GROWING CONCERNS

BUILDING AND MANAGING THE SMALLER BUSINESS

DAVID E. GUMPERT
Editor

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Foreword

For sixty years the *Harvard Business Review* has been the farthest reaching executive program of the Harvard Business School. It is devoted to the continuing education of executives and aspiring managers primarily in business organizations, but also in not-for-profit institutions, in government, and in the professions. Through its publishing partners, reprints, and translation programs it finds an audience in many languages in most countries in the world, occasionally even penetrating the barrier between East and West.

The *Harvard Business Review* draws on the talents of the most creative people in modern business and management education. About half its content comes from practicing managers, the rest from professional people and university researchers. Everything *HBR* publishes has something to do with the skills, attitudes, and knowledge essential to the competent and ethical practice of management.

This book consists of 36 articles addressed to the management problems of smaller companies. Under the direction of David Gumpert, HBR has encouraged contributions by the hard-pressed entrepreneurs who contribute an essential vitality to our business system. We have tried also to encourage academic research into small business and to develop a framework for understanding it better.

In the words of two of the contributors to this volume, a small business is certainly not a little big business. I hope that readers will better understand the full truth of this statement. Managers of smaller companies should be able to find specific support in the interesting experience analyzed here.

KENNETH R. ANDREWS, Editor
Harvard Business Review

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Introduction

DAVID E. GUMPERT

Not too many years ago, a volume such as this would have been difficult to assemble, whether from articles in *Harvard Business Review* or elsewhere. Not only were far fewer articles about small business being published than is now the case, but those that did appear tended to view smaller companies as merely miniaturized versions of large corporations, rather than as entities with distinct problems of their own.

Since 1979, *Harvard Business Review* has been publishing in each issue at least one or two articles directed toward the special management needs of smaller businesses, under the feature title "Growing Concerns." We rather arbitrarily define small businesses as those with between $1 million and $30 million annual sales, though we have published articles in the feature about starting ventures and about managing companies with more than $30 million of annual sales. Of course, *HBR* before 1979 published a number of valuable articles about the managerial problems of small enterprises, and several are included in this edition.

HBR has not been alone in devoting more attention to small business. Several new publications directed specifically toward owners of small companies have sprung up in recent years; among them are *Venture*, *INC.*, and *In Business*. Established publications such as *The Wall Street Journal* and *Forbes* have started special sections about small businesses. Dozens of books about starting and managing small ventures have been published in recent years.

The increasing volume of printed material about small business is indicative of spreading interest in entrepreneurship. Each of the Big Eight accounting firms and many large banks have in recent years started special departments to seek out and effectively service small business customers. Lately, variety of commercial institutions and academicians have surveyed owners of small businesses about their attitudes and behavior related to a wide variety of subjects ranging from the impact of the recession to the level of owners' salaries.

Why all the interest in small business? How has this heightened interest—particularly as expressed through the articles in this volume—contributed to our knowledge of small business management? Which areas of small business management are in need of further exploration?

The answers to these questions, however tentative they may be, can assist entrepreneurs in better understanding their roles in today's society, in solving vexing management problems, and in appreciating which managerial areas warrant additional research.

In my view, the growing interest in entrepreneurship and small business management is the result of several independent but simultaneously occurring national developments. These trends are of a social, political, technological, and economic nature. The effect of these trends has been to create a climate increasingly favorable for new venture start-ups; since 1971 the number of new business incorporations has more than doubled to nearly 600,000 in 1982.

This new interest in entrepreneurship is not without its ironies. It has been occurring during a period of economic stagnation and recession in the United States. Indeed, 1982 saw more business failures than any year since the Great Depression. And many more small companies have teetered on the edge, struggling to avoid bankruptcy. But as disturbing as these economic problems are, they have also helped stimulate interest in entrepreneurship, as we will explore later in this analysis.

The favorable trends for business start-ups have had the additional effect of creating an identifiable new market—the small business market—for educational, financial, technical, and other goods and services. The products, which include the assorted publications and accounting banking services referred to previously, make available to owners of small businesses valuable assistance that either wasn't available or wasn't easily obtainable a decade ago.

