



EASY

business

The Easy Route to
Business Management



Study Manual

**European Business
Competence* Licence**

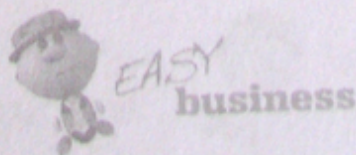
EBC*L Level B - Part 1

Business Plan
Marketing
Sales



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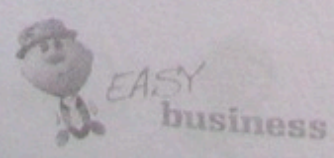
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Introduction

Thorough economic planning should be part of everyone's business life as well as private life. Someone who does not have a 'business plan' is likely to face serious consequences that may go as far as private bankruptcy.

A person who is competent in 'business planning', however, will certainly do better in his job, can look forward to a brighter career and will enjoy a more successful life. This is our promise.

The target group of this book includes all those people who do something that has commercial or economic consequences – no matter whether they set up an enterprise or organise a party for their club. For any of these business activities, a business plan should be drawn up.

Members of our target group are:

- ➔ entrepreneurs and business managers
- ➔ company founders / promoters
- ➔ heads of company divisions and departments, and
- ➔ key employees with planning competence.

Thus this book is different from most other books on 'business plans', which focus almost exclusively on newly-founded enterprises.

Focused preparation for the EBC*L Level B exam

Naturally, the target group also includes those people who want to prepare themselves for the EBC*L exam. For them this book will certainly be of great help.

This book is structured in line with the Catalogue of Learning Objectives of EBC*L Level B. Its centrepiece is the 'business plan' and its wide range of planning and analytical instruments. Once you have studied the book thoroughly, you will be skilled enough to draw up suitable business plans and know how to present convincing (sales) arguments.

In addition – after working through the EBC*L books Levels A and B – you will be familiar with the majority of all commonly-used business terms. In other words, our books may be your stepping stone into your new career or the foundation of your new enterprise.

You may want to look into the English version of www.wikipedia.org for additional information.



Didactic structure

In order to provide practical and clear insight into the entire process of business planning, this book uses a concrete case study: the 'Bossi Pizzeria', a restaurant that is operated by Mr and Mrs Bossi. This case study is used to demonstrate

- *that it can be lethal to run an enterprise without thorough business planning*
- *how a business plan is drawn up for a special project (= realisation of a new business idea).*

The 'Bossi Pizzeria' case provides important practical reference and is easy to understand. The story about the Bossis is highly realistic and told in a lively style, and the readers may actually sympathise with the characters when they get into trouble. Furthermore this case may offer guidelines for enterprises in their start-up phase, for existing firms and for any projects that need to be realized.

Layout

► *Layout*

- The Bossi case study is printed in *italics* for easier identification.
- On the page margins, you find references to the topic at hand, references to examples and other notes.

Additional measures taken to facilitate comprehension

- In general, this book uses the universal 'he' exclusively for the sake of simplicity and easier comprehension. To compensate for this, a woman (Mrs Bossi) is actually the main character of the Bossi case study.
- Companies trade in goods and services. In this book the expression 'product' is often used as a synonym for anything a company has on offer.

Tips on how to use this book

Please use this book as intended: it is your personal study guide in which you may highlight and underline text elements as you like.

For people with basic knowledge of business administration, this book will be sufficient for their EBC*L exam preparation. For everyone else, attending a course at an accredited EBC*L educational institute is recommended.

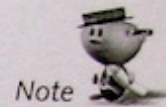
For further information please refer to

www.ebcl.eu

and

www.easybusiness.at

We wish you all the best for your EBC*L exam preparation and for your professional career.



Note

GOALS, METHODS AND INSTRUMENTS OF BUSINESS PLAN DESIGN



General Learning Objectives

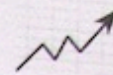
- ▶ *Being able to explain the goals, contents and structure of a business plan*
- ▶ *Being able to explain analytical and planning instruments of business management and give examples of how they are applied*

1. 1. Basics of Business Plan Design

Learning targets:

- Being able to explain the goals of a business plan and identify occasions and situations for which business plans need to be designed
- Being able to identify potential business plan users, their interests and goals
- Being able to explain questions and issues that arise and explain the fundamental structure and design of a business plan
- Being able to explain the criteria which decision makers use in assessing business plans, the rules to be followed and the potential mistakes made in business plan design.
- Being able to explain the term 'critical success factors'
- Being able to explain how to draw up a clear and attractive business plan
- Being able to explain the difficulties in and limits to entrepreneurial planning

Learning targets

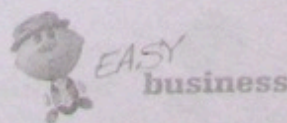


1. 1. 1. WHAT IS A BUSINESS PLAN GOOD FOR?

In order to provide practical and clear insight into the entire process of business planning, this book uses a concrete case study: the 'Bossi Pizzeria'. The story is supplemented by the business project 'Bossi's Pink Sauces' which will be followed throughout our book (*and is printed in italics for easier identification*).

Bossi Pizzeria: What went wrong?

Bossi Pizzeria has been a well-established enterprise in its area for ten years. After the usual start-up difficulties, it has always been in the black, which makes its owner, Mr Bossi, incredibly proud. He knows that in the restaurant and catering industry, restaurants come and go. Many hopeful owners find themselves in bankruptcy in no time and all they leave behind is piles of debt. So far, Mr Bossi has made fun of his unsuccessful counterparts, and he is convinced that such a thing will never happen to him, now that he has been in the business for all these years.



He is all the more shell-shocked when his tax advisor calls him to tell him the bad news: Bossi Pizzeria has suffered a substantial loss over the past year.

Mr Bossi refuses to believe this and is enraged: "This is not possible – how on earth could we have produced a loss? We have always managed to pay our bills and there was even enough money left for me to buy a new company car."

The tax advisor tries to explain to Mr Bossi that while all that may have looked quite pleasing, it was simply the result of a positive cash flow that was generated. The truth is, though, that the company is making losses and that its business future is highly uncertain. As impulsive Mr Bossi doesn't know what to do with this information, they make an appointment. His tax advisor intends to offer a detailed explanation in all peace and quiet – if this is possible, given Mr Bossi's state of mind.

At their meeting, the tax advisor points out that there have been indications of the firm's poor financial results. Mr Bossi has apparently failed to notice that his business has been heading south for some time.

In an intense, four-hour talk, the tax advisor makes clear that the situation of Mr Bossi's enterprise is far from rosy. Because of the recent loss, the firm's income-to-equity ratio has turned negative and its liquidity is in jeopardy. In fact, a liquidity squeeze is imminent. The open invoices, including the open instalments for the company car that was bought a year ago, can probably not be paid without external financial support. This means that Mr Bossi will most likely have to apply for a loan with his bank. In view of the firm's meagre 15 percent equity ratio, it is highly questionable, however, whether the bank will grant this loan.

After the meeting, Mr Bossi is totally desperate and a picture of misery. "What am I supposed to do now? Should I close down my business right away? How will my wife and my loyal employees react?"

At this point, the tax advisor feels that Mr Bossi needs some reassurance. Her analysis may have been a bit too drastic – and she certainly doesn't want to lose her client. She therefore points to some of the firm's positive features: the beautiful restaurant and its favourable location, many regular customers, its friendly personnel, and more.

It is time, though, to reconsider what formerly was a set of appropriate business ideas but is somewhat obsolete now. Mr Bossi would be well-advised to spend a number of days working on the design of a new business concept and draw up a business plan for his enterprise. In doing so, he should not shy away from tackling basic questions, such as:

- ➔ Do guests still want to eat pizza these days? Will they perhaps soon prefer the lighter Asian cuisine?
- ➔ Do people still like eating out, or do they prefer eating at home?
- ➔ Is the number of regular customers rising or declining?
- ➔ Is there anything the competition does better?
- ➔ Can the employees live up to the customers' new expectations? Have they had proper training?
- ➔ Are there any ideas of how to make the firm's product portfolio more attractive?
- ➔ Are sufficient funds available for the necessary investments?
- ➔ and many more.

Answers to these questions may clarify where Mr Bossi's journey will take him and show his employees what lies ahead and what needs to be accomplished.

Ultimately, Mr Bossi will need a sound business plan to convince his bank to grant him the loan he needs.

"Business plan? I've heard about business plans," Mr Bossi mumbles to himself. He has always tried to avoid all the issues of business administration but must now admit to himself that he can no longer do without them.

The tax advisor hands Mr Bossi a list of questions (which happens to resemble the list of learning targets of EBC*L Level B) and instructs him not to waste any time now. She advises him to neglect his day-to-day business for the time being and work through the questions in detail.

1. 1. 2. WHO NEEDS A BUSINESS PLAN? WHO ARE ITS POTENTIAL USERS?

The story above clearly shows how important it is to know your 'business itinerary', i.e. to have a business plan. Enterprises that don't have one have no future either. Business plans are drawn up for the following occasions:

➤ *Business plan: goals, occasions and users*

Setting up an enterprise

Very often banks are addressed by optimistic business promoters who apply for a loan but have nothing but a business idea and cannot answer any of the questions the credit expert usually asks at the interview, which may include:

- ➔ Are there really enough potential customers for the product?
- ➔ If so, how can potential customers' attention be attracted?
- ➔ Has anyone else had the same idea but benefited from more advantageous conditions, such as more funds and / or experience?
- ➔ How much will it cost to make the idea into a reality?
- ➔ Costs arise almost instantly. At what point, however, can revenues be expected?
- ➔ What happens if things don't proceed as planned? How easily can various setbacks be coped with?

When a business is established, the potential users of a business plan are:

- ➔ the business promoters themselves
- ➔ banks that have been approached for a loan
- ➔ investors who need to be convinced that the business is a promising investment opportunity
- ➔ public funding authorities

Looking for creditors' funds or owners' funds (= equity capital)

Mr Bossi will have no other chance but to address his bank and try to convince it to grant his business a bridging loan. The bank, however, won't be prepared to do so unless it can expect the debtor to repay the loan and pay interest. For that reason, banks more and more frequently want to see solid business plans in addition to the usual collateral. Such business plans should offer a detailed business outlook that includes information about:

- industry trends and market changes
- the competition
- marketing plans
- financial planning
- production and personnel capacities
- and more.

Business plans are also required if a loan is not needed to solve a liquidity crisis but if new investments are intended to be financed. If a firm wants to invest in a new product, a new procedure or a new country, it will have to prove that these investments may actually pay off, i.e. that the venture will yield more than it costs.

Of course a solid business plan also serves the purpose of convincing investors to put their money into the enterprise and thus to strengthen its capital base.

Applying for national and international funding

Many inexperienced small enterprises have been unpleasantly surprised when they tried to collect 'quick money' through national funding or E.U. grants. In order to become eligible for such a grant, an enterprise must work out a detailed business plan, in which it has to outline that the tax money it has applied for will leave a lasting imprint.

