revenue and Customs when it commences or is terminated.

Many people find the added security offered by a partnership attractive. With two or more people working together, there is usually a better interaction of ideas when it comes to decision-making. There is also mutual support available in the event of illness or accident, and to facilitate more flexible working hours and holidays. Profits are retained by the partners and, although they are shared, they will often be greater than the same individuals could achieve by working separately. This is because of savings made by sharing administration and overhead costs, and by using specialist skills and expertise; for example, one partner may have stronger sales skills, whilst the other may have better financial and administration abilities than the first. Partnerships can also make raising finance easier, or give access to larger sums of money, where money is pooled or security for loans is shared.

There is a negative side to partnerships which should not be underestimated. It is often said that there is nothing like a business partnership to test a friendship, or to divide family loyalties. Disagreements can arise over what direction the business should take, or over who is working the hardest or the longest hours, or drawing the biggest income from the business. The issues become more acute when the business is under financial pressure, or when individual partners come under pressure from their own spouses or families.

The biggest drawback of partnerships is the liability of the partners for the debts of the business. This is known as “joint and several liability”, wherein each partner is liable for his or her own proportion of any debts plus the debt as a whole. Consider the following example: a two-woman partnership is assessed for a tax liability of £20,000. Partner A pays HM Revenue and Customs her half of the liability, i.e. £10,000, on time. Partner B defaults on her share, and disappears to South America. Partner A now becomes liable for Partner B’s £10,000 tax liability as well as the money she has already paid for her own liability.

From the point of view of legal reporting, the requirements for a partnership are comparable to those of the sole trader. The same accounting returns have to be made, stating turnover, expenses and profits for Income Tax purposes. The PAYE and National Insurance requirements are the same, as is the VAT threshold, a figure which is more likely to be reached when two or more people are generating income for the business.
Limited Companies and Limited Partnerships

Limited companies are often regarded as being of a “higher” status or a more respectable or stable form of trading than sole traders or partnerships, although in a legal sense that is not the case. Registered companies can be purchased quite readily and quite cheaply via the internet, and then renamed as required by the new owner. Assuming that the proposed trading name is available for use, the company can start trading almost as soon as it has been purchased and the company officers have been nominated. Alternatively, new companies can be set up very cheaply from scratch under the proposed operating name in just two to three weeks, and without much legal advice. In reality, given the time delay and administration involved, it is much simpler to pay a little more for a company from a specialist supplier and then simply change the name.

The main documents required in order for the company to operate are the Memorandum and Articles of Association, which define the company’s legitimate trading activities and powers to raise finance. The company must also maintain a Minute Book, which records the share capital, issue of shares, details of company officers, minutes of Annual General Meetings etc. Every limited company also has a company seal, which is affixed to official documents and contracts.

A limited company is managed by one or more directors who have specific duties and responsibilities under the various iterations of the Companies Act. The Act also defines the statutory returns (and penalties for non-compliance), which are explained in more detail on the UK Registrar of Companies/Companies House website. At one time, UK company law stated that there must be at least one director plus a company secretary who had the designated responsibility to complete annual returns to Companies House. That is no longer the case, as only public limited companies have to designate a company secretary. Those companies that originally had a company secretary prior to the change in regulations can continue to operate that role or they can choose to amend their Articles of Association and dispense with it, although the annual returns still have to be made (by the directors).

The key difference between sole traders, partnerships and the directors who own or manage limited companies is that whereas the former are self-employed, the directors cannot legally be so as they are employees of the company. This is because the limited company is a “body corporate” – i.e. it has a legal existence in its own right, irrespective of the people who own it, invest in it, or manage it. Similarly, whereas self-employed sole traders and partners are taxed as individuals and pay Income Tax, a limited company is liable for Corporation Tax as it has a corporate identity. That same corporate status makes the liability of its owners “limited”, as unlike sole traders and partners (whose liability for business debts is total), the owners, investors and shareholders of a limited company are only liable for the sums that they have already invested in the company, or which they have guaranteed on its behalf. (That liability also includes the value of any shares that are issued but not fully paid up.) Therefore, if the company becomes insolvent, the creditors can only pursue the assets of the company itself; they cannot take action against the shareholders or directors, except in cases of fraud or where the directors have knowingly continued to trade when the company is insolvent, or have been negligent in their responsibilities.
Overall, this seems a very attractive and low-risk way of setting up a business, as the limited company status ostensibly takes the owners one step back from potential creditors. However, the drawback is that a newly established limited company with no financial track record, and with only £100 of issued share capital, is no less risky in the eyes of a potential lender or supplier than any partnership or sole trader. With the added risk of limited liability, it may also take the limited company a good deal longer to obtain credit facilities.

For any start-up business, the two main problems are finding the finance to get started and then obtaining credit from suppliers to trade and expand the sales of the business. It doesn’t matter if the business is a sole trader or a limited company, if it has no proven track record or trade references, and no tangible assets or security to offer, then borrowing money or obtaining credit will be hard. Quite often, suppliers of goods to limited companies will take a harder line than with sole traders, simply because they know that it is easier to recover debt from a sole trader than from the owners of a limited company. It is quite common for initial terms of supply to be cash-with-order or cash-on-delivery, with credit facilities being withheld until the buyers have proven their reliability. Even then, credit may be limited to a fixed monthly maximum figure, or to payment within a fixed period of time, until a good working relationship has been established.

In terms of legal and statutory reporting requirements, owners of limited companies have more onerous obligations than their self-employed counterparts. For those companies with a relatively low turnover and balance sheet (under £6.5 million and £3.26 million respectively, and an average of fewer than 50 employees), abbreviated accounts can be submitted. For larger limited companies, it is necessary to submit full audited accounts annually to the Registrar of Companies. All employees (including the directors) come under the PAYE and National Insurance regulations. In addition, there is an additional requirement to provide HM Revenue and Customs with separate details of all expenses for directors and higher-paid staff. VAT thresholds are the same as for any other business. For sole traders and partners, tax liabilities are assessed against the profit of the business against which personal tax allowances can be offset. Tax is paid at the standard and higher rates (currently 20% and 40% respectively); Corporation Tax for limited companies is currently 20% on profits up to £300,000 and 25% on profit between £300,000 and £1.5 million.

Limited liability partnerships (LLPs) are a cross between partnerships and limited companies. They are popular with professional people such as solicitors, surveyors or accountants who would previously have used conventional partnerships, primarily because of the growth of litigation for professional negligence against professional firms in recent years. They combine the simplicity, flexibility and ease of decision-making of a partnership with the protection of limited liability, rather than the greater personal liability that exists with partnerships. Partners are jointly liable for the debts but their liability is limited to the extent of the sums invested, any sums outstanding for share purchase, or any sums secured by partners against borrowing.

LLPs are established by registering the limited partnership with the Registrar of Companies. They make Annual Returns with audited accounts (depending on turnover) to the Registrar of Companies, and they have to register with HM Revenue and Customs for VAT, Corporation Tax and the payment of PAYE for employees.

A comparison of the features, advantages and disadvantages of sole trader status, partnerships, limited companies and limited partnerships is shown in Table 12.1.
Table 12.1: Trading Status Options for Small Businesses – Summary of Key Features

<table>
<thead>
<tr>
<th>Definition</th>
<th>Sole Trader</th>
<th>Partnership</th>
<th>Limited Partnership</th>
<th>Limited Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ownership of the business is held by one person, irrespective of the number of employees. The business and the owner are effectively the same for legal purposes.</td>
<td>Ownership is held between two or more partners.</td>
<td>A cross between a partnership and a limited company. Ownership is held by two or more partners, but the business has a corporate identity that is independent of the partners.</td>
<td>Ownership belongs to the shareholders who have invested money in the business. The company has a corporate identity that is independent of the investors.</td>
<td></td>
</tr>
<tr>
<td>Statutory Reporting Requirements</td>
<td>HM Revenue and Customs for VAT, taxation of profits, and payment of Class 2 and Class 4 NICs and PAYE for employees.</td>
<td>HM Revenue and Customs for VAT, taxation of profits, and payment of Class 2 and 4 NICs and PAYE for employees.</td>
<td>HM Revenue and Customs for VAT, Corporation Tax, and payment of PAYE for employees. Registrar of Companies for Annual Returns, with audited accounts (depending on turnover).</td>
<td>HM Revenue and Customs for VAT, Corporation Tax, and for payment of PAYE for employees. Registrar of Companies for Annual Returns, with audited accounts (depending on turnover).</td>
</tr>
<tr>
<td>Liabilities</td>
<td>The owner takes on the total risk – including his or her personal assets and property.</td>
<td>All partners are both individually and jointly liable for all the debts (joint and several liability).</td>
<td>Partners are jointly liable for the debts but their liability is limited to the extent of the sum they invested or the sum outstanding for share purchase (or any sums secured by the partners).</td>
<td>Liability is limited to the extent of the sum invested or the sum outstanding for share purchase (or any sums covered by the directors’ personal guarantees).</td>
</tr>
<tr>
<td>Advantages</td>
<td>Simple to set up and operate: simple decision-making and total control. The owner keeps all of the profits. There are some tax advantages for expenses.</td>
<td>Simple to set up and operate and provides mutual support and joint decision-making. Governed by the Partnership Act 1890, with clearly defined responsibilities/liabilities for partners. The partners keep the profits and share the risks. There are some tax advantages for expenses.</td>
<td>Combines the simplicity and ease of decision-making of a partnership with limited liability protection.</td>
<td>Investors have limited liability. Corporation Tax for small firms is 10% (20% for sole traders). The tax rate for dividends paid to shareholders is 10% Company status confers perceived credibility as an organisation.</td>
</tr>
<tr>
<td>Disadvantages</td>
<td>Exposure – no cover for health or accidents or for holidays and sickness. The owner has total liability for all losses and consequential debts.</td>
<td>There is a risk of partner disputes, especially in family-based partnerships. The partners share the profits and the losses.</td>
<td>There is a risk of partner disputes. Partners are employees so pay tax and NICs under PAYE.</td>
<td>It can be hard to get credit in the early stages. Directors are employees so pay tax and NICs under PAYE. Audited accounts can be expensive for larger companies.</td>
</tr>
</tbody>
</table>
Public Limited Companies

Public limited companies (PLCs) are defined as limited liability companies with a minimum share capital of £50,000. They are “public”, as distinct from the private limited companies described earlier in this chapter, because their shares can be freely sold and traded to the public via the stock markets such as the Stock Exchange or, more commonly in the case of smaller PLCs, the Alternative Investment Market. They are identified by the letters “PLC” after the company name.

PLCs are subject to stricter regulation that their smaller private counterparts. They must have a company secretary and at least two directors, one of whom may also be the designated company secretary if they have the requisite qualifications/experience. The shareholding must be at least £25,000 and at least 25% must be in fully paid-up shares. Half-year and full-year results have to be reported to the stock market, and a detailed Annual Return has to be made to the Registrar of Companies, including:

- a Directors’ Report
- details of the directors, company secretary and auditors
- details of shares issued and all shareholders who own 5% or more of company shares
- details of any changes to directors or shareholders and changes to accounting practices in the previous year
- audited accounts for the year
- a number of other specified disclosures.

The advantage of PLCs is that they can raise share capital by selling shares on the stock markets; the downside is that external organisations can potentially buy up the shares to take control of the company. PLC status is not normally appropriate for start-ups or early stage companies unless they are heavily capitalised.