New Stature

Socially, entrepreneurship is now more accepted, and indeed popular, than at any time in many years. During the Vietnam War years it was quite acceptable among academics, university students, and even some of the more popular politicians of the day, to view business disdainfully. Young people who talked openly about starting ventures were fair game for extensive ridicule. Today, popular attitudes toward entrepreneurship and small business are much different. Many daily newspapers have expanded their business sections to include glowing profiles of local entrepreneurs making good. The newsweekly and other mass circulation magazines make much of young fast-growing high-technology companies and the engineering wizards who have started them.

The new social acceptance of entrepreneurship has led to the creation of important nongovernmental resources for owners of small businesses.

The number of colleges and universities offering courses on starting and operating small businesses has grown to several hundred from only a handful in 1970. Organizations established by women to advance the interests of female entrepreneurs—nearly nonexistent in the early 1970s—have proliferated in recent years. Women seeking to start businesses or who already own businesses can thus turn to other women for management assistance and moral support. Similarly, hundreds of local chambers of commerce have established small business groups in the last few years to provide lobbying, technical, and other assistance to entrepreneurs.

A Role in Policy Making

Among the political powers that be there is an increasing awareness that small businesses offer hope for reversing this country's deteriorating competitive position versus the Japanese and Europeans in the areas of productivity and industrial innovation. Perhaps even more important in the eyes of politicians, evidence has accumulated suggesting that small businesses provide many more new jobs than large corporations. (Studies out of Massachusetts Institute of Technology indicate that businesses with fewer than 100 employees were responsible for about 70% of the new jobs created during the 1970s.)

Lawmakers have taken some specific steps to improve the overall climate for small businesses. For instance, the move to deregulate the transportation, financial service, and telecommunications industries, among others, has improved the competitive climate for new ventures in those areas. As a consequence, young, upstart companies in the airline, stock brokerage, and telephone service areas are providing significant competition to well-established giant corporations.

Among the most significant legislative steps of recent years from the viewpoint of stimulating financing for promising start-up and early-stage businesses has been the two-stage reduction of the capital gains tax to a maximum of 20% from the maximum of 49% reached in 1978. The lowering of the tax has provided a significant incentive to wealthy individuals to place funds in private venture capital firms, which then invest the money in small companies judged to have the greatest likelihood of achieving sales and profit growth of 50% or more compounded annually for five to seven years. Venture capital companies during each of the last two years have had more than $1 billion available for investments, versus less than $50 million in 1977.

At federal, state, and city levels, government agencies have in recent years begun taking a direct hand in making loans and management assistance available to small companies. Prior to the Reagan Administration, federal loan programs for small businesses had grown by billions of dollars. Some of those programs have been cut back or eliminated, but the overall scope of the programs is still greater than it was a decade ago. The Reagan Administration has also continued and upgraded educational and consulting programs funded by the Small Business Administration and Commerce Department through business departments of universities around the country. More than half the states now have financing, managerial assistance, procurement, or ombudsman-information programs specifically designed for small business owners. Nearly all of the nation's 50 largest cities have economic and financial specialists trained to put together private and public financing programs for smaller companies.

Effects of Technology and Economics

The plummeting costs of computers in recent years—which is fueling a worldwide technological revolution—has made possible the formation of new businesses that possess sophisticated modeling and records systems. For only a few thousand dollars, entrepreneurs can obtain computer systems that not too many years ago cost hundreds of thousands of dollars. The owners can then do sophisticated financial projections to understand the effects of changes in prices and costs as well as set up efficient accounting, payroll, inventory, and other systems. The effect of all this is to enable new businesses to plan more effectively and to operate more efficiently at an earlier stage and a lower cost than was ever before possible.

The current technological revolution also means that small companies now have access to important marketing information that was once the domain of large companies. For relatively nominal fees, small companies can plug into extensive computerized data banks and learn about complex demographic, competitive, and other trends they might otherwise be unaware of.

Finally, the sluggish, recessionary economy of recent years has helped spur interest in entrepreneurship. The well-publicized financial difficulties of many of the nation's largest corporations—and the layoffs that have resulted—have shaken people's confidence in the prospects of big business. Probably those most shaken are individuals who have lost their jobs. Being in business for themselves, with its accompanying sense of independence, is suddenly an attractive notion for at least some of these people.

The fact that the economy is moving away from manufacturing and toward services is also a boon to entrepreneurship. Because they require little or nothing in the way of equipment and inventory, service businesses can usually be started with much smaller financial investments than manufacturing businesses. They can also most quickly and easily make use of the low-cost computers now available.