When a business applies for public funding, it frequently competes with hundreds of other enterprises and institutions which want to be financially supported as well. The ones most likely to succeed are those which can submit the best business plans and, in particular, meet the key criteria of the funding authority.

Financing intra-company ideas and projects

When employees of large enterprises in the past thought they had a good idea, they first presented it – in most cases verbally – to their superior. The latter either looked into it personally or passed on the idea to the company's operations research unit. That meant little mental work for those who had come up with the idea but also greatly reduced their influence on whether the idea would be followed up on.

Today the situation in many firms is different. If someone has a project (idea) which he wants to realize, it is he who has to design a business plan that gives his superior sufficient background on which to base his decision. The business plan has to outline the goals of the idea or project and must carefully weigh its benefits against likely costs.

Such a project need not be a revolutionary innovation but may very well be of small dimension, such as a company presentation at a fair, the organizing of a customer event, the purchase of a new computer or software system, or renting a new office.

Users of such business plans are ultimately corporate financial planners who are in charge of providing the funds for the project. They may be the immediate superiors of the visionary employee or decision makers at the group's headquarters thousands of miles away.

Whoever presents the most solid and positive cost-benefit-analysis is the person likely to beat his intra-company competitors (other employees with their own project ideas) to a share of funds from the company's tight budget.



A new oven? Rejected!

Mr Salt, the cook of Bossi Pizzeria, has been struggling with an oven that is no longer state-of-the-art for quite some time. Because of its restricted capacity, guests must wait endlessly for their pizzas at peak times. In addition, its defective electronic system requires almost constant maintenance service. By the time a repair person comes by and takes care of the problem, an entire day may have passed. During this time, of course, no pizzas can be made. After this happens once more, the cook has had enough and asks Mr Bossi to invest in a new oven. Mr Bossi, however, has his own problems and couldn't care less: "What do you want? Look, it's working again. Besides, aren't you a master of improvisation?"

Once again, Mr Bossi has succeeded in taking the wind out of Mr Salt's sails.

If Mr Salt had been able to present tangible figures of the detriment caused by the oven's frequent failures, he may have had much better chances of being heard.

Financing private projects

As most people don't have abundant funds, they should think about drawing up a business plan for major private projects that cost money or could produce income. Better still: they should have one on paper because even private individuals must follow a basic economic principle: It's the efficiency rule, which says that you should generate the maximum output with the given input.

Mrs Pepper's house in the country: A pipe dream?

Mrs Pepper, the waitress, has been dreaming about a house in the country for ages. There is too much noise and too little space in their city apartment. Besides, the rent is exorbitantly high. After years of looking, she has finally found the house of her dreams. All she needs to do now is convince her husband. She wants to do precisely that during a nice dinner. What she accomplishes, though, is exactly the opposite and the evening ends in disharmony. "Do you know what this will cost us? How can we afford it? Are you crazy? Our apartment gives us everything we need." Her husband's reaction couldn't have been more discouraging.

Without well-prepared answers to her husband's questions Mrs Pepper will find it difficult to make the house of her dreams real.



1. 1. 3. GOALS OF OPERATIONAL / BUSINESS PLANNING

Success can be planned

Having a plan greatly enhances a person's chances of accomplishing his goals. This is true for any private individual and for any business organisation as well. The private individual, however, has a significant advantage in that he can more easily oversee his personal circumstances. An enterprise, regardless of whether it is a small business or a group of companies, operates in a highly complex environment and is exposed to a variety of external forces. It must therefore be more flexible than ever in its response to changes and new challenges.

For that reason, a business plan must always be examined critically. It is advisable to review it at least once every quarter to make sure the company is still on track and has not deviated from it.

In view of incredibly fast developments which businesses are exposed to – globalization is just one of the buzzwords – also the general goals of a business plan need to be questioned regularly (at least once a year).

Realize projects that make sense – stop those that don't

Frequently ideas that are doomed to fail from the very beginning are put into practice. Valuable energy is wasted, financial disasters are pre-programmed and, in the worst case, the enterprise is pushed out of business. Personal hardships such as job losses and health and family problems often result for the individuals involved.

This is only one side of the scenario, though, and the damage that is created because many brilliant ideas are not put into practice is probably much greater. Opportunities are wasted because a number of ideas are not documented in writing and fall into oblivion as quickly as they popped up.

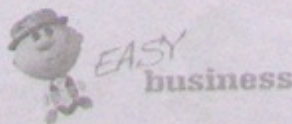
Yet it would be quite easy to draw up an initial business plan which can show whether to continue working on a project makes sense or whether the idea should be abandoned.

Select the best alternative

Wishes and brilliant ideas are legion, but nobody in the world has access to unlimited resources. Most people lack money, some don't have enough time, and thus people again and again have to choose between alternative decisions. Here a business plan can serve people well and provide them with information that is crucial for making business decisions which generate the maximum output with the given input.

Inform and convince investors

In order to realize most projects, third parties need to be convinced to make the necessary means available. They won't be prepared to do so, however, unless they are sure that it is sensible to invest their money and / or time. A well-designed business plan has a far better chance to convince a bank, a superior, your husband or your wife than a verbal plea, no matter how much effort and charm you put into it.



1. 1. 4. STRUCTURE OF A BUSINESS PLAN

➤ *Structure and design of a business plan*

There is no generally accepted rule of how to structure a business plan, but frequently business plans consist of the following items:

- ➔ Executive summary (short summary of the project)
- ➔ Starting position / Actual analysis (of enterprise, business environment, business team)
- ➔ Marketing plan
- ➔ Project plan
- ➔ Investment analysis and assessment of economic efficiency
- ➔ Financial plan
- ➔ Appendix / Notes to the business plan

Executive summary

➤ *Executive summary*

Decision makers often have little time and, secondly, too little interest to be bothered with details. They want to receive a quick overview, which is their first criterion in deciding whether to deal with the project personally or delegate it to others.

This highly important part of the business plan determines the direction of what follows, even though it should not be longer than one or two pages. This may frustrate the author of a comprehensive business plan which comprises perhaps more than one hundred pages ("What did I go through all that trouble for?").

➤ *Critical success factors*

Still, the people who make the decisions have designed many business plans themselves and have accepted or rejected dozens if not hundreds of others. They know precisely what the one to two pages of a business plan must hold and which factors determine the success or failure of a project. In most cases these are not highly sophisticated issues but simple business-related questions in connection with the target group, the market situation or the planned costs:

Example



- ➔ *Are you sure that there are people who would actually spend money on that? I wouldn't pay you anything for it.*
- ➔ *What do you intend to do if the market leader considers you an unwelcome rival and uses an aggressive pricing policy to push you out of the market before you have even started?*

- ➔ *Are there any alternatives that are more economical and could lead to nearly the same results?*

This list could be continued endlessly and complemented with issues on pricing policy, personnel and production capacity, channels of distribution, business location and many more.

These factors are referred to as **critical success factors** and include those crucial elements which have a particular influence on the success or failure of an enterprise. For that reason, one must be familiar with them and be prepared to answer questions which are almost always asked when a business plan is presented.

Starting position / Actual analysis (of enterprise, business environment, business team)

Only a person who knows about his present position can set realistic goals and take appropriate steps to realize them. This is why any business plan needs to start from a solid actual analysis.

The business organisation itself and the business team need to be examined thoroughly. Accounting statements such as the balance sheet and the profit and loss account as well as cost accounting results provide the necessary data for the analysis. From these documents you can derive important figures and draw conclusions about which products have generated the highest sales or which contribution margin can be expected.

Still, you need to look beyond your nose as well. It is not just your own enterprise, the department and the project that must be analysed, but also the business environment in which the enterprise operates (including the competition, the legal framework and predictions of future trends) requires scrutiny.

Marketing plan

Eventually projects must also be marketed, so that they reach the customer and contribute their share to the success of the business organisation. A thorough marketing plan ought to take care of the following items in detail:

- ➔ consider the needs of the customers
- ➔ design a product suitable to meet those needs
- ➔ work out a pricing strategy / figure out the associated costs

- communicate the project, i.e. develop a strategy that makes the customers accept the project

Project plan

Realizing a project needs detailed planning of time and the necessary resources. A project plan must present and explain the major project stages as milestones and must not ignore possible restraining factors.

Investment analysis and assessment of economic efficiency

A project should always yield more than it costs. It should be profitable. It is the task of an investment analysis and / or an assessment of economic efficiency to demonstrate just that.

Methods include a number of different procedures, which range from the simple static calculation of the break-even point to the construction of sophisticated dynamic models by means of the calculus of probability.

Financial plan

The best ideas and the most profitable investments cannot be realized if the enterprise cannot afford them. It happens quite often that a firm runs out of financial means and has to step on the brake when it is only half way through a project. It is therefore crucial to determine whether or not there will be sufficient funding for the project.

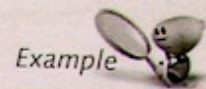
Appendix / Notes to the business plan

In order to keep the core of a business plan concise, additional information should be added in an appendix.

Examples of the basic structure of a business plan

The table below shows you in cue words how a business plan for the following projects can be put together:

- establishing an enterprise
- bridging loan for an existing enterprise
- company-internal project



	Establishing an enterprise	Bridging loan for an existing enterprise	Company-internal project
Executive summary	<p>Great idea. We are the first and only ones in the market to offer the product. Conditions couldn't be more perfect.</p> <p>Will be in the black in three years at the latest.</p>	<p>The enterprise that has been successful for years is facing difficulties because of the unexpected bankruptcy of a major customer.</p> <p>Will be profitable again in two years at the latest.</p> <p>Half of the loan can be secured by collateral.</p>	<p>Because of higher capacity and better quality, the new machine will eliminate the supply shortage which has already cost us many customers.</p> <p>The investment will pay off in 24 months at the latest.</p>
Actual analysis	<p>The entire industry is suffering from ...</p> <p>In the course of working on ...the idea of how to solve this problem came up.</p> <p>Competing products cannot be expected to be offered any time soon. Requirements are met because of years of experience in the business.</p> <p>My partner has the necessary skills in business administration.</p>	<p>The enterprise has been producing high-quality merchandise for fifteen years. Most of its products are at the beginning of their life cycle.</p> <p>The firm has been able to build a considerable customer base and secure a 20% market share in an expanding market. The personnel is well-trained and highly motivated. The management has excellent international business contacts and has the necessary experience in entering new countries.</p>	<p>The old machine does not have the necessary capacity to meet orders in time.</p> <p>In addition, its high failure rate results in full-day production losses.</p> <p>In such cases, workers are idle and must be paid expensive overtime at a later point in order to compensate.</p>