Cooperatives, Social Enterprises and Charities

Another less-common trading status option for smaller businesses is to become established as a cooperative or joint ownership venture. These businesses are owned and controlled by a minimum of seven members, normally but not necessarily its own employees as there can also be non-working members – this arrangement is usually described as a workers’ cooperative. All of the business policies, the assets, and the profits of a cooperative are controlled by its own members (or staff), who all have equal voting rights in how the business is organised and managed. Wages are paid to staff, and surplus profits (dividends) are shared between them, according to their level of participation in the business. Like limited companies, registered cooperatives are classed as a “body corporate” and are subject to Corporation Tax, although if they are unregistered, they are treated as partnerships with unlimited liability for the losses or debts of the business. When registered in the form of a limited company, their reporting requirements will be the same as those of normal limited companies, as will be the operation of PAYE, tax liabilities, VAT registration, etc.

Involvement in a cooperative usually generates a high level of commitment from its members, as they are effectively working for both the good of themselves and of the cooperative, and they participate in the management and decision-making processes. At times, however, this democratic process can be counter-productive, when business decisions are based on
personal feelings or interests rather than sound business practice. Where a cooperative has been created via a buy-out of a failing business by workers faced by possible redundancy, the result is often the continuation of inefficient labour-intensive working methods to maintain employment for members. This can threaten the cooperative’s own success or survival.

**Social enterprises** are not-for-profit organisations in that they may operate on a business-like basis but re-invest any surplus revenue to further their objectives. Some of these social enterprises exist to provide services for the benefit of local communities or specific disadvantaged groups within a community. Others, often called **social firms**, exist to create employment for disabled people but operate on a commercial basis to generate profits that are re-invested to further their objectives.

**Charities** are non-profit-making organisations that exist to provide specific benefits to the communities in which they operate, or to target groups within the community. They are often supported and funded by public and/or private donations and, although they can have subsidiary trading operations for fundraising purposes, they are not expected to charge for their services. In the UK, they are usually registered with the Charity Commission, by virtue of which they can usually achieve tax-free status.

Under the Charities Act 2006, charitable organisations with an income of less than £5,000 per annum are exempt from charity registration, and those with an income of up to £10,000 can register as **charitable associations**. This is an ideal status for small voluntary groups and for local clubs or sports associations: it gives them legal status and tax relief, without the need to comply with excessive regulations, apart from a simple Annual Return to the Charity Commission. **Charitable trusts** are larger charitable organisations, the governance of which is defined by a Deed of Trust and which are managed by a board of trustees.

**Community interest companies** (CICs) are another form of not-for-profit organisation. They are based on the limited company model with directors and shareholders, but they are not allowed to pay dividends to shareholders as all of their trading profits (surpluses) have to be re-invested in the company and used for the objectives for which it was established. CIC status is ideal for larger social enterprises that may have substantial trading activities or revenues and so need the limited company protection for shareholders. Many CICs are also registered charities, although charities can operate as ordinary limited companies, using their charitable status to obtain tax relief on trading surpluses and gift aid donations.

Some charities and social enterprises also operate as a **company limited by guarantee**. This is another form of not-for-profit company, although this particular status is more commonly used by clubs and associations. They have directors and members rather than shareholders and their shares are guaranteed by members to a specified limit.

**B. IDENTIFYING RELEVANT LEGISLATION**

This section will examine the range of current legislation affecting enterprises under seven headings.

- Company law and business registration.
- Health and safety.
- Employment.
- Finance.
- Fair trading and misrepresentation.

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- Anti-discrimination.
- Environment.

The following lists are not exhaustive: there may be other legislation that applies to specific industrial sectors, e.g. nursing homes, transport companies, catering and hospitality. Anyone who is planning to start a new business should check out their particular business idea to identify the regulations that they must comply with.

**Company Law and Business Registration**

In the UK, all private limited companies, LLPs, CICs and PLCs are required by law to register with the Registrar of Companies at Companies House. They are also required to submit Annual Returns within a specified time after their financial year end; PLCs must also submit independently audited accounts and an Annual Report by their directors. Each company’s information is held on public file and can be inspected by any member of the public on payment of a small fee.

In addition, all trading organisations (sole traders, partnerships, limited companies, LLPs, CICs, PLCs, charitable associations and charitable trusts) must register with HM Revenue and Customs when they start to operate. If they employ staff, they must make regular tax deductions from staff wages under the PAYE system and must pay National Insurance (an employment tax). If they have a sales turnover in excess of £78,000 per annum, they must register for VAT and must collect it and pay it to HM Revenue and Customs on a quarterly basis. They must also submit an Annual Return to HM Revenue and Customs, summarising their income and expenditure and any tax allowances claimed.

The main non-financial legislation relating to businesses is as follows.

- **Companies Acts (last modified in 2006).** This Act (in its various iterations over the years) formulates the rules under which all limited companies and PLCs operate. It specifies the registration requirements, and the Annual Returns that have to be made, reporting the accounts and financial situation of the company, etc. The reporting requirements were summarised in the Section A of this chapter, Trading Status Options.

- **Partnership Act 1890.** The main features of this Act were covered in Section A of this chapter. In addition to the formation/registration of, and reporting requirements for, partnerships, the Act also defines the role of Partnership Agreements. The Partnership Agreement, once signed and witnessed, is a legally binding document. In the absence of a formal agreement, the Act specifies that profits and losses will be allocated equally between partners in the business. It also prescribes that if a partner wishes to resign, the partnership must be wound up and a new partnership formed by any remaining partners. This can be an onerous process, particularly in professional partnerships (accountants or solicitors), where changes in partners can be quite frequent. However, Section 113 of the Finance Act 1988 allows for the production of a Notice of Election to Continue Partnership, wherein one partner can leave or another join the partnership without having to dissolve or rewrite the Partnership Agreement, thereby simplifying the whole system for Income Tax purposes.

- **Business Names Act 1985.** The names of limited companies are registered with the Registrar of Companies at Companies House. Before a name is registered, there is a search process to ensure that the name has not already been used by an allocated company, or is not allocated to a newly formed but inactive company. The Registrar
can provide advice on names, which must not be offensive or constitute a criminal offence. In the case of partnerships or sole traders, there is no registration requirement by law, and proprietors can use their own names or can trade under other names, e.g. “Bob Jones trading as Shifter Removals Services”. It is still a legal requirement for the company letterhead and documents to show the registered company name and number, the names of the company directors, and the registered office. In the case of partners and sole traders, where they are not trading under their own names, they must be identified as proprietors on all business documents.

- Insolvency Act 1986 and Company Directors Disqualification Act 1986. One of the main objectives of the Insolvency Act was to curtail the legal but improper practice of operating “Phoenix” companies – when companies traded for a while, accrued debts, were bled dry of cash by the payment of high directors’ salaries, and then were liquidated overnight. A new limited company would then appear a few days later under a different name, but with the same directors, operating from the same premises, producing the same goods or services – but free from the previous creditors, who were left with no prospect of repayment. The Insolvency Act made it a criminal offence for any individual or company director to knowingly continue to trade whilst insolvent. The penalty for failing to take corrective action or for failing to inform creditors of an insolvency situation could involve the company directors being personally liable for all company debts, being barred from future directorships and, in some cases, facing charges of fraud. Also, company directors could no longer to put businesses into voluntarily liquidation and appoint themselves as liquidators. Businesses that were profitable but insolvent due to cash flow problems could continue to trade by making a Voluntary Agreement with creditors: if at least 60% of creditors agreed to forestall action to recover debts, the insolvent business could negotiate a planned schedule of repayments that would be legally binding on all creditors. The Act also introduced the Statutory Demand for Payment, whereby creditors could demand payment within 21 days; if payment was not made, they could apply for an immediate Winding-up Order against the business.

- Enterprise Act 2002. This Act covered a range of business areas including competition and mergers, but it also updated the 1986 insolvency regulations in several key areas relating to business insolvency and personal bankruptcy, including:
  - reforming The Insolvency Service, making it simpler, fairer to creditors and more transparent; and streamlining the procedure of administration to make it more efficient and accessible in order to aid the rescue of viable companies
  - restricting the ability to appoint an administrative receiver to lenders or financiers holding pre-existing charges or capital involvement, where the appointment of an administrative receiver by those parties might impede efficient market operation
  - introducing powers to extend certain insolvency proceedings to foreign companies, Industrial and Provident Societies and Friendly Societies
  - removing the Crown's preferential creditor status and rights in all insolvencies to ensure unsecured creditors are major beneficiaries – effectively downgrading government and local government organisations to the status of ordinary creditors
  - a number of changes relating to bankruptcy regulations, including reducing restrictions on undischarged bankrupts; allowing automatic discharge of most bankrupts after a maximum of 12 months; introducing Bankruptcy Restrictions Orders to protect the general public and the business community from bankrupts whose conduct before and during bankruptcy has been found to be culpable; and limiting trustees’ control over bankruptcy assets to just three years.

- Contract law (which includes debt recovery). This is essentially different from statutory law in that the laws of tort, or contract, are not established and precisely defined by Act of Parliament. Instead, they have evolved over a period of time as a result of
numerous cases in civil law, which have formed established precedents. As a result of this process, there are established procedures within the Civil Courts that facilitate the recovery of debts, which are proven under civil law – see Section B of Chapter 11.

- Property laws. These affect the purchase, ownership and leasing of property. They are a mixture of statutes and case law and are also part of civil law. This is an area where proper legal advice is more important than just about any other, particularly where legal liabilities are concerned. One example, which has always been contentious, is that of long-term leases, where a leaseholder who sells on the remaining lease to another party will still remain liable for any subsequent debts on that lease (such as non-payment of ground rent by the new leaseholder). Similarly, if the new leaseholder becomes insolvent, the responsibility for the lease reverts to the original leaseholder.

**Health and Safety**

Health and safety is an issue that affects all businesses and they way they and their staff interface with each other, their customers and visitors, and the general public. The UK legislation on this topic also reflects similar legislation across Europe and other parts of the world. The main legislation is as follows.

- Health and Safety at Work Act 1974. With its many subsequent updates, this applies to all private sector businesses, public sector organisations and charities alike. Employers, or organisations or persons in charge of premises, processes or services, have a duty to ensure they:
  - provide a safe and secure working environment including ensuring a hygienic environment; keeping passageways clear of obstruction or trip hazards; using non-slip materials on floors; providing training for manual handling and lifting; and providing staff and visitors with protective clothing where appropriate
  - protect persons other than those at work against risk to health and safety arising from, or connected with, the activities of the business operations or persons in the workplace, including employees, customers, visitors and passers-by
  - ensure that staff can work with trained and competent colleagues who do not pose a risk or threat to themselves or the other staff
  - possess and display a current Certificate of Insurance
  - signpost fire exits, and display warning notices for hazards
  - have a member of staff who is trained in first aid, keep a first aid kit on the premises, and keep an Accident Book on the premises to record details of any accidents, injuries or incidents involving staff or visitors
  - label hazardous materials and store them safely
  - (where there are five or more employees in the organisation) carry out a risk and hazard analysis of the premises, and fire risk assessments and have a written health and safety policy made available to all staff, and an induction training process for all new employees.

- Control of Substances Hazardous to Health (COSHH) Regulations 2002. This legislation relates to the safe use, handling and storage of potentially dangerous substances on the premises, care and safety of staff and visitors, and prevention of damage to the environment. The definition of hazardous substances includes fragile or sharp items, explosives, poisons, poisonous gases or fumes, and corrosive or radioactive materials; it also relates to more commonplace substances such as bleach or cleaning materials. Dangerous or hazardous materials must be clearly labelled, identifying the type of potential hazard, and must be stored in safe and secure conditions. Staff must also be trained in the safe handling of these materials.
• Reporting of Injuries, Diseases and Dangerous Occurrences Regulations (RIDDOR) 1995. This legislation covers notifiable injuries and/or illnesses and overlaps with the Health and Safety at Work Act 1974 in requiring reports of serious accidents or incidents in the workplace to be submitted. It also requires employers to notify the health authorities of any members of staff who contract certain specific serious illnesses or infectious diseases, including tuberculosis, polio, cholera, smallpox, and typhus.