In addition, owning your own business stands out as one of the last remaining investment opportunities with the real possibility of yielding returns far in excess of the inflation rate. Common stocks, collectibles, precious metals, and even single-family homes, by contrast, have mostly been disappointing investments over the last few years. Various commercial loan sources, among them insurance and factoring companies, have signaled their recognition of the economic importance of small businesses by significantly increasing the amounts they loan to small companies.

Managerial Lessons

If nothing else, the new attention being paid to small business management has taught us, in the words of an article in this volume by John A. Welsh and Jerry F. White, that "A Small Business Is Not a Little Big Business." That is, successfully starting and running a small business is not simply a matter of adapting principles developed over the years in the areas of finance, marketing, organizational behavior, and production-manufacturing and applying them on a smaller scale to new ventures.

Young companies are usually not in a position, if they need financing, to tap the public marketplace. Or if they want to develop a new product, they can't simply commission extensive market surveys, complete with focus groups and hundreds of individual interviews, to try the idea out. Similarly, small companies typically do not have extensive personnel departments to test the latest human-resource management techniques; nor can they offer fancy benefits to lure and keep employees.

Small companies don't implement all the options available to large corporations mainly because they can't afford such approaches. But that isn't the only reason. The argument can also be made, and indeed is made in many of the articles in this volume, that small companies face issues sufficiently different in nature from those confronting large corporations as to require quite different managerial approaches. In addition, even when the issues small and large companies face are the same, there is the question of whether small ventures aren't perhaps better off exploiting certain special attributes that their size allows them.

No occurrence is more unique in the business world than a new venture start-up. The birth of a new business requires generous amounts of creativity, energy, and money. It can be argued that large companies go through a similar process when they launch new products or start new divisions; certainly the creativity and energy required are at least somewhat similar. But in large companies, there is usually more than an ample amount of money to carry the new product or division comfortably for several years to test its profit potential. The financial risk to the corporate managers involved is much less than for entrepreneurs; corporate managers risk their jobs while entrepreneurs often risk all they own.

It's important to keep in mind, though, as several of the authors in the first section of this book remind us, that starting a new business is more than a matter of obtaining adequate financing. It is a matter of entrepreneurs objectively assessing their own business expertise, their personal aspirations, their partners' strengths and weaknesses, and broad-based marketing trends.

Equally important for entrepreneurs to keep in mind is that either starting out in business or diversifying an existing business doesn't have to be done from scratch. There is always the acquisition route. Several articles in the first section make that point, suggesting that acquisitions have some advantages over starting from scratch—notably, evidence of market interest and an existing organization. For entrepreneurs confident of their managerial and financial analysis abilities, the acquisition approach offers the prospect of reaching a profitable stage more quickly than via starting a new business.

Growth and Maturation

Just because a business makes it beyond the precarious start-up or acquisition stage doesn't mean that its problems are over. Indeed, the effects of the personal, partnership, and market planning done in the initial stages become increasingly apparent. Entrepreneurs who haven't done the hard analysis of their own goals as well as those of their partners invite the kind of difficulties Derek du Toit so graphically describes in "Confessions of a Successful Entrepreneur."

While the dream of most entrepreneurs when they start out is to have an avalanche of orders pour in, skyrocketing growth can create as many problems as not having enough business. The small business unprepared for fast growth can find itself unable to keep up with the financial demands of marketing products before being paid for them. There are also the problems of finding the right managers to handle the new responsibilities constantly arising in a fast-growth situation. And there are always big corporations on the prowl for new opportunities carved out and tested by enterprising small companies.

As a number of authors in this volume point out, though, small companies have certain advantages over large companies for coping with the problems of motivating employees and keeping up with changes in the marketplace. Perhaps the most significant advantage for dealing with both sets of challenges is a function of size—because the companies are small the owners can more easily identify problems and opportunities.

The advantages of size aren't always readily apparent to entrepreneurs. Probably the most frequent and vocal complaint of owners of small businesses is that nobody seems to want to work any more. Subordinates seem not to care as much about the quality of their work as they once did, the owners claim. Employees are too easily enticed to job-hop, it's argued.

The complaint is understandable. In many small companies, labor costs are the largest single expense. Moreover, the quality of people is directly related to the quality of the product or service that the company is ultimately able to produce. In other words, employee care and motivation can make or break a small company. (Probably more than in large companies, which have well-established marketplace reputations and are often extensively automated.)