	Establishing an enterprise	Bridging loan for an existing enterprise	Company-internal project
Marketing plan	<p>As the product may help enterprises save hundreds of thousands of euros, demand for it is huge.</p> <p>It is an innovative product that requires quite some know-how and it will not be easy for possible competitors to imitate it.</p> <p>It will therefore be possible to apply a skimming pricing policy, i.e. to sell the product at a high price.</p> <p>Distribution will be to customers directly.</p> <p>The target group will be addressed by PR articles in special magazines and direct mailings.</p>	<p>Demand for ... is secured for years to come.</p> <p>Market potential is particularly high in the following countries: ...</p> <p>The products are regularly adapted to customer requirements.</p> <p>A skimming pricing policy can be maintained because of the outstanding quality.</p> <p>Effective distribution is guaranteed because of our business partners' excellent contacts with customers.</p>	<p>There is no doubt that there will be sufficient demand for the larger number of items that can be produced as a result of higher capacity. We can expect prices to remain stable, and our sales team can finally guarantee our customers supply of the desired quantity.</p> <p>Customer satisfaction and loyalty will thus further increase.</p>
Project plan	<p>The planning phase will be completed in two months, at which point realization of the project will start.</p> <p>The following four stages are the milestones of the project: ...</p> <p>Interim results can be expected on the following dates: ...</p> <p>Completion of the project is scheduled for ...</p>	<p>Once the bridging loan has been granted, our company will instantly address and move into the target markets ...</p> <p>Our first investment returns can be expected at the following time: ...</p>	<p>As delivery can be effected in four months at the earliest, the new machine should be ordered instantly. Putting it into operation will take one month. (For this procedure) workers with the following qualifications are needed: ...</p> <p>After one additional month at most, trial operation may start.</p> <p>The machine will be fully operational after six months from the date of order.</p>

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Appendix

	Establishing an enterprise	Bridging loan for an existing enterprise	Company-internal project
Investment analysis and assessment of economic efficiency	<p>Annual fixed costs are ...</p> <p>Variable costs will be ...</p> <p>The price of the product will be ...</p> <p>The break-even point will be reached at ... units.</p>	<p>The loan amounting to ... would secure the existence of the firm for years to come.</p> <p>If the loan is not granted, insolvency of the business cannot be ruled out. In this case, the bank would lose part of the current investment credit amounting to ... as well as a client who could bring lucrative future business (in the form of export transactions, for example).</p>	<p>Acquisition costs for the equipment amount to ... euros.</p> <p>Higher capacity would raise output by ... units. In addition, variable costs can be lowered by 20%. Repair and maintenance costs can be reduced by 40%.</p> <p>This means that the investment will pay off in 24 months at the latest.</p>
Financial plan	<p>For starting the business, the following investments amounting to ... are required.</p> <p>We have equity capital amounting to ...</p> <p>We need a loan of ...</p> <p>We will be profitable as early as in our third business year, in which we expect the rate of return to be ... percent.</p> <p>This figure will jump to ... percent in the fourth year.</p> <p>In year five we will be able to repay the entire loan.</p>	<p>Because of the additional loan, our current equity ratio of ... percent would temporarily drop to ... percent.</p> <p>Current expenditure can be covered by our cash flow.</p> <p>In 18 months at the latest we can start repayment of the loan.</p>	<p>We are aware that investment activity has been greatly reduced as a result of the financial situation of the enterprise.</p> <p>Because of the short amortization period, however, we expect the project to be feasible.</p>
Appendix	<p>Included in the appendix:</p> <ul style="list-style-type: none"> → CV → results of market analyses → data analyses → etc. 	<p>Included in the appendix:</p> <ul style="list-style-type: none"> → annual accounts of the most recent years → CVs of board members → customer lists → press reports 	<p>Included in the appendix:</p> <ul style="list-style-type: none"> → cases of malfunction / days of downtime over the past year → technical description of the new equipment → cost estimate

1. 1. 5. CRITERIA FOR ASSESSING A BUSINESS PLAN – SUCCESS FACTORS

As outlined above, you can distinguish between two basic users of a business plan:

- ➔ the person designing the business plan
- ➔ institutions and people whose commitment to provide financial or any other sort of support is sought; in other words, those to whom you have to sell the business plan

In order to convince the latter, you need to consider the following in advance:

- ➔ What are the goals of the institutions?
- ➔ What are the goals and needs of the decision-making individuals in those institutions?

Possible goals of the institutions:

➤ *Assessment criteria*

- ➔ Banks pursue two goals: Firstly, they want to offer loans to as many clients as possible so as to make a profit through interest income. Secondly, they have to make sure the money lent is not lost. In order to protect themselves, they demand that the borrowers secure their loans (through mortgages, guarantees, etc.) and they thoroughly examine the businesses to which they lend. The basis for such scrutiny is a business plan.
- ➔ The same is true for investors who are asked to put money into a business. They have to be convinced that the potential return on their investment justifies the risk and that a certain investment income in the form of interest or share in the profit can be expected.
- ➔ National and international funding authorities want the available tax money to be used most effectively so that economic and socio-political goals can be reached. In each case they want to make sure they can prove to the taxpayers that their money is administered properly and used wisely.
- ➔ Finally, management teams would like each and every project to make its contribution so that priority business goals such as profitability and liquidity are reached and safeguarded.

These goals must be evident throughout a business plan, and there must be continuous reference to how the project can contribute to accomplishing the goals.

Goals of individuals:

Outside observers often overlook that bankers, investors, civil servants and business executives are also human beings – even if they are business-oriented. Accordingly, they too often trust their gut feelings when they make decisions and are therefore influenced by:

- the trustworthiness of people who stand behind and present a business plan
- the professionalism with which a business plan is designed and structured
- the prestige and image which a project signals

Examples:

- *a banker who can pride himself on having facilitated the idea of the century or having saved an important community business and the jobs it provides*
- *a managing director who announces in a press release that under his leadership, business outlets in as many as ten new countries have been opened*
- *the head of a data processing department who is proud to tell the members of his team that their firm's IT system is the most sophisticated and user-friendly equipment in the entire region*



Examples

Those who manage to present business arguments convincingly and at the same time meet the individual requirements of the decision maker will have the highest chance to succeed.

Some individuals, however, are prejudiced because of some bad experience they had in the past. Business people, for example, often allege that technical engineers focus only on technically perfect solutions without paying any attention to the economic goals of a project.

It is therefore worthwhile to be aware of such prejudices and to make every effort to refute them with appropriate arguments in the business plan itself and in the course of its presentation.

Correctly used business terms, such as break-even point, contribution margin, etc., will certainly have a surprising and positive effect on the decision makers.

Emphasize benefits instead of features

Although the chapters "Marketing" and "Sales Management" will deal with this issue more thoroughly later on, one point should be mentioned at this early stage: It will always be the tangible benefits of a product or a project that lead to its purchase. A camera is not bought because it has eight mega pixels (= feature) but because the large number of pixels enable a person to take great pictures he can really enjoy (= benefit).

Accordingly, a business plan should use arguments that emphasize the benefits of a project.

Business plan design

Even if the basic structure of a business plan most frequently resembles the one introduced earlier on, there is no general norm that determines what business plans must look like. You are well-advised, however, to follow the structures that are familiar to the institutions to which you intend to apply. In doing so, you make it easier for decision makers to find their way through your business plan.

This means that before you address banks you may want to find out whether they have business plan forms that can simply be filled in. If you apply for public funding, this will most certainly be the case. Also enterprises often have models which the applicant is advised to follow when he designs his business plan.

The right length

As a rule, a two-page business plan will be too short and is likely to signal that you have not dealt with the subject matter thoroughly enough. On the other hand, if decision makers receive a volume of a hundred pages, they will be equally displeased because of the time pressure they are subject to.

In general, five to twenty-five pages, depending on the complexity and size of the project, should be sufficient to allow outsiders a good view into the matter.

criteria

The right language

It often happens that decision makers don't have the necessary technical background knowledge. If possible, difficult technical expressions and complicated details should therefore be left out or presented to the layman in a simple and comprehensible manner.

As mentioned above, correctly-used business expressions create a professional impression.

In addition, long compound sentences are to be avoided. They impede legibility and reduce the reader's desire to deal with the subject in greater detail.

Finally, spelling mistakes make an absolutely unfavourable impression and can be detrimental to a business plan that is otherwise of good quality. One should therefore use a spell-check computer program or the proofreading skills of a third party to eliminate all mistakes.

Realistic assumptions and correct figures

The purpose of a business plan is to accompany its designer and help him accomplish his goals. The underlying project must be described and presented in a neutral and realistic manner. The rules are

- to make only realistic assumptions; don't exaggerate
- to design a best-case / base-case / worst-case scenario, i.e. calculate the project on the basis of excellent, average and poor circumstances
- to check your calculations. Miscalculations are one of the killer arguments that can rule out any further favourable treatment of a business plan.

Visual stimuli

Charts, diagrams and pictures may help to present issues and relationships in a more comprehensible and attractive manner.

➤ *Business plan design: mistakes*

Reasons for rejection

There are various reasons behind the rejection of a business plan. The list is topped by:

- ➔ "being at the wrong place at the wrong moment"
- ➔ the project doesn't fit with the enterprise's strategy and / or its corporate vision
- ➔ the features and characteristics of the project are brilliantly described, but its benefits are unclear or have been poorly presented
- ➔ there is an imbalance between cost and benefit; the costs are not justified by the return
- ➔ the business plan offers a vast number of details but doesn't focus on what really counts
- ➔ number mysticism instead of clear and concise calculations

1. 1. 6. DIFFICULTIES IN AND LIMITS TO ENTREPRENEURIAL PLANNING

The future is the major problem of planning

It may very well happen that the future circumstances that influence a project turn out to be completely different from what was assumed in the business plan. It is of paramount importance to remember that.

➤ Difficulties and limits

In practice, it happens far too often that those who have spent quite some time on planning a project thoroughly are unaware of such changes or, perhaps, don't want to notice them. They refuse to let go of all those data and numbers they have calculated, figured out and defined with such great care, and want hold on to them at all cost (in the proverbial sense)

Where do the (correct) data come from?

The past and the present may also pose significant problems to business plan design. In particular, collecting the data necessary to make certain assumptions can be arduous, and answers to the following questions must be sought:

- What is the real size of our target group?
- What are their real needs?
- How successfully do the competitors operate?
- What goals do my partners / my employees pursue?
- Have costs been calculated properly?

Doing research on the market and on your own business situation may be highly time-consuming and expensive, especially when research studies must be commissioned or when external consultants need to be brought in.

It is true that the Internet represents an easily accessible source of information, but you may easily get lost in it. Besides, all data retrieved – regardless of the source of information – must be taken with a decent portion of scepticism. One can never be sure whether the random sample was selected properly, whether the questions asked were unbiased, etc.

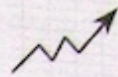
Goals, content elements and basic structure of a business plan have now been explained. The following chapter will introduce the most important analytical and planning instruments of business management.