• European Working Hours Directive. This is really an aspect of employment law that limits the working hours employees can be asked to undertake over a fixed period of time. It is a contentious piece of legislation, originally conceived in Germany to prevent businesses in other EU member states with fewer restrictions on working hours from being too competitive. As the UK had opted out of the EU Social Charter, it did not apply initially but was eventually brought in for the UK under the guise of health and safety. It prohibits employees from working an average of more than 48 hours per week in any rolling 17-week period unless they specifically agree in writing to opt out of that right. For that opt-out to be valid, there must be no pressure from the employer. Some professions (e.g. doctors) are exempt from the Directive. Where it is valuable is in limiting the driving hours of drivers of heavy goods vehicles, thus reducing the risk of them falling asleep at the wheel if they drive for too long or fail to take regular breaks.

**Employment**

In recent years, in the UK and other EU member states the legislation relating to employment has been influenced by two main factors.

• The political party in power, and its relationship (or otherwise) with the trade unions, and its attitude towards promoting business growth. Whilst one party, influenced by its trade union paymasters, may favour pro-employee legislation, another with a pro-business stance will regard too much employment legislation as damaging the interests of business and impeding growth.

• The steady stream of European Directives, developed in the interests of promoting social and human rights, which have created a heavy burden of bureaucratic compliance for businesses. In the case of small firms, this is mostly disproportionate to the resources they have available. It is interesting that, in contrast, some former communist countries (notably China and Russia), which used to heavily regulate private enterprise, have moved towards deregulation to help make their businesses more internationally competitive.

Employment law is very complex and is constantly changing. For that reason, all businesses are advised to seek professional guidance where disputes or areas of doubt arise. The consequential legal expenses of facing an industrial tribunal can be crippling, particularly for a small business that is struggling to establish itself. Some of the issues of employment law are also covered in Section D of Chapter 9. Many of the provisions of the various employment Acts overlap with other legislation discussed here. Fundamentally, in law the employer is obliged to:

• provide a safe and secure working environment
• pay staff at agreed rates and at agreed intervals, including the observance of minimum pay requirements
• provide staff with a contract of employment
• inform staff of health and safety policies, and discipline and grievance procedures
• ensure that staff do not exceed permitted working hours
• provide staff with paid leave for holidays, statutory sick pay, paid maternity and paternity leave
• observe the statutory rights that staff have for time off for jury service, parental responsibilities and trade union duties
• pay staff for redundancy, as appropriate, and give suitable notice to terminate employment
• treat staff fairly and reasonably, particularly where dismissal is concerned
• not discriminate against staff in any way.

In return, the employer has the right to expect staff to:
• do a fair day’s work for a fair day’s pay
• observe workplace rules and health and safety policy
• act in a safe, competent and reasonable way alongside other employees
• act honestly, and not against the employer’s interests
• take care of the employer’s property
• honour the employer’s ownership of any patents or inventions developed within work time or in the workplace
• not disclose any confidential information about the business to outsiders
• obey lawful and reasonable instructions from the employer.

The main UK employment Acts are as follows.
• Employment Protection Act 1975 (and subsequent amendments). This gives employees who have been with an organisation for at least two years automatic rights to, and guarantees of, minimum levels of statutory redundancy pay (although this is under review at the time of writing). They are also allowed paid time off work to look for alternative work if facing redundancy. After six months of employment, female staff are entitled to receive statutory maternity pay, and after two years in employment, their jobs must be kept open for them to return to work after their maternity leave. After two years, employees have the right not to be unfairly dismissed from employment. Since 1995, all of these rights apply to part-time as well as full-time workers. Male parents are also now allowed to take optional paternity leave for which the employer must pay them a fixed proportion of their wage for up to two weeks. The rights of women to maternity leave under this Act, and as protected by the Equality Act 2010, are specified later in this section.
• Contracts of Employment Act 1972. Within two months of starting employment, every employee must be provided with a written contract of employment, specifying the nature and location of their work, rates and methods of payment, hours of work, holiday entitlement, period of notice, discipline and grievance procedures, and the organisation’s health and safety policy if this has not already been provided. Under the employment Acts, every employee is entitled to a minimum of four weeks’ paid leave per year (pro rata for part-time staff) although national statutory holidays can be included in the four weeks.
• Employers’ Liability (Compulsory Insurance) Regulations 1998. All organisations, whether they are sole traders, large commercial businesses, public sector bodies, educational institutions or charities, must take out employer’s liability insurance to cover all staff (full time or part time) for the risk of accident or injury in the workplace. A copy of the current certificate of insurance must be displayed in a prominent position on their premises, where it can be seen by employees. Since January 1999, the minimum sum to be insured for is £5 million for any one claim, and employers are required to keep all past insurance certificates for a period of 40 years.
• Minimum wage regulations. In October 1998, under an EU Directive, the UK Government introduced a basic minimum wage for all employees aged over 21, with a slightly lower level for very young employees. The actual rates increase each year under annual reviews. It was argued that this was a positive social move but it has resulted in some employers removing other staff benefits to offset the cost. Over time, others who may have previously paid higher rates now regard this as the industrially accepted standard and have reduced wages accordingly. Whilst some very low-paid occupations have benefitted, for many newly established or struggling small firms, it simply increases overhead costs.

• Stakeholder pensions. From 2013, where a firm employs more than five staff, it must make provision for them to have access to a Stakeholder Pension Scheme, unless it already offers a personal pension scheme or an occupational pension scheme.

• Trade Union Reform and Employment Rights Act 1993. It is illegal to discriminate against members of staff on the grounds of trade union membership or participation in trade union activities (unless this interferes with normal working duties and has been carried out without the approval of management). Businesses do not currently have to recognise trade unions but they cannot prohibit staff from belonging to one. Even where no trade union is involved, staff consultation is still required where redundancy is a possibility, or where the potential sale of the business would affect the livelihoods of more than 20 staff. Employers are entitled to receive at least seven days’ notice of any official industrial action by trade union members, during which time members must be balloted. Failure to do so could render the trade union liable for any losses resulting from breach of contracts with commercial customers of the business. Unofficial activity is not the responsibility of trade unions, but would no doubt constitute a breach of the contracts of employment by the participants, possibly justifying termination of employment.

Finance

The laws that relate to the legal format and structure of businesses invariably become involved with the financial aspects of capitalisation and distribution of profits, which in turn have implications for taxation, etc.

The finance Acts are the means by which the Government is able to raise money by taxation, and to operate its fiscal policy. As such, they are effectively revised or modified every time there is a new government budget, which is usually at least once a year via the Chancellor’s Annual Budget statement. However, they also define some of the processes and procedures within which businesses must operate, and act as a convenient mechanism to modify or redefine parts of other more significant pieces of legislation, such as the Companies Act 2006 or the Partnership Act 1890.

The finance Acts and annual variations also determine the scope and actions of the government agencies that are responsible for tax collection. These include the following.

• HM Revenue and Customs’ VAT regulations. VAT is another legacy of membership of the European Community, and its rates have climbed slowly but steadily since its introduction to the current standard rate of 20% (which was set in 2011). There are lower rates for insurance and fuel supplies and some products, such as food, children’s clothing, animal feeds and books, are zero-rated and attract no VAT. The tax is based on the concept that at each stage of the supply or production of goods or services, value is added to those goods or services and this added value is taxed. At
the time of writing (2012), any business that has a sales turnover of at least £78,000 per annum (this is reviewed annually in the Chancellor’s budget) must register with HM Revenue and Customs, and must charge VAT on the value of its invoices to customers. Every quarter, it must pay to HM Revenue and Customs the sum of all VAT collected in that quarter, less any VAT which it has paid to its suppliers during the same period. Dates for payment are fixed, and penalties for transgression can be heavy. Be warned, unlike other creditors, HM Revenue and Customs does not need to obtain a court order before sending the bailiffs into premises to confiscate stock or equipment, and they will not hesitate to do so if necessary.

- Laws of taxation. These are essentially derived from the finance Acts as principles in law, but the specific operation of the tax system (in terms of rates of taxation, tax-free allowances) is modified by the Government each year as part of the Annual Budget. Amendments to taxes and the introduction of new taxes are usually made under changes to tax regulations, rather than by introducing specific new Acts of Parliament. The laws on taxation are quite complicated, and this is one particular area where the advice of an accountant or taxation specialist can often more than pay for what it costs. Remember, tax avoidance is legal; tax evasion is not. The two are often finely divided, with the difference between them being only accurately determinable by an experienced taxation expert.

- The Chancellor’s Annual Budget. The Chancellor uses the Annual Budget to regulate the Government’s fiscal policy including raising sufficient taxes or identifying levels of borrowing to cover planned expenditure for the coming year. Apart from determining rates of VAT, this also includes rates of personal Income Tax, Corporation Tax for businesses, National Insurance payments (an employment tax), and a range of other taxes including excise duty (petrol, alcohol, cigarettes, vehicle road taxes), Inheritance Tax, and stamp duty on share and property purchases. It also determines social benefits such as pensions, welfare payments and unemployment benefit.

**Fair Trading and Misrepresentation**

Fair trading regulations relate to a wide range of aspects of trading including misrepresentation, trade descriptions, business names, civil law concerning the sale of goods, labelling of packaging and safety of products, pricing and competition. Some of these were updated as part of the Enterprise Act 2002, including the formation of an independent Office of Fair Trading. Legislation relating to fair trading and misrepresentation includes the following.

- **Sale of Goods Act 1995/Consumer Protection Act 1987.** These two pieces of legislation are designed to protect the interests of the consumer, and are primarily administered by the Trading Standards Officers employed by local councils. They define the rules under which warranties can be enforced, goods exchanged, refunds obtained etc. Originally, when goods were sold, they were supposed to be “fit for the purpose” for which they were designed, or of “merchantable” quality; however, those terms have now been replaced by “reasonable quality”, which swings the balance more in favour of the consumer. Essentially, goods must correspond to their description, whether verbal, written or illustrated, and they must be of satisfactory quality and fit for the purpose for which they were supplied. Services must be carried out with reasonable care and skill, in a reasonable period of time, and for a reasonable charge, unless previously agreed with the customer. In the first instance, it is the vendor of the goods who is legally responsible to the consumer for any faults or problems, including those inherent in the product itself, but ultimately the cost of repair or replacement goes back to the manufacturer (or importer). In the case of death or
substantial personal injury, the liability may extend to all parties involved in the product, from manufacturer, importer, carrier, wholesaler to retailer. Where vendors and manufacturers fail to meet their responsibilities to the consumer, or where goods are dangerously faulty, then the Trading Standards Officers can prosecute them. These days it is quite common for most of the larger retail stores to offer refund and replacement facilities that go far beyond the minimum legal requirements; this can reflect badly, though, on the smaller independent traders who do not have the resources to provide the same terms. In the case of online selling, there are further requirements relating to disclosure of facts to potential customers: the vendor must display a business name and postal address, must give a description and full price of the goods or services offered and how long that price is valid, must define payment and delivery arrangements, and must state any cancellation rights and the duration of any contracts for services.