Despite the recessionary economy, the competition for effective and loyal employees is quite keen among many small companies. In the area of high-technology, for instance, electrical engineers and managers with technological expertise are chronically in short supply. Similarly, the many new service businesses springing up frequently require specialized sales and service people to help ensure success.

But, as both Lore Harp in "The Entrepreneur Sees Herself as Manager" and Thomas Melohn in "How to Build Employee Trust and Productivity" suggest, the problem is far from hopeless. By virtue of their size, small companies can take certain steps to stimulate employee involvement that large corporations are unable to try. For instance, owners of small companies can be out on the plant floor, inquiring into workers' frustrations and inviting suggestions for improving productivity. Small companies can also retain the trappings of informality, such as flexible hours, casual dress, and few lines of authority, that many employees welcome and thrive on.

Small companies often can't provide the sophisticated profit sharing and comprehensive insurance programs of large corporations, but they can give employees tangible benefits unavailable elsewhere. For instance, small companies are able to reward employees who come up with productivity-improving ideas with immediate bonuses. And owners can provide detailed and realistic employee evaluations that workers appreciate, and which large companies typically can't or won't supply. That allows employees who are doing well to obtain feedback, and raises, based on performance.

In the area of marketing, too, small companies have more advantages than owners often realize. There's a tendency by owners to assume that corporations, by virtue of their financial resources, can do all the sophisticated research necessary to make effective marketing decisions. What owners forget is that large corporations are lumbering giants, with burdensome bureaucracies. True, they can and usually do carry out extensive marketing research before launching a new product, but they tend to spend much time evaluating their research and hemming-and-hawing before making a final decision.

Owners of small companies, for one thing, are usually much more aware of changes taking place in the marketplace than senior executives of large companies. The owners are talking to customers, visiting trade shows, and doing all the other tasks that, mundane as they might seem, keep the entrepreneurs in touch with marketing trends. Corporate executives must usually rely on reports of underlings for such on-the-spot assessments, and those secondhand reports may be inaccurate or out of date, if they come at all.

Once they note significant trends, small business owners can quickly start implementing fundamental changes to adapt. The changes might involve altering product design, using new distribution channels, or trying alternative methods of promotion. The changes might even be more fundamental—introducing new products or withdrawing existing ones. Whatever the changes are, though, smaller companies can usually not only see the need for the changes, but make them more quickly than their corporate counterparts.

Financial Considerations

Anyone who reads the financial press on a regular basis—including *The Wall Street Journal, Business Week,* and *Forbes*—can easily come to believe that any company's main financial yardstick is its year-end profit and the change from the prior year.

What's wrong with using profitability as the main criteria of financial health? Nothing, as long as that criteria is applied to well-established large companies. But using profitability to measure a young growing business's financial health can be misleading, and even dangerous, as John A. Welsh and Jerry F. White argue so persuasively in their article, "A Small Business Is Not a Little Big Business."

For small companies, especially if they are fairly new and fast growing, a more important consideration than profitability is cash flow. Because they rarely have the financial reserves or easily salable assets of large corporations, small companies tend to be operating very much on a hand-to-mouth basis. Business may appear to be great, with tremendous profits off in the distance. But the immediate concerns are to meet the payroll, pay for raw materials, buy new equipment to keep up with the orders, and so forth. Coming up with the cash—despite the promise of eventual high profits—can be difficult, especially for companies that have underestimated their financial needs or have fallen behind in their collection of receivables.

Owners of small companies, then, must devote much attention to anticipating their cash flow situations, planning at least a year ahead. They must also, at least in the early years, seek to temper their worries about profitability. In too many cases, companies within sight of profitability fail for lack of cash.

Another easy trap for entrepreneurs to fall into is to leave management of their financial statements entirely in the hands of their accountants. Business owners do that because, more often than not, they have primarily marketing or engineering backgrounds instead of financial backgrounds and are easily intimidated by the financial technicalities of management.

But, as several authors, including James McNeill Stancill in "Managing Financial Statements—Image and Effect" and Neil Churchill in "Don't Let Inflation Get the Best of You", suggest, a company's financial statements and results serve a larger purpose than merely satisfying the Internal Revenue Service. They are also used to plan growth, and to convince bankers, potential investors, and possible acquirers to get involved with the company. To sophisticated financial types, a company's operating statements and the ratios that are derived from them convey important messages.