1. 2. Analytical and Planning Instruments

Learning targets:

- Being able to explain the goals and structure of a strengths / weaknesses analysis
- Being able to explain the goals and structure of an opportunities / threats analysis
- Being able to explain the goals and structure of a SWOT analysis
- Being able to explain the goals and structure of a scenario analysis
- Being able to explain the goals and structure of a portfolio analysis
- Being able to explain the goals and structure of a life cycle analysis
- Being able to explain the goals and structure of an ABC analysis
- Being able to explain the term "creativity technique"
- Being able to explain the term "brainstorming"

Learning targets



Business management has developed a number of tools which greatly support an enterprise's business analysis and planning processes and offer people valuable help in personal / private situations as well.

The most significant aspect is that the application of these tools forces people to put thoughts and plans which otherwise exist only in their minds into writing. Once on paper, everything can be put into a certain order and can be displayed with such clarity that it is apparent at first sight which decisions need to be made.

The application of these tools plays an important role for the planners as well as for decision makers, who request it or even consider it a pre-requisite because it enables them to make quick decisions based on solid fundamentals.

In the following, this book introduces a wide range of tools which can be applied in business plans and project plans in general or used for individual projects. Depending on the complexity of the problem scenario, several of these tools can be combined (as in the case of setting up a business plan) or only one suitable tool may be selected (as for an ABC analysis for the "Summer Party for Regular Customers" project).

The Bossi Pizzeria and the entrepreneur Mr Bossi himself will support us in presenting these tools.

1. 2. 1. STRENGTHS / WEAKNESSES ANALYSIS

► Strengths / Weaknesses analysis

A long time ago there must have been a Chinese scholar who said, "Throughout your life try to strengthen your strengths and weaken your weaknesses."

This wisdom certainly applies to everyone. Still, in order to follow this rule, you need to analyse what your strengths and weaknesses actually are.

Performing such an analysis, which focuses on an enterprise's internal strengths and weaknesses is easy and comprises the following steps:

- ➔ Step 1: Analyse strengths and weaknesses.
In addition, you may try to determine and categorize the significance or weight of individual strengths and weaknesses.
Example: 1 = highly significant, 4 = insignificant
- ➔ Step 2: Plan measures to reinforce your strengths and eliminate or mitigate your weaknesses.



Bossi Pizzeria: Strengths / Weaknesses analysis

STRENGTHS	SIGNIFICANCE	MEASURES TO REINFORCE STRENGTHS
The enterprise is well-known.	1	Certain activities should encourage the guests to do even more word-of-mouth promotion.
Mr Bossi is very popular with his guests, many of whom come because of him.	1	Mr Bossi should spend a considerable amount of time with his guests and delegate other tasks as far as possible.
The pizzas are known for their quality.	1	Take measures to secure quality.
The regular staff is loyal and highly motivated.	1	Make sure that the good working atmosphere is maintained.
The location of the restaurant is exceptionally favourable.	1	No measures necessary.
A guest praised the assortment of fine wines.	3	Find out whether other guests are of the same opinion.

<i>WEAKNESSES</i>	<i>SIGNIFICANCE</i>	<i>MEASURES TO ELIMINATE WEAKNESSES</i>
<i>The financial situation of the firm is tense.</i>	<i>1</i>	<i>Find creditors.</i>
<i>The menu has not been changed for years.</i>	<i>1</i>	<i>Offer new dishes at least on the menu of the day and plan medium-term changes to the general menu.</i>
<i>Mr Bossi runs the business autocratically.</i>	<i>1</i>	<i>Mr Bossi should attend a leadership training seminar.</i>
<i>Labour turnover is high.</i>	<i>1</i>	<i>Hold staff talks and put planned measures into effect.</i>
<i>The kitchen equipment and the pizza oven frequently need repairs.</i>	<i>2</i>	<i>Ask for cost estimates for new equipment.</i>
<i>Residents complain about noise pollution and smell.</i>	<i>2</i>	<i>Offer a free meal to local residents once a month.</i>
<i>The storage basement needs repainting.</i>	<i>3</i>	<i>Ask for cost estimates.</i>

These lists of points are themselves enough to offer excellent insight into the business and give ample advice for future activities. On top of that, one must remember that the external business environment will present the enterprise with a number of positive and negative surprises as well.

1. 2. 2. OPPORTUNITIES / THREATS ANALYSIS

► *Opportunities / Threats analysis*

A second basic rule is to seize opportunities and to protect yourself against risks as well as you can or to take precautionary measures.

The opportunities / threats analysis which focuses on external aspects is developed in a similar manner as the strengths / weaknesses analysis and comprises the following steps:

- ➔ Step 1: Analyse opportunities and threats.
At this point you may categorize according to two criteria:
 - a) Significance: How important is the opportunity / how serious is the risk for the future of the enterprise?
 - b) Probability: How likely is the opportunity / the risk to occur?
1 = highly significant / highly probable
4 = insignificant / highly unlikely
- ➔ Step 2: Plan measures to seize the opportunities and avoid risks.



Bossi Pizzeria: Opportunities / Threats analysis

OPPORTUNITIES	SIGNI-FICANCE	PROBA-BILITY	MEASURES TAKEN TO SEIZE OPPORTUNITIES
A rival business goes bankrupt. Chances are good of winning their customers and recruiting their excellent cook.	1	2	Intensify promotional activities. Initiate talks with the cook.
A large enterprise with 500 employees is relocating to Bossi Pizzeria's immediate neighbourhood.	1	1	Talk to the company management with reference to arranging lunch for the employees.
One can bid for a special bottle opener on the Internet.	4	2	Bid for it.

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<i>RISKS</i>	<i>SIGNI- FICANCE</i>	<i>PROBA- BILITY</i>	<i>MEASURES TAKEN TO GUARD AGAINST RISKS</i>
<i>There are rumours that a U.S. pizza chain is planning to open a restaurant in Bossi's immediate neighbourhood.</i>	1	3	<i>Intensify marketing and PR efforts to prevent the rival from realizing its plan. Take particular care of regular customers.</i>
<i>A tax audit has been announced, and a tax liability of as much as 30,000 euros may have to be settled.</i>	1	1	<i>Make an appointment with the tax consultant.</i>
<i>The crime rate in the district is rising, and women dare come to the restaurant only with chaperones.</i>	2	3	<i>Better parking lot lighting.</i>
<i>A new building will be constructed on the property next to Bossi Pizzeria's outdoor dining area. Construction time is expected to be two years.</i>	1	2	<i>Renovate the unused inner yard as an alternative. Talk to the builders and arrange for construction to be discontinued on weekends, to guarantee undisturbed outdoor dining for that time.</i>

1. 2. 3. SWOT ANALYSIS

► *SWOT analysis*

Alert readers may already know what is hiding behind the abbreviation 'SWOT analysis': It is a sophisticated combination of

- the strengths / weaknesses analysis and
- the opportunities / threats analysis.

Both analyses are presented in a so-called SWOT matrix that is designed as follows:

SWOT analysis		INTERNAL ANALYSIS	
		Strengths	Weaknesses
E X T E R N A L A N A L Y S I S	Opportunities	S-O strategies: Pursue new opportunities that go well with the company's strengths.	W-O strategies: Eliminate weaknesses so as to seize new opportunities.
	Threats	S-T strategies: Make use of company's strengths to fend off threats.	W-T strategies: Develop defence tools so as not to allow existing weaknesses to become targets of threats.

The two most important areas to focus on are:

- the combination of good opportunities and major strengths and
- the combination of major threats and major weaknesses.

SWOT analysis Bossi Pizzeria

SWOT ANALYSIS		INTERNAL ANALYSIS	
		STRENGTHS	WEAKNESSES
E X T E R N A L	OPPORTUNITIES	<p>S: Bossi Pizzeria is an employer of high repute.</p> <p>O: The rival business goes bankrupt and there is the chance to recruit their excellent pizza cook.</p> <p>→ Seize the unique opportunity</p>	<p>W: Bossi Pizzeria is suffering from low liquidity.</p> <p>O: The neighbouring business outlet becomes vacant.</p> <p>→ No activity</p>
	THREATS	<p>S: Bossi Pizzeria offers pizza delivery service.</p> <p>T: More and more people want to eat their pizzas at home or at the office.</p> <p>→ Expand the delivery service</p>	<p>W: Because of high costs, Bossi Pizzeria cannot win a price war.</p> <p>T: A pizza chain is planning to open a new restaurant in the neighbourhood and offer their food at dumping prices.</p> <p>→ increase promotional activities to draw the customers' attention to outstanding quality</p>
A N A L Y S I S			

1. 2. 4. SCENARIO ANALYSIS

► *Scenario analysis*

Businessmen as well as any other people who are highly active and start projects of all kinds frequently distinguish themselves from others because of one outstanding characteristic: they think positively.

- ➔ From the moment of establishing their enterprise, company promoters see themselves taking a bath in millions of dollars just like Disney's Scrooge McDuck.
- ➔ Employees who have a stroke of genius visualize holding a top position in their enterprise very soon.
- ➔ Homebuilders expect their multi-storey house plus swimming pool and electric awnings to appear in no time.

If it weren't for such people, there would be no enterprises, no innovation and no beautiful houses.

Still, you must not forget that thousands of enterprises go bankrupt, tens of thousands of projects fail and many homebuilders must sell the house of their dreams when it is only half-finished. A simple scenario analysis could have spared all those people a lot of woes and suffering.

A scenario analysis is quite similar to an opportunities / threats analysis. In order to design such a scenario analysis, you need to set aside a couple of hours or days and think seriously about what can go well and what can go wrong with a particular project. The rest is again a simple approach that can comprise the following steps:

Step 1: Draw up a best-case scenario

First you may picture what the most favourable development of a project could be. Once all positive aspects have been listed, you could allow realism to set in and try to figure out how likely these scenarios actually are to occur (estimate the probability of occurrence). Particular attention will then be paid to those scenarios with a high probability of occurrence.

- 1 = highly probable
- 4 = highly unlikely

Finally you can think about what you can contribute in order to allow the "best case" to become reality.

Bossi Pizzeria: Best-case scenario



BEST-CASE SCENARIO	PROBABILITY OF OCCURRENCE	POSSIBLE SUPPORTIVE ACTIVITIES
<i>Pizzas become fashionable / highly popular again.</i>	3	<i>Create new pizza products and thus raise turnover further.</i>
<i>Two competitors go bankrupt.</i>	3	<i>Win new customers. Recruit cook of bankrupt competitor.</i>
<i>The economy is booming and people have enough money to spend.</i>	1	<i>Introduce particularly exclusive activities like "fish-weeks".</i>
<i>The number of pizzas sold can be raised by 10% and prices by 20%.</i>	3	<i>Marketing</i>

Step 2: Draw up a worst-case scenario

After you have drawn up the best-case scenario, you should still have some energy left in order to tackle that part of the scenario analysis that is probably the more important one: listing all those horror events that could occur in the worst case. This collection of atrocities is referred to as worst-case scenario.

As with the best-case scenario, you can estimate the probability of occurrence here as well.

- 1 = highly probable
- 4 = highly unlikely

In addition, there is a second important step to be taken. You need to consider

- what you can do to prevent some of these scenarios altogether and
- what measures you can take so as to keep the damage to a minimum.