- Advertising Standards/Trade Descriptions Act 1968. Advertising Standards are not so much statutory regulations, but a code of standards that is designed to encourage good practice within the advertising industry, and to discourage adverts that are considered in bad taste, offensive, inaccurate, misleading or libellous. The code of practice is administered by the Advertising Standards Authority, which was set up by the Government for this purpose. The Trade Descriptions Act requires that any description of goods or services must be accurate – to provide false or misleading information, or information that is misleading by implication, is an offence with unlimited fines of up to two years’ imprisonment. There is also separate and more specific legislation relating to particular industries or trade sectors, for example food and drink, precious metals, holiday operators and hotel accommodation.

- Consumer Credit Act 1974. Two aspects of this legislation are of relevance to small businesses. The first is that any business that advises on, arranges or gives customers extended credit, such as hire purchase or leasing agreements, must first be licensed to operate under this Act. The other aspect relates to, and benefits, unincorporated businesses (sole traders and partnerships) where any loans of less than £15,000 that are raised by individual proprietors for business purposes are regulated under the terms of this Act. These terms include “cooling-off” periods after signing, during which the borrower can change his or her mind; and the requirement that once a fixed proportion of repayments has been made, a Court Order is needed to recover goods or enforce payment.

- Other relevant pieces of legislation relate to price-fixing (the Restrictive Practices Act 1976/Resale Price Act 1976), activities that are anti-competitive (Competition Act 2011, which updated the Enterprise Act 1998), and unfair terms of contract (the Unfair Contract Terms Act 1977).

- Data Protection Act 1984. This legislation is about protecting the confidentiality of customer data, particularly to prevent it being accessed for purposes of theft or fraud. Under this Act, all computer users who store details or information about private individuals, or information of a personal nature, must register with the Data Protection Registrar. This ruling applies whether the holders of the information are private individuals, sole traders, partnerships, limited companies, or PLCs; it does not apply, however, to information about individuals that is stored on manual systems such as a card index file. The onus is on the holder of computer data to register under the Act, and not to wait until registration is questioned. Anyone who suspects that their personal data might be stored within a computer system has a right to be informed whether that is so, and a right to see the stored data on payment of a reasonable fee. The Act was recently updated in response to the growth in e-commerce and online trading, to provide more specific guidance about the retention of private data. Firms can only hold data that is actually needed and is directly relevant to trading (as
opposed to market research data that could be sold to other organisations). They must ensure that information is up to date and must review it and delete superfluous information at regular intervals. Above all, data must be stored securely. The latest amendments to the Act also require that data holders must observe subjects’ rights to privacy, and must not mail them without pre-agreement.

**Anti-discrimination**

The Equality Act was introduced in 2010 to simplify and eliminate inconsistencies from earlier legislation. Prior to this, the UK anti-discrimination legislation was a complicated collection of older pieces of legislation that related to individual areas of equality and discrimination. Together, these Acts prescribed that no person or business was allowed to discriminate against any employees or applicants for vacant jobs on the grounds of age, race, colour, disability, religion, ethnic origin, gender, sexual tendency or marital status.

The legislation repealed and revoked by the Equality Act 2010 includes the following.

- **Race Relations Act 1976.** This Act also empowered the Commission for Racial Equality, which, along with the Equal Opportunities Commission, has now been replaced by the Equality and Human Rights Commission (EHRC). The EHRC has a broader remit.
- **Disability Discrimination Act 1995.** This Act aimed to promote the inclusion of disabled persons in the workplace. It built on the Disabled Persons Employment Act 1944, which was introduced to facilitate and improve employment opportunities for the many injured and disabled servicemen returning from military service.
- **Sex Discrimination Acts 1975 and 1986.** These Acts made it unlawful to discriminate on the basis of gender, for example when advertising job vacancies, or interviewing staff.
- **Equal Pay Act 1970.** This Act stipulated that employers must pay men and women equal pay, and provide equal employee benefits, pensions, terms of contract, etc., where they are carrying out the same, or similar, jobs.
- **Employment Equality (Religion or Belief) Regulations 2003.** These Regulations related to religious discrimination.

The Equality Act specifies nine protected characteristics, of which every person has at least two (their age and gender) and many have more. These characteristics cannot be used as a reason to treat people unfairly or to discriminate in any way. The protected characteristics are as follows.

- **Age** – this refers to a person who belongs to a particular age group. Where people are referred to as sharing this protected characteristic, it means that they are in the same age group. In a business context, people cannot be discriminated against for being too young for a job (perhaps being perceived as inexperienced or not credible in the eyes of customers) or too old (perhaps being perceived as being unfit/unhealthy, or out of touch with modern technology).
- **Disability** – this refers to the existence of a long-term medical, physical or mental condition that would impair or prevent them from engaging in normal work activities without aid or assistance. This does not just mean people with severe disabilities or incapacity: for example, a person with arthritis may be “disabled” in terms of having limited leg movement or lifting capability, but could have excellent analytical, financial, or computing skills, which can be exercised whilst sitting down. Individuals with disabilities have the right not to be discriminated against during the process of
recruitment, or within their employment. This implies that they must be given equal opportunities to receive training and to be considered for promotion. In the work context, employers have “a duty to make reasonable adjustments” under the Equality Act. This might include provision of reasonable physical access and working systems to allow them to perform their duties (e.g. wide doors and access ramps for wheelchair-users, or disabled toilets) and this provision also applies to disabled customers.

- Gender reassignment – a trans-sexual person or person undergoing gender reassignment (sex change) also has a protected characteristic for equality purposes. Such persons have the same rights as any other person of their chosen sex, and must not be discriminated against. For employers, this can be a difficult practical problem as the discrimination may come from peers (other employees) – particularly, for example, when they challenge the appropriate use of male or female toilets by a trans-sexual person in the early days of their sex change.

- Marriage and civil partnership – couples of the same sex (whether male or female) who are in a civil partnership (often described as a same-sex marriage) have the same rights of protection against discrimination as a couple in a male–female marriage. However, whilst this is legal and acceptable in the UK, entrepreneurs must be aware that in other countries, cultures or religions elsewhere in the world, such civil partnerships might be illegal and unacceptable.

- Pregnancy and maternity – women are protected both before and after the time of the birth. Employers must not discriminate against them at job interviews, or when they are being considered for promotion (whether actually pregnant or perceived by the employer as likely to become pregnant in the near future). The Employment Protection Act 1975 (discussed earlier in this chapter) explains their rights under the terms of employment, along with the rights of their husbands/partners to paternity leave.

- Race – this protected characteristic includes, race (and caste), colour, ethnic or national origin, and combinations of racial groups. The former Equal Opportunities Commission issued a useful code of practice on avoiding racial discrimination in the workplace, which helped UK businesses to produce equal opportunities policies for staff guidance. The EHRC replaced this with new guidance for employers (see the Useful Sources of Information at the end of this chapter).

- Religion or belief – this is a more complex area as the definition of the protected characteristic of “religion or religious or philosophical belief” used in the Act is based on the definition provided in the European Convention on Human Rights, which requires a “clear structure or belief system”. It also applies to sub-divisions of religious beliefs, e.g. Protestant and Catholic denominations in Christianity, or Shiite and Sunni Muslims. For employers, the main issue is not to discriminate against members of one religious group in preference to another, which might be difficult in homogeneous societies in which the variety of faiths may be broad and the differences between them not fully understood. Another more common practical issue is that whilst the employer may not discriminate when recruiting, problems can occur because of conflict between staff of different beliefs when they have to work alongside each other.

- Sex (gender) – employers must not discriminate against either men or women in favour of the other sex when, for example, recruiting staff, considering promotion, offering training opportunities, or making payments for comparable work. Certain exemptions may exist where, for example, gender is specifically relevant as a genuine qualification for the job. Examples include mineworkers, where the working conditions are deemed unsuitable for women; or rape counsellors, where a male counsellor would be entirely inappropriate or unacceptable to the clients.
• Sexual orientation – examples of people covered by this protected characteristic would be a gay man or a lesbian. Employers must not discriminate in any way regarding a person’s sexual preference or orientation.

The Equality Act also specifies the various ways in which it is unlawful to treat someone, such as direct and indirect discrimination, harassment, victimisation or failing to make a reasonable adjustment for a disabled person. It prohibits unfair treatment in the workplace, when providing goods, facilities and services, when exercising public functions, in the disposal and management of premises, in education and by organisations and associations (e.g. social or sports clubs and societies).

**Environment**

Environmental legislation is quite diverse but the various elements have been linked together as being of public interest and benefit in protecting the living and working environment as a whole.

- **Environmental Health Act 2010.** The Environmental Health Departments of local authorities manage aspects of public hygiene and food safety. In the case of public health and hygiene, the Environmental Health Act also empowers local authorities to carry out, or enforce, the safe removal and disposal of refuse, and the extermination of vermin or other risks to public health. They are also responsible for monitoring and licensing the operation of funeral parlours. In recent years, the food safety role has become much more prominent, with all manufacturers, suppliers, distributors and retailers of food or drink having to register with their local authority. Specific standards are prescribed for the safe preparation, handling and storage of food, and premises are regularly inspected to ensure that these standards are met on an ongoing basis.

- **Town and Country Planning Act 1971.** Any new or expanding business that is planning to occupy premises must ensure that planning approval exists to cover the type of activity for which the premises will be used. For example, in order to convert a room of a home into a shop, permission is required for change of use from domestic to retail. Similarly, to use a farmer’s barn to manufacture and sell rustic furniture, approval is needed for a change of use from agricultural to commercial. These approvals have to be gained before any new activities can start; they may be granted only for a fixed period of time, or may limit hours of opening or public access. Applications for planning consent are usually made via the local council offices for the district in which the premises subject to the application are located, and can take some weeks or months to be processed, especially if objections are raised.

- **Building regulations.** Whereas planning regulations affect the use that can be made of premises, building regulations specify the quality standards required for any changes or modifications to the structure of the premises, including drainage, to ensure that the work complies with specific standards. Again, applications are made through local councils, which employ building inspectors or surveyors to visit the premises and inspect and approve the structural changes. The inspectors have the power to stop work or order work to be replaced or improved if it is inadequate.

- **Control of Pollution Act 1974 and associated legislation.** Initially the Control of Pollution Act was introduced to update and reinforce some previous legislation, such as the Clean Air Act 1956, and to cover emerging problems and gaps in environmental controls. These included the emission of gases and toxic fumes, the pollution of watercourses, and the licensing and control of the tipping and disposal of waste materials, including how those materials could be safely disposed of. More recent
legislation relating to the reduction of environmental pollution (the Clean Air Act 1993) was instigated to reduce the emission levels of gases, in particular vehicle exhaust fumes and the gases used in refrigerators. In line with European Commission policies to increase recycling and to reduce landfill, there are now also strict regulations relating to the recycling of packaging materials, and specified minimum levels of component materials of vehicles that must be capable of being recycled.

- Environmental Protection Act 1990. This updated and consolidated much of the previous legislation relating to clean air, industrial pollution and pollution control.

The important thing to remember when considering any aspects of legislation is that business and employment law are constantly changing; when researching or referencing legal sources or information, these must be carefully checked to ensure that the information accessed is current, accurate and relevant to the situation.

C. BUSINESS INSURANCE

Business insurance is really one of the resources that is needed to start the business, but it differs from physical resources like premises, stock or computers in that it is not tangible, and unlike administration and support systems, it doesn’t actually contribute anything useful to the running of the business. It is an overhead cost, and one which may be regarded as unavoidable: first, because in many countries parts of it are a legal requirement for running a business; and second, because it is needed in case anything goes wrong – accidents, damage, theft of stock or money, etc. It is because of the compulsory/legal compliance elements that the topic has been included in this chapter.