Moreover, the authors point out, entrepreneurs can exert control over how these statements are presented. In some cases, the timing of purchases and collections, and the labeling of various transactions can affect the statements. In addition, owners must decide whether they are primarily concerned with minimizing taxes or maximizing performance; the decision can have a significant effect on the statements. The key point, though, is that entrepreneurs have more control than they may realize over the outcome and presentation of their financial results.

Using Outsiders

The advent of new resources for small businesses has important implications beyond what it says about the popularity of entrepreneurship. Traditionally, an important difference between large and small businesses has been the availability of resources. When senior executives in Fortune 500 companies need specialized expertise about a new approach to financial planning or data on competitors, they can call on various experts within their companies who either have the answers or will find them very quickly. Small businesses, of course, tend not to have anything approaching that array of internal resources.

The new small business resources make available to young companies managerial expertise that corporations once had a monopoly on. The effect is to make small companies potentially more competitive with their larger counterparts.

The availability of new financing resources has a similar effect. Whereas public companies can always seek to raise funds in the public bond and stock markets, private businesses have traditionally been almost entirely dependent on banks for loans. In recent years, though, small businesses have increasingly been able to tap into venture capital, federal and state financing programs, and various commercial lending options. Once again, the effect is presenting small businesses with additional options that can help make them more competitive.

Making use of the new array of outside resources is, for many entrepreneurs, easier said than done. For one thing, business owners tend to be an independent bunch, not easily given to admitting they need assistance of any sort. After all, they've usually started their businesses from scratch, often ignoring the advice of friends and relatives who argued that the odds were hopeless. When one swims against such a tide for very long, one understandably becomes wary of outsiders.

Business owners also have a tendency, when they do seek outside assistance, of going to extremes—either they hand over total responsibility for the task at hand, or they hand over very little real responsibility. When they deal with accountants and bankers, for instance, owners may let themselves be intimidated, as several authors in this volume suggest. Figuring they have nothing worthwhile to add to decisions, owners tend to place total authority for their financial statements in the hands of their accountants. Similarly, owners view bankers as people in a position to extend favors, rather than seeing themselves as customers in a position to make choices and demands.

Yet when it comes to making use of the expertise of outside directors, owners tend to be much more reticent about supplying information and incorporating the advice they receive. In this case, say authors of articles in this book, entrepreneurs appear to be wary of possible encroachments on their authority.

Whoever the outsiders are, suggest the authors, owners must seek to keep the relationships flexible and open. The outsiders obviously have specialized expertise, and the owners have broad business experience. Each group can learn from the other; the relationships appear to work best when approached from this perspective.

The Planning Challenge

Given all the tasks and opportunities previously discussed, it's not difficult to appreciate why busines owners typically fail to do much personal or business planning. There are simply too many fires to put out to keep the business surviving and prospering for the time being. Who's got time to look a few years down the road? And even if owners have the time, how can they anticipate the future?

While those are certainly legitimate obstacles to planning, they probably should be viewed as merely symptoms of deeper inhibitions. As the article, "Coping with Entrepreneurial Stress," suggests, business ownership is one of the most satisfying career experiences available in American life, providing both substantial psychological and financial rewards to those who succeed. It's so enjoyable, in fact, that owners tend to ignore or simply accept extremely high levels of stress. Their acceptance of the future health dangers associated with stress, and their simultaneous avoidance of planning ahead, are understandable; since running a company is so much fun, why risk rocking the boat by being introspective?

Planning, of course, involves not only being introspective, but confronting possibly unpleasant issues. Foremost among these unpleasant issues are the owner's mortality and the business's future without the owner in charge. Even for owners who are young, planning frequently involves such potentially painful issues as delegating authority, resolving conflicts with partners, and phasing out old products in favor of new ones. And young owners who do a thorough job of planning do indeed consider such mortality-related issues as estate planning and selling the company.

The issue of divesting the company, in particular, is one of the most wrenching that the owner will ever confront. On the one hand, many owners fantasize about the day they can cash in their chips, as it were, and pursue unrelated business or nonbusiness interests. The day-to-day pressure of putting out fires would be gone, replaced by a more tranquil existence, they imagine. Yet, as Michael Berolzheimer in "The Financial and Emotional Sides of Selling Your Company" and Donald Grisanti in "The Agony of Selling Out to Relatives" so graphically describe, the experience of separating oneself from the company is extremely painful emotionally, even if one has made a mental commitment to do it.