Bossi Pizzeria: Worst-case scenario

WORST-CASE SCENARIO	PROBABILITY OF OCCURRENCE	POSSIBLE MEASURES
Increasing health awareness makes pizzas less popular.	2	Create new pizza products such as a "pizza light" line.
The U.S. pizza chain "Superpizza" opens a restaurant in the immediate neighbourhood.	2	Reduce prices, take greater care of regular customers, offer wider selection and address new target groups.
The economy is going downhill, unemployment is increasing and people have no money to spend at restaurants.	4	Offer low-price "pizzas to go".
The restaurant is devastated by a fire.	4	Take necessary precautionary measures against fire and take out sufficient insurance.
The number of pizzas sold drops by 20% although prices were reduced by 15%.	2	Analyse target groups and win new customers. Provide special services such as delivery of meals for lunch.

Step 3: Draw up a base-case scenario

Finally, one can try to deduce a highly realistic scenario (= base case scenario) from the best-case and worst-case scenarios.

Bossi Pizzeria: Base-case scenario

The quantity of pizzas sold remains unchanged. The prices can be raised by 5%.

1. 2. 5. PORTFOLIO ANALYSIS

Portfolio analyses are a wonderful tool for strategic decision-making and can be used by an enterprise in various forms in different areas.

➤ Portfolio analysis

This important planning instrument of business management can, for instance, help anyone towards better time management. We want to approach it by first explaining what an "importance / urgency portfolio or matrix" is.

Importance / urgency portfolio

Many of you know the problem of days being too short for you to take care of everything that needs to be done and to work off the pile of to-do items. This situation is frequently aggravated because people again and again pay too much attention to insignificant problems and, as a result, lack the time to face what actually are the major challenges that urgently need attention.

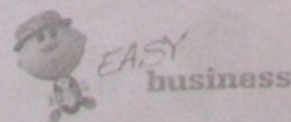
An importance-urgency matrix may help in such cases. It requires the following steps to be taken:

- ➔ Step 1: Prepare a to-do list.
- ➔ Step 2: Evaluate the importance of the to-do items.
- ➔ Step 3: Evaluate the urgency of the to-do items.

Bossi Pizzeria: Scheduling Mr Bossi's day

Without any portfolio analysis, Mr Bossi would have spent his day as follows:

- ➔ 9:00 a.m. Appointment with the restaurant furniture representative
- ➔ 10:30 a.m. Visiting the cell phone store around the corner
- ➔ 11:00 a.m. – 2:00 p.m. Routine restaurant activities
- ➔ 3:30 p.m. Rushing to the wine fair to check out new products
- ➔ 6:00 p.m. – midnight Restaurant activities
- ➔ and then ... oh, there was something else that needed to be done: preparing everything for the appointment with the tax consultant because of the upcoming tax audit. Mr Bossi, however, is too tired for that now.



This lack of planning may cost Mr Bossi several thousand euros (and perhaps even his enterprise) but a portfolio analysis can prevent such misfortune.

Mr Bossi's importance - urgency portfolio

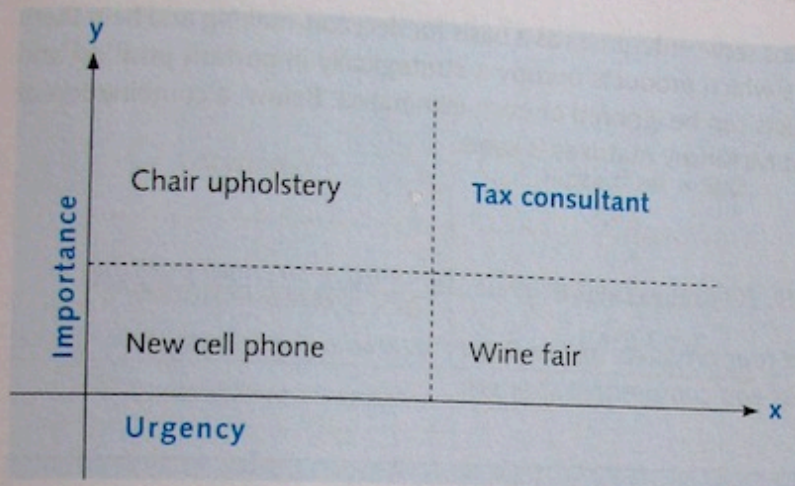
Mr Bossi evaluates the importance and urgency of his to-do items as follows:

To Do's	IMPORTANCE	URGENCY
	4 ... VERY IMPORTANT 1 ... NOT IMPORTANT	4 ... VERY URGENT 1 ... NOT URGENT
Preparation for appointment with tax consultant because of tax audit	4	4
Appointment with restaurant furniture representative because of new chair upholstery	2	1
Visiting the wine fair in the afternoon	2	4
Visit to the cell phone store	1	1

The above matrix makes it clear what Mr Bossi's course of action must be:

- ➔ Prepare instantly and exclusively for the tax audit.
- ➔ Postpone appointment with restaurant furniture representative.
- ➔ Don't go to wine fair this year.
- ➔ Discard the idea of buying a new cell phone now. The one bought two months ago will certainly do a little longer.

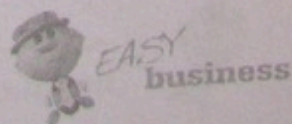
Meaningfulness and clarity are enhanced further if the activities are presented in two-dimensional form in a so-called xy matrix:



- ➔ The horizontal axis, known as the x-axis, shows the urgency of the to-do items.
- ➔ The vertical axis, known as the y-axis, shows the importance of the to-do items.
- ➔ The plane that is created by the two axes is divided into four regions, called quadrants.
- ➔ The upper right quadrant holds those items that are both important and urgent. They have to be given priority.
- ➔ Items that are neither important nor urgent and can thus be ignored are located in the lower left quadrant.
- ➔ The upper left quadrant includes to-do items that are important but can be postponed to a later time.
- ➔ Items that are urgent but of no great importance are placed in the bottom right quadrant. For each of these items, a quick decision has to be made: whether to take care of them instantly or not to take care of them at all.

Market attractiveness / competitive strength portfolio

The best-known portfolio planning framework in business management is the market growth-market share matrix of the 'Boston Consulting Group' management consultancy. The McKinsey matrix is a later and more advanced form of the BCG growth-share matrix and was developed by the Mc Kinsey



consultancy in co-operation with General Electric. In the McKinsey matrix, market attractiveness replaces market growth and competitive strength is used instead of market share.

Such portfolios serve enterprises as a basis for decision-making and help them to determine which products occupy a strategically important position and which products can be ignored or even eliminated. Below, a combination of the BCG and McKinsey matrixes is used.

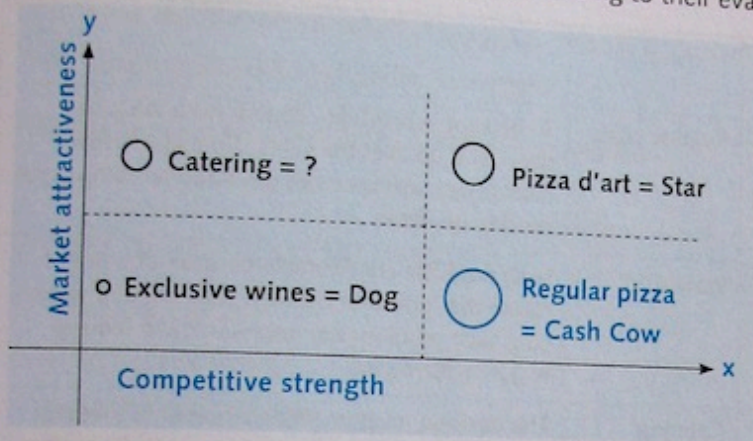


Bossi Pizzeria: Market attractiveness / competitive strength portfolio

We focus on four products of the Bossi Pizzeria and evaluate their market attractiveness and competitive strength.

	MARKET ATTRACTIVENESS	COMPETITIVE STRENGTH	BRIEF COMMENTS
	4 ... VERY HIGH 1 ... VERY LOW	4 ... VERY HIGH 1 ... VERY LOW	
Regular pizza	1	4	Bossi Pizzeria is known for making the best pizzas in town. Still, the market determines the prices and customers are very sensitive to price changes.
Pizza d'art	4	4	The idea that the pizza toppings (with exclusive ingredients) should resemble famous paintings is well received and customers are willing to pay double the regular price. After all, this is what you get only at Bossi's.
Catering	4	1	Recently Bossi Pizzeria included catering service (for company meetings, Christmas parties, etc.) in its portfolio. This service is profitable but competition is fierce.
Exclusive wines	1	1	Orders for 400-euro wines are placed three times a year at the most. The wine merchant around the corner has more attractive prices.

Following the above evaluation, another two-dimensional chart is produced. The y-axis shows market attractiveness and the x-axis competitive strength, and the products are placed in the matrix according to their evaluation.



Among other things, this particular portfolio became known because of the highly distinctive names and symbols used for the four categories of products: cash cow, star, question mark and dog. This portfolio gives clear guidelines of what to do with the products in the four categories.

The table below lists the BCG terms, their evaluation, examples of Bossi's products and recommended strategies.

BCG name / symbol	Evaluation	Product	Strategy
Cash cow (lower right quadrant)	Low market attractiveness but high competitive strength	Regular pizza	To be kept in portfolio. Benefit from what has been built up over the years. No major investments (such as expensive promotional campaigns) need to be made.
Star (upper right quadrant)	High market attractiveness and high competitive strength	Pizza d'art	Such products are desirable because of a bright future that promises success. Securing and expanding such positions are necessary (and require major investments).
Question mark (upper left quadrant)	High market attractiveness but low competitive strength	Catering	The decision must be made whether to invest in order to improve competitive strength (i.e. move to the upper right quadrant) or to leave things as they are.
Dog (lower left quadrant)	Low market attractiveness and low competitive strength	Exclusive wines	Eliminate from the product portfolio instantly so as not to tie up any resources.

Additional aspect: Quantitative significance

You may have noticed that the circles in the portfolio have been drawn in different sizes, which demonstrates an additional important feature. In our particular case it is the sales volume.

The regular pizza is accompanied by the largest circle, which implies that it accounts for the major portion of the enterprise's turnover and that the product must under no circumstances be neglected or even eliminated from the product portfolio prematurely. The small circle next to the exclusive wines, however, shows that this product line produces practically no sales and should be eliminated instantly.

The basic idea of portfolio analysis is easy to understand, but things become more difficult once you move into greater detail and must find answer to the following questions:

- How do I determine whether a market is really attractive?
- What determines competitive strength?

The lists below offer a selection of assessment criteria:

Criteria of market attractiveness

- Market volume
- Market potential
- Market growth rate
- Market quality
- Number and size of competitors
- Market entry barriers for new competitors
- Customers (number, size, volume of demand) and customer behaviour
- Required intensity of market activity
- (Market) profitability, profit contribution
- Exogenous forces (such as legal requirements, dependence on weather, etc.)