When planning a new business, entrepreneurs need to consider a number of insurance aspects and options. Some of them are compulsory by law and/or essential; others are optional but important to have; and others are useful to have but not always affordable for early stage businesses. Insurance policies are paid for by an annual premium, the actual cost of which will vary according to the types of insurance cover required, and the payments for which can usually be spread across the year for a small additional fee, to help cash flow.

It is always advisable to get competitive quotations for insurance costs, and it pays to compare exactly what is covered by the insurance policies: insurance sales people and insurance companies are notorious for selling new businesses features that may not be appropriate or needed, and at a higher cost than could be found elsewhere.

**Essential Insurance**

- Employers’ liability insurance (also mentioned under Employment in Section B of this chapter). This is required by law for all employed staff including self-employed business owners. It is also required for people who may, for example, work as volunteers for charities or not-for-profit organisations. Essentially, it covers the business or charity against any harm or injury to employees or volunteers whilst they are working for the organisation at its own premises, or carrying out their duties elsewhere.
- Public liability insurance. This covers any accidents or harm or damage to visitors to the business, to passers-by, or through accidents caused by staff or acts of negligence by staff. This insurance cover is absolutely essential for businesses.
• Vehicles. This is insurance cover for the business use of cars, vans or trucks. It is very important to have it in place – and in many countries it is a legal requirement. If private cars are used for business purposes, the additional premiums for business use are normally not too high except where the car may be used for commercial sales on a full-time basis.

Optional Insurance

• Professional indemnity insurance. This covers claims for professional negligence and is held by most professional people who provide specialist advice or services, e.g. doctors and surgeons, architects, structural engineers, business consultants, solicitors and accountants. Depending on the profession, the extent of cover required may be from £1 million upwards.

• Premises and buildings insurance. This covers structural damage caused by flood, fire, storm damage or “acts of God”, but – depending on location – normally excludes terrorism or war damage.

• Buildings contents insurance. This covers theft of or physical damage to fixtures, fittings, furniture and equipment within a specific building. It doesn’t cover stock.

• Goods in stock or in transit. This covers stock held for sale, raw materials, work in progress, or goods in transit (to distributors or customers). As stock levels constantly vary, the insurance premium is normally based on the maximum value of stock held at any one time, and the average value of each consignment delivered.

• Loss of profits insurance. This insures against the disruption of trading activities due to circumstances beyond the control of the business (e.g. flood, fire, or if access to the business is blocked for a period of time). It can be very useful to cover the cost of overheads and lost profits, but it is expensive and can take time to be paid out, as the “loss” may not be fully quantified until normal business activities resume. This is one type of insurance cover that can be deferred until the second year of trading because the potential loss of profits really needs to be based on financial information from a full year of trading. Otherwise the cover offered may be limited or inadequate but its cost could be very high.

• Key persons cover. This insures against the death or disability of partners or key employees in the business. Lending banks will sometimes impose this as a condition of lending to partnerships.

• Product liability. This covers injury or harm to users or consumers resulting from the products they have purchased, e.g. injury from sharp objects, or food poisoning from food products.

Other Insurance-related Products

• Combined business insurance policies. These are tailored packages (sometimes called shopkeeper’s policies) that offer the core public and employers’ liability insurance plus a range of options for additional insurance, e.g. fixtures and fittings, stock, goods in transit. They can offer very cost-effective options.

• Health insurance for private medical treatment. This is an expensive option especially for start-ups. However, it can prove valuable to business owners to get prompt treatment from a private hospital rather than having to wait a long time for state-provided medical treatment, and risk being away from the business whilst they wait. It can take the form of proper insurance covering treatment costs, which is relatively
expensive with the level of fees determining the value of treatment costs covered. It can be cover for accident, long-term or critical illness or disability; or for a much lower cost, it can just cover certain basic expenses for medical treatment.

- **Life assurance policies.** These provide a payment in the event of death, either to the dead person’s estate or as security against borrowing. Term policies cover a fixed period for a fixed period of time; term policies with profits are similar but also provide a bonus payment at the end of the term. Endowment policies provide payment of a fixed sum at the end of the term, which might be used to pay a loan or mortgage.

- **Private pension plans.** These can be personal, provided by the business or a combination of both. Payments are made into a fund that is invested to provide a lump sum at the end of a defined period (or at retirement age). It is usually used to buy an annuity to provide a regular monthly income. Pensions are a valuable personal asset to have, but at start-up stage most entrepreneurs do not regard them as essential, especially if they are younger people with many years ahead before retirement.

- **Stakeholder pensions.** Since 2012, it is compulsory for larger businesses in the UK to offer their staff one of these in the absence of a company pension. This will be extended to small businesses over the following two years.

### D. INTELLECTUAL PROPERTY RIGHTS

Intellectual property (IP) covers a range of quite different aspects, some tangible (like physical inventions) and others intangible (like concepts). It is defined as the property of someone’s mind or intellect, such as:

- an idea or concept
- a new or innovative process
- a design concept for a physical device
- a new physical device or invention
- a piece of original creativity, such as artwork or graphic design
- an image such as a logo or photograph
- an original piece of written work such as a book or musical score
- a film or video for public viewing
- an electronic software application or a computer game.

However, the IP of a business could also include:

- patent licences issued to third parties, allowing them to produce something
- licences acquired from third parties, allowing the business to legally copy someone else’s product
- customer databases or customer contact lists
- market research material commissioned or collected by the company
- customised software bought for business use
- training materials/instruction manuals.

The common factor amongst these various items is that the IP is perceived as having some potential monetary value to the owner, or to a third party that could exploit that property commercially. Furthermore, that commercial potential might be extremely valuable to its owners: not only does the ownership of IP bestow the exclusive rights to generate revenue and profit from the production and sale of protected inventions, it also enables the owners to license out the right to produce and sell the products to other companies in exchange for payments of upfront licence fees and royalties based on the volume of products sold.
Apart from the potential for commercial exploitation, the IP also has another value to the owning company as more and more companies are now including intangible assets on their balance sheets. This is not just to increase the overall asset value of the business, but because that inclusion can change their capital gearing ratio. This potentially raises the borrowing capacity of the company, making it possible to leverage finance for expansion. However, a lending bank would probably want a charge against the ownership of that intellectual property rights (IPR) asset if used as security for borrowing, and might also want first claim to its licensing revenue should the company become insolvent.

**Main Types of IP**

When a small business owner is asked what IP he or she owns, most will tend to think in terms of patents and copyright, not realising that IP can take other forms that are less often protected. Any sector-based databases of companies, perhaps used for mailing purposes, or detailed customer lists and records have a value to the business; if they are comprehensive, clean and up to date, they may also have potential value to other companies – although the wisdom of selling such information to a direct rival would have to be questioned. Any bespoke software the company has commissioned is also part of its IP, and has a value to the business for the function it performs, as is any market research material that the company has commissioned. However, most people think of IP in the form of registered or protected material.

The main types of IP that can be registered or protected in some way are as follows.

- **Patents.** A patent is an internationally recognised licence that gives an inventor protection for a limited period (e.g. 20 years, or 25 years for medicinal products) to stop others from copying, making, using or selling the invention without the user’s explicit permission. To be potentially patentable, the invention must be new in that it is not already in the public domain; it must involve some form of inventive step or process; and it must have some form of commercial or industrial application. Patent registration is a means of formally and legally establishing sole rights to an invention, and any competitors who wish to produce the same products will have to do so under licence from the patent holder. However, patents are usually only granted for a fixed period of time and once this expires, the invention can be produced by anyone.

- **Patent licences.** Businesses that own patents are able to sell licences to other businesses around the world, to produce and/or market the products or inventions covered by the patents. Licences can cover specific countries or regions and have specific lifetimes, at the end of which they have to be renewed. The method of payment might vary but could typically consist of an upfront licence fee combined with an annual royalty payment based on the volume of products made or sold. Business model patents are also available to protect business processes or business systems, as opposed to physical products.

- **Copyright.** Copyright law usually relates to printed material, designs, drawings and graphics, electronic data, films and music. It does not protect the idea so much as prevent the copying of material by giving the owners of the copyright the legal right to sue anyone who breaches it. In the UK, copyright for software protection lasts for 70 years from the first date of sale; for written material, it lasts for 70 years from the death of the author. The copyright usually belongs to the author or creator of the material, although where this is an employee of a business, the copyright would normally
belong to the business. Copyright protection allows the originator (or their estate) to benefit financially from their creation; hence, any use or reproduction requires permission and usually payment. When material is made available to the public, such as library books, musical performances, CDs and DVDs, payment is usually collected by the Public Lending Right organisation (for books and music or film loan or rental) and PRS for Music for musical performance, or the playing of music in a public place. These organisations calculate average use for each item and arrange royalty payments, which are funded by charges to the end users.

- Trademarks. Under the Copyright, Designs and Patents Act 1988, a trademark is a sign, including logos, words, colour combinations and slogans, that will distinguish the products, goods or services of one provider from those of another. Classic examples are the Coca-Cola design, the Virgin logo, or the MacDonald’s golden arches. In the UK, their use is governed by the Trade Marks Act 1994, but they must also conform to Council Regulation (EC) No 40/94 of 20 December 1993 on the Community Trade Mark. Trademarks can also be registered internationally via the World Intellectual Property Organization (WIPO).

- Trade secrets. These are not actually registered like trademarks or patents, but they still need to be protected under confidentiality laws. They could include new designs or inventions that are under development but not yet ready for patenting. Employees who are working on them, or potential investors in new projects, may be asked to sign non-disclosure agreements, which, if breached, could result in litigation and claims for damages. In addition, employees working with trade secrets will often have clauses in their contracts of employment, restricting future employment by rival companies for a period of time, and requiring non-disclosure of any trade secrets to any third party.

- Registered designs. In the UK, by registering a design for a product, brand or image, a business can protect itself from having the design copied and used by another company, with the potential redress of legal action for infringement of that protection. Applications to register designs are made via the UK’s Intellectual Property Office, and come under the Registered Designs Regulations 2006. The design rights last for 25 years and can be reassigned. There is currently no international registration system for designs.

- Domain names. With the rapid growth of the internet and the increasing demand for domain names, it was only a matter of time before people started to buy up potentially desirable names to offer for sale to the highest bidder. The next step was the purchase of domain names that businesses or other organisations would want in connection with their business name or activity. These were then offered to those companies at high prices by unscrupulous individuals – almost industrial blackmail – and this led to complaints and litigation. The Internet Corporation for Assigned Names and Numbers (ICANN) is the organisation responsible for the generic top-level domains such as .com, .net and .org, and for minimising potential disputes. ICANN linked up with WIPO to produce the Uniform Domain-Name Dispute-Resolution Policy (UDRP) as a system for managing domain name disputes. This is administered by WIPO using independent experts to review each case and to make a decision on its merits. This offers a quite fast and relatively low-cost form of resolution, avoiding expensive litigation.

- Geographical indicators. These are products that come from a specific geographical region, the name or brand of which is synonymous with that region. Examples include:
- Champagne: by virtue of process (the méthode champenoise) and locality in a specific region of France
- Rioja, Beaujolais, Moselle: regional denomination/appellation contrôlée
- Harris Tweed, Isle of Harris, Scotland: by virtue of location, source of wool, and designs
- Port from the Oporto region in Portugal and Sherry from Jerez in Spain (but definitely not Cyprus Sherry or British Ruby Wine!)
- Scotch Whisky or Irish Whiskey: well-known national identities with associated brands (but not the same as Japanese Scottish whisky)
- Specific foods such as Cornish Pasties from Cornwall, and Melton Mowbray pork pies: both from specific locations in England.

In contrast, there are a number of well-known but unacceptable geographical indicators (those that are commonly regarded as geographical indicators but are not officially designated as such) including:
- Cheddar: this is a “type” of cheese, but is made in a number of countries and sold under a range of brands: for example, English, Scottish, Irish, Welsh and Canadian cheddars. Similarly Camembert, Brie and Feta are styles of cheese from France and Greece
- sparkling wines that use the Champagne process (méthode champenoise) but do not originate from the designated Champagne region, e.g. Cava from the Penedes in Northern Spain (although Cava is itself a designated geographical indicator)
- wines that are produced, but not bottled, in a specific region, e.g. cask imports that are bottled in the country of destination.

- Plant breeders’ rights. These protect the development of new varieties of seeds and plants, the potential sales value of which can be huge for commercial fruit and vegetables, and even for specialist hybrids of garden plants. To be approved, a variety must be new (different from its predecessors), distinctly identifiable, uniform and stable – i.e. it doesn’t regress to the original plant.

The Importance of Protecting IPR

In response to the various problems and issues relating to the protection of IP across the world, there have been a number of treaties jointly signed by the majority of countries over the past 130 years. These harmonise the international registration and recognition of patents and copyrights, and reduce the cost and time involved in achieving international coverage. This is particularly significant when considered in the context of the Dyson vacuum cleaner, which involved something like 2,000 separate patents in its development.

There are two main international organisations that handle IPR registrations and protection: WIPO and the World Trade Organization (WTO).
- WIPO is based in Switzerland, and was established in 1960 as the modern successor to the two international bureaux that were formed as a result of the Paris Convention for the Protection of Industrial Property in 1883 and the Berne Convention for the Protection of Literary and Artistic Work in 1886. WIPO now has 181 member states across the world, and administers 23 international treaties relating to IP, including some of those established by other organisations. The most significant of these is the Patent Cooperation Treaty (PCT), which allows a single international patent application to be made that has legal effect in the countries that are bound by the treaty and are designated by the applicant. The PCT system streamlines the patenting
process, and facilitates broad international coverage without incurring excessive costs. WIPO also has an SME programme aimed at enhancing the competitiveness of SMEs by increasing awareness of the value of the effective management of IP.

- The WTO manages the Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS). This was negotiated in 1984 and applies to all WTO members, as a way of stabilising the management and protection of IP and allowing disputes to be settled more systematically. It established minimum levels of protection that each member government has to give to the IP of fellow WTO members, and subsequently introduced a settlement system for disputes over IPR. The agreement covers five broad issues.
  - How basic principles of the trading system and other IP agreements should be applied.
  - How to give adequate protection to IPR.
  - How countries should enforce IPR adequately in their own territories.
  - How to settle disputes about IP between members of the WTO.
  - Special transitional arrangements for the period when the new system was being introduced.

TRIPS covers a broad range of IP including copyright, trademarks, patents, geographical indicators, industrial designs, layout designs of integrated circuits, and undisclosed information such as trade secrets. The protection of IP is based on the pre-existing WIPO agreement.

In addition to WIPO and the WTO, there are several other national and international organisations that manage patents and that interact or integrate with the PCT and TRIPS registration processes. These include the European Patent Office, which covers 40 EU member states; the United States Patent and Trademark Office, which handles patent applications for the USA; the Office for Harmonization in the Internal Market, which deals with the registration of trademarks and designs for the EU area; the Universal Copyright Convention, which is administered by UNESCO and covers any copyright registered in any country that is a member of the United Nations organisation; and ICANN, which manages the assignment of top-level internet domains.

IP is very expensive to protect. Typically, a single patent will cost between £5,000 and £6,000 for the initial PCT application, plus a further £20,000 to £25,000 for full publication of the patent. In addition, over its 15- or 20-year lifetime, additional maintenance fees have to be paid. This cost can be prohibitive for small firms.

The biggest problem with owning IP is the issue of worldwide enforcement against unlicensed copying of the patent. When a company becomes aware of an infringement against its patent, it first has to identify exactly who is infringing it: the vendor of the copied goods, whilst possibly infringing sales rights, may not be the same company that is producing the illegal copies. Second, the company has to issue “cease and desist” warnings via a lawyer, possibly in a foreign country. Third, if the infringement continues, the IP owner has to take legal action, which can be hugely expensive and time consuming if it is in a foreign country and involves lawyers who speak a different language and operate under a different legal system. Compensation is normally available for loss of profits and damage to goodwill – but enforcement of payment overseas may incur further costs and does not always result in payment of damages anyway if the defendant company chooses to become insolvent. In some cases, the patent may have expired before the dispute is resolved.
Another issue is that of legal patent copying whereby large companies pay permanent members of staff to scrutinise the details of newly published patents that relate to their markets, to see if they can use the patent technology by modifying it just enough to bypass its exclusive features. This is one of the reasons that some innovative firms will adopt a first-to-market strategy to launch their new product and get it established as the market leader before their rivals have time to respond. Not only do they save substantial patent costs, but they might typically have a one- or two-year lead in the market with 100% market share.

**The Patent Registration Process**

The key to successful patent protection is being able to demonstrate that the new product innovation is genuinely original and is not already in the public domain in any form – hence the importance of keeping it covered by non-disclosure agreements. The easiest way to start the patent process is to do a simple internet search using several keywords. This should indicate what other similar or substitute products already exist or are protected. A more detailed follow-up search can be carried out using the same keywords via national patent offices or, in the UK, via the British Library, for which a fee may be payable.

If the preliminary search is successful in revealing no significant direct competitors, then a Patent Attorney (a specialist patent lawyer) can be used to carry out a more detailed search. For this, they will usually go through a similar process of using keywords plus any information produced by earlier searches to examine patent registers or worldwide patent databases. This may result in finding a number of potentially related or overlapping patents, which the Patent Attorney will examine individually. Only if the search process verifies that the invention is new and innovative, has not been previously registered, and does not appear to infringe previous patents will the process move to the next stage.

If worldwide patent coverage is required, the most effective way of achieving this is by filing a registration under the PCT. Initial registrations with the European and US patent offices, coupled with a PCT application, give applicants immediate, effective international protection. This covers the invention for 30 months, to allow sufficient time to carry out international searches to ensure that the invention is new and original. Applications made under the WTO TRIPS process also allow a period of protection whilst international searches are carried out. Once the application has been made, there is a temporary period (patent pending) during which the invention cannot legally be copied. This provides the applicant with protection until the patent is approved and published. At the end of this period of scrutiny and rejection, if the search process has revealed no potential infringements and if there are no objections raised, the patent application can move to full publication. This gives full protection for the countries that are members of the treaty under which the patent was filed.

**USEFUL SOURCES OF INFORMATION**

- UK Registrar of Companies – for company registration and annual reporting procedures and requirements: www.companieshouse.gov.uk
- UK HM Revenue and Customs – for VAT, Corporation Tax and other forms of taxation: www.hmrc.gov.uk
• UK Intellectual Property Office (formerly the Patent Office) – for information about registering patents and other forms of IPR: www.ipo.gov.uk
• World Intellectual Property Organization: www.wipo.int/
• World Trade Organization – TRIPS Gateway: www.wto.org/english/tratop_e/trips_e/trips_e.htm
• Chartered Institute of Personnel and Development – factsheets and HR information: www.cipd.co.uk/hr-resources/factsheets/
Chapter 13

Implementing the Start-up Process

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INTRODUCTION

The process of planning a new business is often compared to the completion of a jigsaw puzzle, and it is only at the implementation stage of the planning process that the pieces fit together and the whole picture is revealed. Up to this point, the market research, identification of staff and physical resources, budgeting and financial planning, and the development of marketing activity have been a series of separate activities building towards a common goal. The implementation plan pulls all these activities together to a time-frame, identifies which of the activities must be complete before others can start, and then analyses the risks involved and the actions required to address those risks.

The amount of work involved in the preparation for start-up will largely depend on the nature of the proposed business and the degree of complexity involved. For example, a mobile hairdresser can start a business with some simple tools of the trade (scissors, combs, brushes, trimmer and portable hair dryer); a window cleaner would need ladders, buckets, cloths etc; and both would require some form of transport. Their marketing could be as simple as some local advertisements and leaflets delivered to local homes. In contrast, a proposed manufacturing business may need to find premises and negotiate contracts for them; then buy, install and test plant or machinery; source and negotiate a supply of raw materials; and recruit skilled staff, or train unskilled staff before work can commence – and that could feasibly take three to six months.

This chapter will examine the implementation process and the ways in which potential problems can be identified, assessed and managed. It is just as important for potential lenders and investors to be able to see that these issues have been properly considered and addressed as it is for them to see strong financial plans and a coherent marketing strategy. They will expect to see that the entrepreneur has planned the process carefully, identified each of the key stages in sequential order, allowed sufficient time to carry them all out, considered the risks and hazards that could potentially cause problems along the way, and has identified ways of dealing with these problems.

A. IDENTIFYING KEY STAGES IN THE IMPLEMENTATION PROCESS

As explained earlier, the implementation part of the business plan is the stage where the whole planning process comes together: where the capital and additional finance are put in place to provide the working capital and to pay for the necessary resources; where those resources are acquired; and where the marketing activities start to roll out to launch the business on the market. Unfortunately, this is also the stage where things can go very wrong unless the implementation is planned carefully. The starting point is to try to identify a date by which trading will ideally start, to identify and examine all of the key stages and events that must take place before that date, and to slot them into a pre-launch timescale. Within these various activities, there will be some that are critical (such as obtaining investment funds or negotiating a lease on premises) because they are a pre-requisite for other activities in the process. These critical events must be risk-assessed to identify any potential problems that could have a knock-on effect on other actions and ultimately delay the launch. These delays create a subsequent possible risk of the working capital being used up before the new business is able to reach its break-even level of trading.
Some business people would argue that the correct approach to planning the implementation is to start by working out the critical stages and the time involved in implementing them before considering setting a target start date. However, this is not always possible as there may be good reasons for aiming for a specific start date, such as the need to be ready to take advantage of seasonal sales. Someone opening a holiday hotel or restaurant, for example, would want to be ready for the spring to take advantage of the summer holiday season; the last thing they would want to do is to delay the opening until the autumn when the main holiday season has ended and there may be little sales revenue for the following few months. Similarly, if customers have placed advance orders and are waiting for delivery, the start date may need to be as soon as possible, with the various pre-start activities being condensed into the minimal time period. However, for other new businesses the start date may not be critical at all: for example, the owners may be initially working on a part-time basis with the intention of working up to full-time activity as the customer base is expanded.

**Key Questions to Ask**

Assuming that you, as a prospective entrepreneur, have identified a viable market and that you have acquired or arranged for the necessary (and sufficient) finance for your proposed business, a number of practical questions need to be answered before you start.

When do you intend to start trading?
- Have you identified a specific start date?
- Is it realistic for you to have everything in place by that date to launch the business?
- How critical is the start date (e.g. to meet a customer’s deadline, or to take advantage of seasonal trade)?
- What would be the implications of failing to meet the target start date?
- Are you planning immediate full-time activity or a part-time start and gradual build-up? If the latter, do you have the flexibility and funds to accelerate the build-up if needed?