Criteria of competitive strength

- Product attractiveness Know-how / Erfahrungspotenzial
- Know-how and experience
- (Low) cost of production
- Capacity
- Financial strength
- Access to financial and other investment resources
- Channels of distribution / Logistics
- Customer service
- Procurement strength

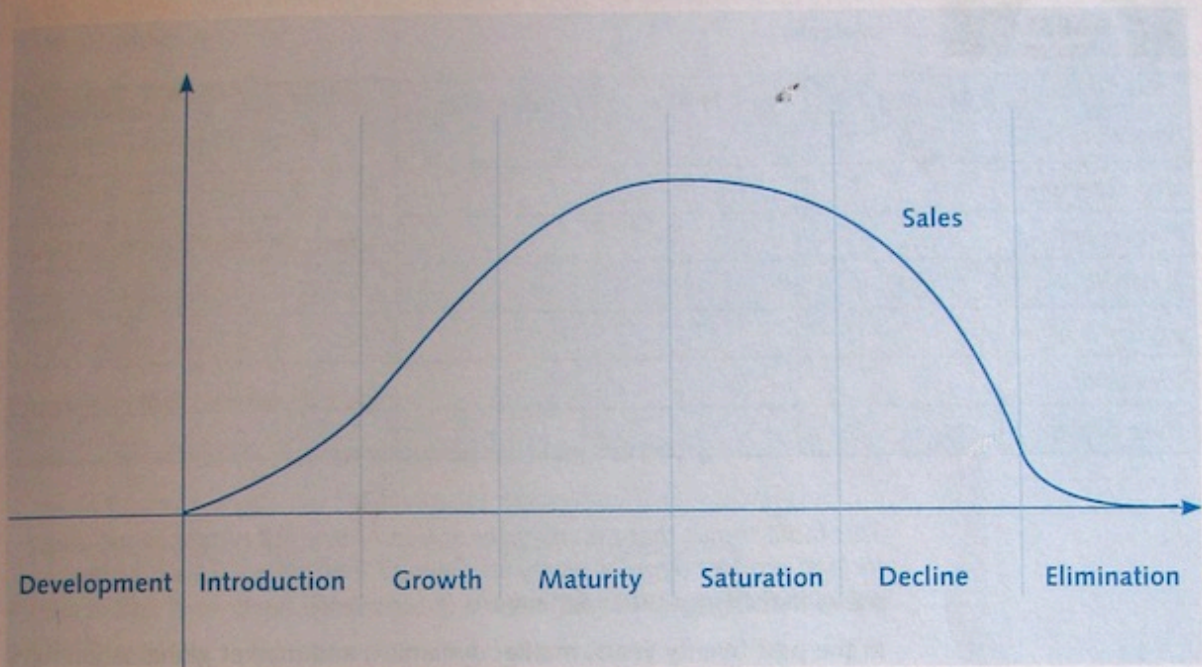
1. 2. 6. LIFE CYCLE ANALYSIS

➤ Life cycle analysis

(Almost) every product goes the way of all flesh and moves through different life cycle stages:

- ➔ Phase 1: The beginning is always difficult and a product has to survive the so-called **introduction stage**. (The preceding **development or incubation stage** is sometimes seen as part of it.)
- ➔ Phase 2: Once a product has overcome market introduction, it enters the **growth stage**. The product catches on and sales increase.
- ➔ Phase 3: At some point, growth will stall and it will no longer be possible to raise sales and profits. The product is well established in the market and, if things go well, this position (frequently characterized by a high market share) can be maintained for a long time. The product is now in its **maturity stage**.
- ➔ Phase 4: Once all target groups have been supplied with the product, market saturation has been reached. The product is now in its **saturation stage**.
- ➔ Phase 5: During the **decline stage**, demand decreases, the product becomes obsolete and soon nobody will care about it anymore.
- ➔ Phase 6: The logical consequence is to withdraw the product from the market. The product **elimination stage** has been reached.

The life cycle of a product is shown in the graph below:



Enterprises must make sure not to hold too many products in their portfolio that are past their prime, have already passed through their saturation stage and are now obsolete. If that happens, the enterprise as such may come close to obsolescence and may not be able to hold its position in the market much longer. Enterprises must therefore also look out for innovative products and cannot just rely on established products. Innovation strength is a highly important competitive factor or, more dramatically put, a factor for company survival.

Still, the product mix must be well balanced, because too many products that are in the early stage of the growth phase may result in a liquidity crunch and could lead to the firm's demise.



Bossi Pizzeria: Product life cycle analysis

A life cycle analysis for Bossi Pizzeria's product mix could be designed as follows:

STAGE	INTRODUCTION	GROWTH	MATURITY	SATURATION/DECLINE	ELIMINATION
PRODUCTS				X	
REGULAR PIZZA					
PIZZA D'ART		X			
CATERING	X				X
EXCLUSIVE WINES				X	
CIGARETTES				X	
HARD DRINKS					

This table shows that the majority of Bossi Pizzeria's products, including its lead product (regular pizza) are beyond their prime. This is a clear signal that there is need for action.

In the past twenty years, market dynamism and market globalisation have radically cut product life cycles. From the 1950s to the 1980s companies were able to sell numerous products (with only marginal adaptations) for decades. The classical example is the VW Beetle which was sold in 1938 for the first time and whose production (in its original version) was discontinued as late as 2002. In 64 years an impressive 22 million Beetles were sold.

Today you may expect product life cycles to last no longer than a few months, if not a few weeks.

- ➔ Cell phones are most probably the best example. Today's state-of-the-art mobile phones are old fashioned in six months at the latest. After one year they are completely obsolete.
- ➔ Software products that are introduced in Europe today are internationally available as pirated copies after a few weeks.
- ➔ A new generation of shoes, whose R&D costs perhaps amounted to millions of euros, is instantly analysed by competitors who may introduce a modified or even an improved version of the product in no time.

This means that companies have less and less time to earn the money they had to spend on developing, producing and marketing new products. For that reason, some industries allow only those products to make it to the markets that are believed to pay off within a few weeks (i.e. cover all the costs and record a profit).

Products in their develop
 • Hydrogen-powered
 • Artificial eye
 Products in their growth
 • Flat-screen TV set
 • Cosmetic surgery
 Products in their maturit
 • DVD players
 • Digital cameras
 Products in their saturat
 • Fixed-line telepho
 • Tobacco products
 • Pork (less consum
 Products that have bee
 life cycles)
 • Telegram (replac
 • Typewriter (replac
 • Walkman plus cas
 phones)
 1.2.7. ABC ANALY
 The so-called ABC analy
 instrument which can mak
 person's decision-making i
 important while unimport
 are eliminated altogether.
 The ABC analysis can be use
 importance for businesses t
 EBC * L – Business plan

Products in their development stage:

- *Hydrogen-powered cars*
- *Artificial eye*

Products in their growth stage:

- *Flat-screen TV set*
- *Cosmetic surgery*

Products in their maturity stage:

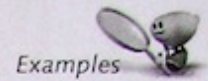
- *DVD players*
- *Digital cameras*

Products in their saturation stage:

- *Fixed-line telephone (gradually replaced by cell phone)*
- *Tobacco products (on the defensive because of legal regulations)*
- *Pork (less consumption because of health consciousness)*

Products that have been eliminated (i.e. have passed through their entire life cycles)

- *Telegram (replaced by telephone and e-mail)*
- *Typewriter (replaced by computer)*
- *Walkman plus cassettes (replaced by MP3 player and music mobile phones)*



1. 2. 7. ABC ANALYSIS

The so-called ABC analysis is another very simple yet effective planning instrument which can make a valuable contribution to facilitating a business person's decision-making process. It tells you to take care of what is actually important while unimportant issues are put at the end of your to-do list or are eliminated altogether.

➤ *ABC analysis*

The ABC analysis can be used in almost any situation in life and is of particular importance for businesses that have to make major strategic decisions.

The letters A, B and C refer to the three categories into which the items or activities that need to be analysed are subdivided.

- ➔ A ... very important
- ➔ B ... important
- ➔ C ... less important



Bossi Pizzeria: Mr Bossi's ABC analysis of his to-do items

Let us again take a look at Mr Bossi's to-do list but expand the timeframe. The following to-do items are waiting for Mr Bossi's attention in the coming week:

- ➔ hold staff talks, negotiate new cell phone terms, appointment with tax consultant, visit wine fair, have new business cards designed and printed, organize Christmas party, redo menu, buy new PC, loan negotiations with bank

Given all these activities and tasks, it is quite obvious that Mr Bossi cannot possibly tick off all the items from the list in the course of one week. It is simply a lack of time that won't allow him to take care of everything.

- ➔ For that reason Mr Bossi has to concentrate on those items which may in fact be crucial. They are of highest priority and known as A activities.
- ➔ If there is any time left, Mr Bossi may turn towards other activities which are also important but are not perceived as having highest priority. They are referred to as B activities.
- ➔ The remaining tasks should be tackled only if no A and B activities are left. These activities with lowest priority are labeled C. It is highly unlikely, though, that Mr Bossi will have time for them because for the company management new A and B tasks are added constantly. C tasks should therefore be ignored or delegated to others.

Now Mr Bossi can apply this ABC method to his to-do list. First he labels all the activities with the proper order.

Hold staff talks
Appointment with tax consultant
Organize Christmas party
Redo menu
Loan negotiations with bank
Visit wine fair
Negotiate new cell phone terms
Buy new PC
Have new business cards designed

Now Mr Bossi really knows what really is his favourite activity of "having fun", which he would have liked to do more often.

The ABC method may help a person to identify his favourite activity. It is more frequently applied to analyze a person's activities. Two examples are the cost analysis and the time analysis.

Cost analysis

Bossi Pizzeria: Mr Bossi's false victory

Once Mr Bossi has received the bad news, it is obvious what must be done. The high telephone bill that landed on his desk in a better moment, and after he finally signed a new contract that he can be really pleased with the outcome.

Now Mr Bossi can apply this ABC analysis to his own time management. First he labels all the activities with one of the letters and then puts them into the proper order.

Hold staff talks	A
Appointment with tax consultant	A
Organize Christmas party	A
Redo menu	B
Loan negotiations with bank	B
Visit wine fair	B
Negotiate new cell phone terms	C
Buy new PC	C
Have new business cards designed and printed	C

Now Mr Bossi really knows what needs to be done in what order. Unfortunately his favourite activity of "having new business cards designed and printed", which he would have liked to do first, has slipped into last place.

The ABC method may help a person to manage his own time schedule but is more frequently applied to analyse important business situations quickly. Two examples are the cost analysis and the customer analysis.

Cost analysis

Bossi Pizzeria: Mr Bossi's false victory

Once Mr Bossi has received the bad news that his business made a loss last year it is obvious what must be done: Costs need to be cut.

The high telephone bill that landed on his desk this morning couldn't have come in at a better moment, and after a lot of searching and talking to people he finally signed a new contract that will reduce costs by 30%.