What factors or facilities need to be in place before you can start, and what lead times are required for them? Where could potential delays occur in getting them in place?
- Delays in funding – where start-up funds are coming from private investors there are usually legal contracts to sign, which can cause delays if terms have to be negotiated. Similarly, lending banks will normally require some form of loan guarantee or security against property, which again can cause delays in the release of funds, especially if legal documents need to be prepared, signed and witnessed, or legal charges have to be assigned to property.
- Staff recruitment and training – times will vary according to the level of skills and experience required, the local availability of suitable staff, and whether or not they need to give notice to leave a current employer. Highly skilled or specialist staff may be harder to find and may take longer to get in place, particularly if they need to move from another area.
- Purchase or rent of premises – contracts for straightforward rental arrangements do not normally take a great deal of time; short- and medium-term renting of premises can be arranged quite quickly if references and financial information about the business are readily available, although deposits of up to three months’ rent may have to be paid in advance. However, negotiating to buy the freehold ownership of premises can take a good deal of time, especially if a mortgage is needed. Long-
term leases can be arranged more quickly than purchases, but any transaction relating to premises purchase or long-term lease contracts will inevitably require the involvement of lawyers. This must always be regarded as a potential source of delays, so ensure that adequate time has been allowed. Make sure that your lawyers are fully aware of critical dates and deadlines – particularly any that may have financial consequences if they are missed.

- Design, decoration and fitting of premises – where contractors are to be employed (for shop-fitting, for example) they may need to be booked weeks or months in advance; often, the better their reputation is, the more notice they will require to be available at the date you need them. The premises may also require planning consents for change of use, or other approvals for structural changes, and these approvals may take time. Planning consents for change of use of premises usually take six to eight weeks, but if there are objections to a proposal that timescale may double, and there is always the possibility of refusal.

- Production equipment – lead times are important here because complex machinery may have to be ordered from the manufacturer around six months before it is required, and may take further time to install and commission before it is ready to be used. It is also important to check access to ensure that plant and equipment can be delivered and installed without any problems.

- Furniture/computer equipment – lead times are not usually a problem, especially for furniture and standard computer equipment. However, if bespoke software has to be compiled and tested, or databases of potential customers have to be prepared, it may take time, especially if the work cannot be started until finance is in place.

- Pre-start advertising or marketing activities – depending on the type of business, marketing activities may need to start before the launch date, and marketing materials will have to be designed and produced or printed well in advance. Once again, the limiting factor might be the availability of funding to pay for the work. However, the more time you can allow for the design and production of marketing materials, the more chance there is of getting them at a good price. Last-minute orders cannot always be scheduled into in-house production runs, and may be more expensive if the designer has to outsource work.

- Contracts with suppliers – these need to be negotiated quite early in the planning stage to allow time to assess the best terms of trade from alternative suppliers. Suppliers may also need to schedule stock into their own production plans. Lead times for delivery from suppliers can vary. If stock is being imported from China or the Far East, for example, the lead time may be several months, including shipping. Stock management can be difficult in the early stages of a new business as it is necessary to strike a balance between keeping sufficient stock available and avoiding having too much working capital tied up in stock. Most suppliers will be keen to keep a new customer happy, but if there is perhaps just one supplier of the products you need, you may have to contend with the supplier’s loyalty to existing customers, especially if they are potential rivals to you.

- Legal compliance – this topic is discussed at length in Chapter 12; however, in the context of implementation it is essential that any permissions, licences or registrations needed to operate a particular business are applied for well in advance of the proposed start date. This is especially true if the licences require inspection of the business premises before they are granted – for example, for food storage and preparation, or the storage and distribution of dangerous or hazardous chemicals or explosives. Compulsory insurance (such as employer’s liability and public liability) will also need to be obtained when the business starts.
B. PLANNING AND SCHEDULING THE IMPLEMENTATION

Scheduling the Pre-start Activities

When you start to identify the activities that need to be completed before the business can commence trading, some items will obviously be sequential (i.e. one must be completed before another can start) whilst others can run alongside each other. The sequential items, such as finding and equipping premises, will typically be the ones that take the longest time to complete, especially if lawyers are involved in preparing legal documents or planning consent is required. Others such as negotiating contracts with suppliers or ordering marketing materials can be carried out at the same time as other activities. For example, the design of marketing materials is not dependent on the lease being signed, so that work can be carried out whilst the terms of the lease documents are being sorted out by the lawyers.

Many of the items or activities will have been identified in the resources section of the business plan; however, at this stage it is necessary to identify the following.

- Those items or activities that will definitely require lead times, e.g. the advance orders for construction of plant and equipment; the booking of contractors for structural modifications and fitting out of the premises; and staff recruitment.
- Those items or activities that are critical in terms of having to be implemented or completed before others can commence, and where any delays in implementation could have a knock-on effect and cause delays with other parts of the project. In the case of premises, for example, the negotiation of leases or purchase contracts can take weeks or month and, although planning consents can be applied for whilst those negotiations are taking place, the signing of the lease should wait until the planning consents are confirmed; the fitting out of premises cannot start until both of these are completed. Delays can be costly if you have to pay rent on unoccupied and unusable premises; they can also be compounded if, for example, contractors are postponed and cannot return precisely when you need them, due to their other work commitments.

The Gantt Chart

It is often said of business that what can go wrong, will go wrong, and usually at the worst possible time. However, careful preparation and planning can help to prevent this from happening. A Gantt chart is essentially a planning sheet. It allows for all of the various pre-start activities and events to be presented alongside each other in a time sequence and also in a form that enables the planner to identify the events that need to be completed before others can start – i.e. the critical stages that, if not completed on time, can potentially create delays and disruption for subsequent activities.
Figure 13.1: Gantt Chart for Preparation Activities Prior to New Shop Opening in Week 27

<table>
<thead>
<tr>
<th>Week Number</th>
<th>Activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Complete business plan</td>
</tr>
<tr>
<td>2</td>
<td>Negotiate bank loan</td>
</tr>
<tr>
<td>3</td>
<td>Identify premises</td>
</tr>
<tr>
<td>4</td>
<td>Negotiate/completes lease</td>
</tr>
<tr>
<td>5</td>
<td>Order water/electric supply</td>
</tr>
<tr>
<td>6</td>
<td>Design layout</td>
</tr>
<tr>
<td>7</td>
<td>Identify suitable contractors</td>
</tr>
<tr>
<td>8</td>
<td>Organise contractors</td>
</tr>
<tr>
<td>9</td>
<td>Refurbishment/decoration</td>
</tr>
<tr>
<td>10</td>
<td>Electrical installation/signs</td>
</tr>
<tr>
<td>11</td>
<td>Shop-fitting</td>
</tr>
<tr>
<td>12</td>
<td>Identify potential suppliers</td>
</tr>
<tr>
<td>13</td>
<td>Negotiate with suppliers</td>
</tr>
<tr>
<td>14</td>
<td>Confirm supplier contracts</td>
</tr>
<tr>
<td>15</td>
<td>Order stock</td>
</tr>
<tr>
<td>16</td>
<td>Receive stock</td>
</tr>
<tr>
<td>17</td>
<td>Design/order advertising</td>
</tr>
<tr>
<td>18</td>
<td>Adverts in local press</td>
</tr>
<tr>
<td>19</td>
<td>Advertise for/recruit staff</td>
</tr>
<tr>
<td>20</td>
<td>Train staff</td>
</tr>
<tr>
<td>21</td>
<td>Install/test electronic till</td>
</tr>
</tbody>
</table>
Figure 13.1 is a simple Gantt chart for some of the activities that might be involved in opening a new shop and how they might be phased and implemented prior to the start date. The solid areas of shading indicate the planned activity timescale, and the activities that are followed by hatched shading indicate where extra time has been allowed for possible delays. Note that in addition to the allowances for overrun, there are some weeks (e.g. 7, 9 and 18) when there is relatively little going on. This allows the entrepreneur some leeway to deal with any other issues or problems that arise.

For some businesses, the Gantt chart may be very simple, with just a few lines, but invariably where business premises have to be acquired, or specialised plant and equipment manufactured, installed and commissioned, those stages will be much be more complex; they may, in fact, require the use of project planning software, or the employment of a consultant project manager to monitor and control progress. The value of the Gantt chart lies in the visibility it gives to the timing of the implementation, and also because by identifying the critical stages of implementation, it signposts the activities that need to be subjected to the risk analysis process.

C. RISK ANALYSIS, RISK MITIGATION AND CONTINGENCY PLANNING

The risk analysis presented in the implementation section of the business plan is intended to address three questions.

- What are the main risks that the new business will face in preparing to start trading and in the early stages, before it reaches break-even level? This includes the pre-start risks that are identified from the critical events shown in the Gantt chart, and the risk that the sales and financial forecasts shown in the business plan may vary from what was predicted. It should also consider potential areas of operational weakness in the business, including staffing, product or service quality, competitors’ response to your entry into the market, reliability of suppliers and distributors etc.
- What is the likelihood/probability of any of those risks actually occurring?
- What impact would they have on the performance or survival prospects of the business if they did occur?

Here are some examples.

- Sales activity – sales revenue grows much more slowly than forecast/sales grow much more quickly than forecast.
- Financial and cash flow problems – the business runs out of working capital, possibly from lack of sales causing a depletion of cash or from more sales than expected causing a shortage of cash to fund growth/working capital becomes depleted because of the need to give customers extended credit to get their business/customers are not paying their bills on time.
- Problems with suppliers – difficulty in getting regular supplies of stock/suppliers failing to meet delivery deadlines, which causes stock shortages/inconsistent quality of stock, which leads to product returns and warranty issues.
- Staffing and recruitment problems – problems with recruiting adequate numbers of suitable staff/the available staff having inadequate skills and/or experience to do their jobs properly.
- Premises issues – completion of the lease contract may be at least three to four weeks late; by this point, the contractors will be unavailable for a further four weeks, which causes further delays to the opening of the premises for trade.
• Operations issues – a key member of staff unexpectedly goes long-term sick/a breakdown occurs with a vital piece of equipment for which spare parts will take three weeks to deliver.
• Marketing issues – the largest competitor introduces major price cuts to prevent you developing a share of the market/just after you start trading, a competitor launches a new product that is superior to yours.
• Legal issues – you have opted for a first-to-market strategy for a new innovative product but a competitor launches a legal action for infringement of copyright/you discover you have failed to obtain a required licence to operate and may have to stop trading until it is issued.

**Preventing the Risk Analysis**

In order to analyse the probability and potential impact of some of the hypothetical risks, we use a risk analysis grid (Figure 13.2). This evaluates both the **probability of occurrence** and the **impact of the risk** as low, medium or high. A low figure rates as one point, medium as two points and high as three points, and the points for the two factors are then multiplied together on the grid. Hence, a medium probability incident with a potentially high impact scores $2 \times 3 = 6$ points. Essentially anything with three or more points constitutes a risk that needs to be addressed and high scores (six to nine) are potentially serious risks.

*Figure 13.2: Risk Analysis Grid*

<table>
<thead>
<tr>
<th>Probability of occurrence</th>
<th>Low</th>
<th>Medium</th>
<th>High</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>1</td>
<td>Problems with supplier’s quality</td>
<td>Machine breakdown</td>
</tr>
<tr>
<td>Medium</td>
<td>2</td>
<td>Low sales revenue</td>
<td>Premises delayed</td>
</tr>
<tr>
<td>High</td>
<td>3</td>
<td>Cash flow problems</td>
<td>Lack of working capital</td>
</tr>
</tbody>
</table>

**Contingency Planning**

Once the risk analysis has been completed, there are three further steps that need to be carried out. For each of the risks that has been identified as needing to be addressed, it is necessary to do the following.
• Identify what actions can be put in place to avoid the risk occurring in the first place.
• Identify what actions could be taken to limit or mitigate the impact of the risk on the business.
• Where the impact of the risk is potentially significant and could disrupt the operation of
the business, prepare contingency plans to address the problems if they actually
 occur.

For example, the business starts up and starts to move towards break-even level. However,
the rate of growth of sales is much faster than planned and more customers than expected
are insisting on receiving 30 days' credit. This causes cash flow problems and puts pressure
on the working capital. This type of over-trading situation is not uncommon in business start-
ups and although the business is trading profitably, it risks insolvency if it runs out of cash to
operate.

What actions can be put in place to avoid the risk occurring in the first place? At the financial
planning stage, it may be worth preparing worst case and best case forecasts, so that if sales
are slower or faster than expected, the impact on cash flow and working capital can be
identified in advance, and adequate funding built into the financial plans.

What actions could be taken to mitigate the impact of the risk on the business? With the
positive sales figures, it may be possible to approach suppliers to see if they would be willing
to give credit on purchases. For service-based businesses where that may not be possible,
there are two options.
  • Approach the company’s bankers to obtain a short-term overdraft to make up the
    shortfall in working capital until the increased profits from trading start to work though.
  • Ask the bank to set up invoice factoring for regular customers, to improve the cash
    flow.

If the level of growth continues to be very rapid, obtaining a medium- or long-term loan or
additional capital investment might be the best option for creating more working capital to
fund the continued growth.

What contingency plans could the business have in place to address the problems? If the
pressure on working capital was anticipated as a possibility at the planning stage, the
business could pre-agree an overdraft facility with the bank to help with the short-term cash
flow problems resulting from the extra sales. Bankers are always more amenable to requests
based on proactive planning, where the use of an overdraft is triggered by higher sales
figures, than to those where the business owner is having to react to a problem and request
additional funds to cover it. Another contingency option might be to have a private investor
lined up for a second-stage investment when sales volume reaches a certain level; or to have
a pre-arranged second-phase bank loan set up to be accessed at the same level of sales.

D. MONITORING THE PROGRESS OF THE BUSINESS

A further critical part of implementing the business plan is to set up regular monitoring
processes across the business to ensure that it is performing against its targets and that no
unexpected problems are occurring. This sounds such an obvious thing to do, but the
realities and time pressures of running a small business mean that the monitoring process
can be easily overlooked or occasionally postponed or forgotten. On a weekly or monthly
basis, it is important to monitor the ongoing operations of the business to ensure that each
area is functioning properly and that no unexpected problems are developing. On a longer-
term basis, it is also important to monitor the profitability and effectiveness of the business to
ensure that it is meeting its owners’ strategic objectives and growth potential.
Monitoring the Business Operations

The main monitoring and record-keeping activities fall into four areas: finance, quality, sales and marketing, and staff.

Finance
In addition to providing information about profitability and cash flow, the monitoring of financial information can reveal a great deal about the non-financial aspects of the business, and potential problems that may be emerging.

- Accounting systems – this covers the sales and purchase ledgers, cash book, bank statements, etc. These ideally need to be updated daily, or at least weekly if a part-time book-keeper is used. There also need to be weekly reconciliations of cash and bank figures with the accounts ledgers and cash book, especially in businesses that handle substantial cash sums, where theft may be a possibility.
- Comparison of budget forecasts for income and expenditure with actual figures – this is an absolute necessity and should be carried out monthly, not least because the identification of variances (whether positive or negative) can be the first indication of potential problems or risks. Budgets are not just about financial figures: they can also be used to monitor changes or fluctuations in sales levels and sales revenues, down to individual products or services.
- Credit control – this is also a monthly activity to ensure that customers are within acceptable credit limits and to identify potentially doubtful or bad debt. For some customers, credit control may become a weekly activity if potential problems are identified.
- Stock control – if stock is held for sale to customers, it should be monitored on an ongoing basis, ideally through a computerised accounting system. However, it also needs to be physically checked at regular intervals to ensure that there are no problems of error, poor stock rotation, wastage or theft, particularly where any valuable items are held.
- Annual accounts – these will produce the information that bankers and investors expect to have reported to them (profit and loss account, balance sheet, and cash flow statements). These documents will be the source of data that can be analysed using accounting ratios to evaluate the broader performance of the business and its financial stability.

Quality
The monitoring of quality at a baseline level is about ensuring that products or services are of consistent quality and fit for the purpose for which they are intended. In a broader sense, though, it should be about monitoring the customers’ perceptions of the quality of the products or services and of the business as a supplier.

- Monitoring customer retention levels is a good way of identifying potential issues with the products or services, but it also reflects customers’ experience of the business as a supplier. Given that a competitor can offer very similar products at a similar price, the retention of a customer may be down to the quality of service they feel they have received from the business.
- Seeking regular feedback from customers can provide valuable information about their perceptions. This is typically monitored using questionnaires, telephone calls or other review procedures, although the information customers provide may be restricted by
the questions asked. It is important that the feedback is acted upon and that customers are made aware of changes that result from their feedback.

- Unsolicited feedback (negative or positive) from customers is a more useful source of information but it is much harder to capture and record, especially if it is verbal.

- Monitoring the volume and nature of complaints offers the opportunity to analyse whether there are any common factors that might indicate a problem area that needs to be addressed. In an ideal world, there would be few complaints, of course, but when they do occur, they need to be analysed.

- Monitoring the performance of the business against its own quality standards gives a good indication of whether these standards work. We must continuously ask the questions: Are the standards working and what is the evidence that will justify that belief? Are the staff aware of the quality standards and do they work to them? Are customers aware of the quality standards and if not, why not?

- Although the most difficult to achieve, client recommendation (and subsequent growth without advertising) is the most valuable form of customer feedback. It is a clear indication that the various quality systems and standards are working as they should be. A simple question to ask of all new customers is: “How did you hear about our business?”

Sales and Marketing
Monitoring revenue from individual products or services against targets can identify changes in sales patterns (perhaps seasonal) or longer-term trends.

- Monitoring the relative profitability of different products or services. It is important to determine which products or services are contributing the most towards the profitability of the business. For example, the product with the biggest sales volume but a relatively low profit margin may be contributing less actual profit than a product with fewer sales but a good profit margin. This knowledge is essential when planning marketing activities to ensure that the products that contribute most are properly promoted. Similarly, it is important to know which products or services are the cash generators in order to aid cash flow when needed, as these may differ from the products that generate the real profits for the business, which are the ones to focus on for growth. A product that generates a large sales volume but low profit may contribute significant cash income for the business but the actual profit generated might be less than another product that sells a lower volume but with higher profit margins.

- Monitoring the effectiveness of advertising and sales activities in generating new leads or enquiries, and converting them into new clients or increased sales. This includes counting the enquiries and responses generated by each type of advertising or promotion, and the subsequent proportion of those enquiries that is converted into actual sales, in order to produce a “cost per sale” figure for the advertising or promotional activity. It also includes monitoring the number of customers that are lost each year, and the number of sales visits made by each sales person against the number of new customers gained.

- Evaluating the impact of special promotions on sales volumes in terms of numbers of enquiries and actual sales; and on sales revenues to see which activities or which products generate the most revenue.

- Monitoring competitor activity, their new products or potential substitute products, the features, benefits and USPs that they use to sell them, their changing prices and special promotions; and also those of any new companies entering the market.
Staff
Managing staff performance, whether by appraisals or performance reviews, is often overlooked by owners of small firms, who may consider themselves sufficiently close to the staff not to need them. However, appraisals are a good way to formally exchange information and review staff performance and objectives that can also reveal issues of which the owner may not be aware.

- Small business owners are often reluctant to invest in staff development and training, but small investments can often significantly improve staff performance and their attitudes to the job. Appraisals are a good way of identifying development needs.
- Regular staff reviews are an important factor in the creation and development of innovative and enterprising cultures in small businesses, particularly when they are used to encourage staff to use their initiative or to set their own targets for innovation within their areas of responsibility.
- High levels of absence, sickness and staff turnover are often perceived as an inconvenience to small business owners. However, as discussed in Chapter 9, they are often symptoms of underlying staff dissatisfaction, or of a poor relationship between the staff and the owner, and need to be addressed before they get out of hand.

Monitoring Overall Performance

In Section B of Chapter 5, we considered the differing expectations of lenders and investors when they evaluate a new business proposal. Here is a summary.

- Lenders manage funds they have obtained from investors, savers or their own institutional profits. They are expected to invest those funds prudently and to achieve a certain level of return for their savers and investors. They are looking to lend money at minimal risk, and expect to be repaid within a fixed period of time and to receive a pre-defined level of interest from the loan. They also expect the companies to provide them with regular progress reports, and warnings of any problems arising.
- Private investors are using their own money. They are prepared to take balanced risk with the investment if the potential return on their investment is sufficiently high, but know that it may take several years to achieve. Their profit may be partially achieved by the payment of dividends from company profits but they are generally more interested in capital growth in the value of the business. They look to exit the business after an agreed period of time, when they will sell their shareholding back to the entrepreneur, or perhaps a third party, for a much higher price than they invested. This will reflect the increased capital value – perhaps in the region of 25% of the value of their investment for each year of the investment – to reflect the risks they have taken. They may also want to be represented in the management of the business, which means they will expect access to details of business performance.

Both lenders and investors will expect to be provided with annual data about the company they have lent money to or invested in – and at the very least this will be in the form of the three key Annual Returns documents that the company would normally file at Companies House.

- The **profit and loss account**, which shows how efficiently the business has traded and what profits (or losses) it has made.
- The **balance sheet**, which shows its assets and liabilities at the year end.
- The **cash flow statement**, which shows where its money has come from and gone to during the financial year.
Apart from wanting to see that company profits are sufficient to repay their loans, lenders are usually interested in the borrowing capacity of the business. This is usually expressed as **capital gearing** – the ratio between the company’s share capital and reserves compared with the fixed interest and loan capital; the higher the ratio, the better the borrowing capacity of the business.

Both lenders and investors want to see that the business has sufficient **working capital** to be able to operate properly and pay its bills on time. This liquidity is measured through the working capital ratio, which compares current (short-term) assets with current liabilities with an ideal minimum ratio of 2:1. Another measure of liquidity is the Acid Test, which compares liquid (cash or near cash) assets with short-term liabilities, with an expectation of a minimum of 1+:1.

There are many other ratios that compare various aspects of business performance, including comparisons that show the average period of credit given, the efficiency of use of working capital and how frequently it is turned over during the year (sales turnover compared with the working capital employed); and the frequency of stock turnover. These are useful indicators of business performance that can be monitored during the financial year, rather than being based on the previous end of year figures.

The information that investors are more interested in is the profitability of the business and the overall growth in its capital value from one year to another. They will want to see growth in the **return on capital employed** (profit as a percentage of capital employed) and the **net asset value** (ordinary shareholders’ funds compared with the number of shares issued).

In non-financial terms, both the owners and investors will also want to monitor the overall strategic plan of the business: how it is growing its sales volumes, sales revenues, and profits in comparison with its **strategic targets for growth**, as well as its overall position in the market and its market share. Ultimately, it is the achievement of these strategic targets, the strengths of the balance sheet, and the ongoing profitability that will generate the growth in capital value that will facilitate a satisfactory and profitable exit for the investors, and a good solid company that the owners can continue to grow, can choose to sell to another business, or can float on the financial markets.