Can he really be pleased with the outcome?



The answer is "No" and can quickly be confirmed by applying an ABC analysis. If all the enterprise's cost items are listed according to this method, one notices instantly that the telephone bill makes up only 0.1% of total costs and must be labelled C.

Bossi Pizzeria's cost analysis:

COST ITEM	COST IN EUROS	CATEGORY
Staff (permanently employed)	220,000	A
Procurement of food and beverages	200,000	A
Temporary staff	40,000	B
Operating costs	15,000	B
Van, gasoline	4,000	C
Insurance	3,000	C
Telephone bill	500	C

With the same time input, Mr Bossi could have achieved a multiple in cost reduction if he had thought about measures of

- ➔ how to use personnel more effectively or
- ➔ how to obtain better conditions from his suppliers.

Reducing procurement costs by only 2% would produce savings which far exceed the amount the 30% cut in telephone costs resulted in.

- ➔ Reduction in procurement costs by 2% = 4,000 euros
- ➔ Reduction in telephone costs by 30% = 150 euros

The ABC analysis presented above clearly shows why businessmen, controllers and management consultants alike first take a good look at personnel when cost reductions are inevitable. In many enterprises – especially in those of the services sector – staff costs are simply the largest cost item.

Customer analysis

Bossi Pizzeria: The wrong guests

Mr Bossi would like to celebrate his tenth business anniversary and thank his guests by inviting them to a free dinner banquet. He sends out invitations to all his guests whose names are stored in his data bank. In no time he has received 200 responses and his seating capacity is exhausted, which he is quite happy about. After studying the registrations more thoroughly, however, he notices that many of them don't belong to his regular customers and cannot be expected to become regular customers after the event either. What is worse is that many of his loyal guests are now upset. They either responded too late or assumed that they would be welcome even without notifying Mr Bossi about their appearance. Unfortunately Mr Bossi must tell them that there are no more seats available. In reaction, some of the regulars openly said that Mr Bossi would not see them again any time soon as there are certainly other decent pizza restaurants in town.



Also in this case many problems could have been avoided if a prior ABC analysis had been conducted. According to the familiar method, guests would have been categorized as A, B or C customers (very important, important, less important).

Of course, you must think about which criteria to apply when making your choice. Do you look at turnover and profit contributions only or do you also take soft criteria into consideration (image boost through presence of a prominent figure, quality of customer relationship, etc.)?

Bossi Pizzeria: ABC analysis of customers

CUSTOMER	CUSTOMER CATEGORY	REASONING
E. Smith	A	Turnover, comes every week
M. Brown	A	Turnover, has lunch regularly
G. Blake	A	The cook's best friend
Mayor of the city	A	Image
F. McRough	B	Comes regularly but doesn't spend much
K. Heart	B	Life and soul of every party
J. Thompson	C	Doesn't come often
J. Hill	C	Unpleasant type

Once an ABC analysis has been conducted, Mr Bossi can first invite his A customers, then his B customers and think about including C customers only if there is still seating capacity.

For sales people, an ABC analysis can be crucial because many of them fail to allocate their most precious resource of "time" appropriately and waste it on customers who yield little. Consequently they don't have the time which important A customers would deserve.

Additional application scenarios for ABC analyses:

- ➔ Product mix analysis:
Does the product mix include too many C products, whose turnover doesn't justify the effort put into them?
- ➔ Inventory analysis:
Are too many spare parts in stock which are needed once a year at the most but occupy valuable space?

1.2.8. CREA
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1. 2. 8. CREATIVITY TECHNIQUES

Special challenges require special solutions and in order to find those, creativity is needed. So that creativity can take its own course, methods have to be pursued where pure reasoning is initially excluded and where there are no limits to a person's fantasy. Creativity techniques can make the discovery of unique solutions possible.

A daily business grind in which people become mired means the demise of any creative solution. Greater time pressure and stress deprive people of the chance to lean back and allow their souls to wander. Not only is that a pity, it is also dangerous, because many of the best ideas of mankind have been products of such phases of relaxation.

For that reason, the perhaps most important rule for finding creative solutions is to deliberately detach oneself from everyday business, to take the time needed and to withdraw to a place where one is undisturbed. The famous "bird's eye view" and looking "beyond one's nose" may be quite effective.

If a number of brains do creative work, there is greater likelihood of positive results than if a person broods over things in private. Thus it definitely makes sense to invite several people to participate in such creative meetings. Regardless of all creativity, it is still a must to define rules so as to avoid misunderstandings and avert chaos at such gatherings.

► Creativity techniques

1. 2. 9. BRAINSTORMING

One of the best-known and most frequently applied creativity techniques is brainstorming: People gather in order to contribute their ideas about a particular subject.

► Brainstorming

Brainstorming must follow the simple principles outlined below:

- ➔ Basic principle 1: Everyone is allowed to say what comes to his mind. No matter how absurd a thought may be, it may and should be presented.
- ➔ Basic principle 2: Nobody may interrupt another person and it is strictly forbidden to comment on or offer feedback to somebody else's statement.
- ➔ Basic principle 3: All ideas and thoughts are written down.

- Basic principle 4: Only after this brainstorming session is over will the statements be analysed and scrutinized. For this process an analytical instrument such as an ABC analysis or a portfolio analysis can be used as a supportive tool.

As concerns the recording of brainstorming ideas, one can use

- a flip chart on which an assigned person takes notes or
- memory cards which are attached to a pin board.

Both offer the advantage that suggestions and flashes of inspiration are not ignored and that everyone who participates in the meeting can remember more easily what has been said.



Bossi's Pink Sauces – An absurd idea?

After talking to his tax advisor, Mr Bossi knows that he has to put his cards on the table and inform his wife, who has been building their firm with him from the very beginning, and his two most loyal employees, Ms Pepper and Mr Salt, about the present difficulties. In their first reaction, they are quite stunned. Instead of blaming each other, however, they all quickly decide to join forces and look for promising solutions. In order to facilitate their efforts, Mrs Bossi rents an apartment in a country hotel to which they can withdraw for several days and where no one can disturb them. They even turn off their mobile phones and have the TV taken out of their meeting room. Instead of it, a flip chart is put up and two pin boards are mounted. Ms Pepper turns on her laptop and off they go. Mr Bossi opens the meeting and explains how important it is for him that they can jointly work on finding solutions and think about where the road will take them from here.

In the course of the next hour, the other three notice how difficult it is for Mr Bossi to abandon the principles he has relied on so far. Furthermore, he is not really able to relinquish his role as boss and interrupts any idea that is presented by the others.

Just before his employees have had enough and are about to depart in discord, Mrs Bossi takes over and introduces the instrument of "brainstorming" as a means of finding ideas. This works miracles, and in the course of the following days a completely new business idea is born.

During her vacation in Thailand, Mrs Bossi discovered a spice that gives the tomato sauce for their pizzas an incomparable taste. Bossi's guests are simply thrilled by this exceptional flavour but don't know that this one spice in the sauce is primarily responsible for it. They attribute the taste to the pizza as

a whole and in particular to the excellent toppings.

If the Bossis want to draw the guests' attention to the sauce, they have to be creative. One way to achieve this would be to apply food colouring to the tomato sauce. After lengthy discussions, they agree on the rather courageous colour of pink. This means that almost the entire pizza would radiate this unusual colour, which is certainly something that takes time to get used to. On the other hand, it would allow the Bossis to distinguish their pizzas from other, ordinary pizzas of their competitors.

There is more to this idea, though:

The Bossis could of course consider producing this special tomato sauce not only for their pizzas but also for other dishes such as pastas, etc. Eventually the sauce itself could be offered as a new product (= new strategic business area), and – filled into bottles – sold to

- ➔ *other pizzerias (which are located outside of Bossi Pizzeria's territory) or*
- ➔ *private households (directly or through the retail system).*

Unfortunately the spice comes from a protected plant that cannot be cultivated outside its natural habitat. For that reason Mrs Bossi can obtain only very limited quantities which hardly suffice to satisfy their own pizzeria's demand. It would thus be ideal if the plant extract could be produced in a chemical laboratory. Purely out of curiosity, Mrs Bossi has inquired at the University of Natural Resources and Applied Life Sciences whether this would at all be possible. After his first analysis, Professor Sour is quite sure – although he can't guarantee it – that lab production would indeed be possible. It would take some intensive research and lab work, but with a budget of about 30,000 euros he could see himself doing it.

This amount naturally dampens everyone's enthusiasm for the unique business proposition and brings everyone back to reality. The mood becomes even more sombre, because in addition, a bottling facility and related equipment would drive up the total investment amount to almost 100,000 euros. Considering the Bossi Pizzeria's tense financial situation, no bank would be willing to finance this project. They all know that.

Mrs Bossi, however, refuses to be discouraged. From now on, she is willing to do anything to turn "Bossi's Pink Sauces" into a success story – if necessary, even without her husband.

The first two chapters of this book have presented

- the basics of business plan design and
- analytical planning instruments.

In the following chapters, the individual elements of a business plan will be explained. They are:

- project planning
- actual analysis
- marketing plan

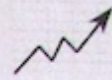
The "Bossi Pizzeria" case study and the new "Bossi's Pink Sauces" project will appear again and again to demonstrate the design of a business plan.

EASY BUSINESS IN TELEGRAM STYLE

GOALS, METHODS AND INSTRUMENTS OF BUSINESS PLAN DESIGN

The following keywords and concise descriptions give an overview of the EBC*L Level B learning objectives. They do not, however, offer detailed explanations of the business terms and contexts (which are required for Level B exams). For those, please see the business texts and examples in this book. In addition, we advise you to identify practical examples from the real business world – for further progress.

Learning targets



- Name and explain the goals of a business plan and identify occasions and situations for which business plans need to be designed.

Business plan goals:

- Work out success strategies
- Realize projects that make sense – stop those that don't
- Select the best alternative
- Inform and convince creditors / investors

Business plan occasions and situations:

- Setting up an enterprise
- Looking for creditors' funds or owners' funds (= equity capital)
- Applying for national and international funding
- Developing and presenting intra-company ideas and projects
- Planning private projects

- Identify potential business plan users, their interests and goals.

- Banks: interest and security (collateral)
- Investors: profitability of investment, share in the profit
- Company management: accomplishing major corporate goals
- National and international funding authorities: support for economic and socio-political goals

- Explain questions and issues that arise and explain the fundamental structure and design of a business plan.

Questions:

- Where do we want to move from here? What do we want to accomplish? (Strategic planning)
- How can we realize our goals? (Operational planning)

Issues: See business plan occasions and situations

Structure:

- Executive summary (short summary of the project)
- Starting position / Actual analysis (of enterprise, business environment, business team)
- Marketing plan
- Project plan
- Investment analysis and assessment of economic efficiency
- Financial plan
- Appendix / Notes to the business plan

- Explain the criteria which decision makers use in assessing business plans, the rules to be followed and the potential mistakes made in business plan design.

- Criteria:
 - Are the benefits clearly identifiable?
 - Is the cost-benefit relationship favourable?
 - Is the project in line with the overall company strategy?
 - Can the person who has designed and presented the business plan be trusted?
 - Does he have the right qualifications?
 - Does it give a quick overview? (clear structure, good visualisation)
 - Does the project enhance corporate prestige and image?

Rules for successful business plan design:

- The right length
- The right language: no difficult technical expressions and complicated details
- Realistic assumptions
- Correct figures: no calculation mistakes
- Correct spelling
- Visualization
- What really counts must be emphasized, details ignored

Violations of these rules lead to typical mistakes (such as excessive length, unrealistic assumptions and calculation mistakes) and may result in business plan rejection.

- Explain the term 'critical success factors'.

Factors which determine the success or failure of a project:

- Are there enough customers who will actually spend money on a certain product?
- Is there (fierce) competition?
- Are there any alternatives that are more economical and could lead to nearly the same results?
- Are there enough resources and capacity to carry out the project?
- Do the employees have the necessary qualifications?
- Is the business location suitable?
- Does the pricing policy make sense?

- Explain how to draw up a clear and attractive business plan.

- Clear structure and logical design (See: Rules for successful business plan design)
- Visual stimuli such as charts, diagrams and pictures
- Attaching additional, highly informative material

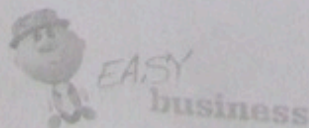
- Explain the difficulties in and limits to entrepreneurial planning.

- The unpredictable future is the major problem of planning: future circumstances (customers, competitors, costs, etc.) that influence a project may turn out to be completely different from what is assumed today
- Collection of relevant and correct data may be difficult.

- Explain the goals and structure of a strengths / weaknesses analysis.

Perform a thorough analysis of a company's strengths and weaknesses (= internal aspects)

- Step 1: Analyse strengths and weaknesses. In addition, you may try to determine and categorize the significance or weight of individual strengths and weaknesses.
- Step 2: Plan measures to reinforce your strengths and eliminate or mitigate your weaknesses.



► Explain the goals and structure of an opportunities / threats analysis.

Perform a thorough analysis of opportunities and threats an enterprise (external aspects) may encounter.

- Step 1: Analyse opportunities and threats. Categorize according to two criteria:
 - Significance: How important is the opportunity / how serious is the risk for the future of the enterprise?
 - Probability: How likely is the opportunity / the risk to occur?
- Step 2: Plan measures to seize opportunities and avoid risks.

► Explain the goals and structure of a SWOT analysis.

The 'SWOT analysis' is a sophisticated combination of the strengths / weaknesses analysis and the opportunities / threats analysis.

► Explain the goals and structure of a scenario analysis.

Possible future scenarios are drawn up. One can distinguish between:

- best-case scenario: What could the most favourable development be?
- worst-case scenario: What could the most unfavourable development be?
- base-case scenario: What is the most realistic scenario (deduced from the best-case and worst-case scenarios)?

Scenarios can be categorized according to importance and probability of occurrence

► Explain the goals and structure of a portfolio analysis.

Such portfolios serve enterprises as a basis for decision-making and help them to determine which products / markets are strategically important and which products / markets can be ignored. They are presented in two-dimensional form in a so-called XY matrix.

The market attractiveness - competitive strength matrix shows four product categories:

- cash cow (low market attractiveness – high competitive strength)
- star (high market attractiveness – high competitive strength)
- question mark (high market attractiveness – low competitive strength)
- dog (low market attractiveness – low competitive strength)

This concise portfolio allows conclusions to be drawn easily / decisions to be made quickly.

► Explain the goals and structure of a life cycle analysis.

Products are categorized according to the life-cycle phase they are in.

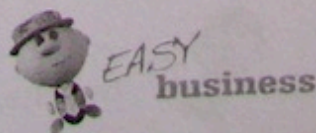
- Phase 1: development and introduction
- Phase 2: growth
- Phase 3: maturity and saturation
- Phase 4: decline
- Phase 5: elimination

The product mix must be well balanced. An enterprise needs established products in its portfolio but must also work on product innovation.

► Explain the goals and structure of an ABC analysis.

This planning instrument helps to set priorities and allocate scarce resources (such as time, money, storage space, etc.) effectively. The items or activities that need to be analysed are subdivided according to importance:

- A = very important
- B = important
- C = less important



One should first take care of what is very important; if resources are left over they can be allocated to items or activities in the other two categories.

➤ Explain the term "creativity technique".

Creativity techniques ought to be applied when problems cannot be solved with traditional methods. The basic rule for finding creative solutions is to detach oneself from everyday business. One of the most important creativity techniques is brainstorming.

➤ Explain the term "brainstorming".

Rules for a brainstorming session:

- Everyone is allowed to say what comes to his mind.
- Nobody may interrupt another person or comment on somebody else's statement.
- All ideas and thoughts are written down.
- Only after the meeting will the statements be analysed and scrutinized. For this process an analytical instrument such as an ABC analysis or a portfolio analysis can be used.

PROJECT PLANNING



Overall Learning Objectives

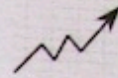
- ▶ *Being able to explain the goals and structure of a project plan as well as the key terms of project planning*

2. 1. Basics of Project Planning

Learning targets:

- Being able to explain the goals and structure of a project plan
- Being able to explain the term "target planning"
- Being able to explain the term "resource planning"
- Being able to explain the term "project team"
- Being able to explain the term "project realization planning"
- Being able to explain the term "milestones"
- Being able to explain the term "project activities planning"
- Being able to explain the term "(project) time planning"
- Being able to explain methods of project plan illustration
- Being able to explain what mistakes may be made in project plan design

Learning targets



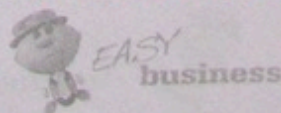
Bossi's Pink Sauces: Project planning

Mrs Bossi has determined the basics of the marketing strategy for Bossi's Pink Sauces and has used her sales skills to convince Mr Bossi of her idea to produce the Pink Sauce on a large scale. Now the time has come to put all the measures that have been planned into effect.

Her goal is to start selling the Pink Sauce in ten months at the latest. She knows that this is an ambitious target but firmly believes it can be reached. Given the huge size of the project, it has become clear to her that it will be a long road with hundreds of little steps. Without a plan, there is a substantial risk that she may get lost on the way.

For this reason, Mrs Bossi begins by identifying the first steps in the project planning process and determines the following important milestones:

- Milestone 1: Complete the business plan with all its details (purpose, business analysis and analysis of the external environment, costs, profit expectation, liquidity planning, calculating financial ratios, etc.) and adapt it if necessary.
- Milestone 2: Convince the bank to grant the loan needed to do the project.
- Milestone 3: Stop- or go-decision. If it is decided to go ahead, then



- ➔ Milestone 4: Determine who will participate in the project and which tasks will be assigned to whom
- ➔ Milestone 5: Put into motion the first activities of the project plan.
- ➔ Milestone 6: Start of production
- ➔ Milestone 7: Event to mark the occasion of the new product's presentation

The project should be started immediately and milestone 7 should be reached in ten months at the latest.

2. 1. 1. GOALS AND STRUCTURE OF A PROJECT PLAN

➤ Project plan, goals and structure

Mrs Bossi's idea to launch a completely new product line is most definitely a large-scale project that is almost on par with setting up a small firm. As even small projects can fail without sufficient planning and preparation, professional planning is an indispensable prerequisite for the success of major, complex projects. Still – even though enterprises have always regarded planning as highly important – the notion that the core competence of professional planning should not be exclusively in the hands of top management is fairly new. Today it is believed that any corporate team member may play a key role in project planning, provided that he or she has the required skills.

"Project management" is the subject of dozens of thick books and many of today's business seminars. This book will restrict its focus to the basics of project planning and the most frequently-used technical terms.

(Recommended literature: "Project Management" by Christoph Berger and Karin Schubert, Manz)

In her first draft, Mrs Bossi has already taken the most basic elements of project planning into consideration. She has identified and laid down the following:

- ➔ project goal
- ➔ the project principal (= the party planning or commissioning the project) and project sponsors / creditors who provide the necessary funds
- ➔ project schedule, including the start and finish dates of the project
- ➔ important milestones within this schedule
- ➔ composition of the project team (= those who participate in the project) and their tasks



Not

- starting date of operative planning activities

Some explanations in connection with these points:

A **project** is a set of tasks / a complex task which

- pursues certain goals
- is limited in time (a temporary endeavour with predetermined start and finish dates), and
- is often a new and one-time event that is not part of a business organization's everyday activities.

Project initiation may be due to:

- new strategic decisions
- problems that have appeared
- internal suggestions for improvement
- new ideas, or
- new technologies.

Once a project idea has come up, the following steps are to be taken:

- Performing a feasibility analysis
 - Which resources (staff, time, know-how, physical and financial assets) are necessary?
- Performing an economic (feasibility) study
 - Will the project pay off?
- Drawing up a written project application
- Presenting the project application to the principal (company management, creditors)
- Making a stop- or go-decision (Also referred to as go- or no-go-decision)

As soon as the strategic decision for a project has been made, the operative planning activities may start. The project team is put together, tasks and activities are determined and precise time frames are defined.

2. 2. Planning Steps

2. 2. 1. TARGET PLANNING

The most essential element of any project is a clear definition of the project target, which has to be agreed upon with the party requesting the project and the one financing it. If goals are not set and laid down in writing, problems with the project principal and the project team members are certain to arise.

► Target planning

As outlined in the chapter on business analysis, the goals must meet the so-called SMART criteria, which are:

- **S** specific, i.e. the goals must be precisely formulated
- **M** measurable; i.e. it must be possible to produce and record quantifiable results
- **A** attractive; i.e. it must be worth supporting the goals
- **R** realistic; i.e. realizing the goals must be feasible, and
- **T** time-bound; i.e. a time must be identified by which objectives have to be reached.

It may also make sense to stipulate clearly what are not the goals of the project (= non-targets). This helps the parties involved in the project to protect themselves against inflated expectations.

If an "image campaign" project is commissioned, it is advisable to stipulate that an instant rise in profits is not one of its goals.

Example



2. 2. 2. RESOURCE PLANNING

➤ *Resource planning*

In order to carry out a project, it is necessary to provide:

- ➔ staff that has the required know-how and time
- ➔ physical assets, and
- ➔ financial assets.

The specific demand for and scope of these resources must be defined and secured by an appropriate budget.

2. 2. 3. PROJECT TEAM

➤ *Project team*

Although certain projects can be done by one person only, there are normally several people who form teams that work on and complete projects.

If a team is in charge of a project, a project manager is selected who is responsible for the entire project procedure and its results. He has to have all the appropriate competencies such as the right to request results from team members and – if results are not presented – the right to react accordingly by eliminating and replacing project team members. All project team members are given clearly defined tasks.

2. 2. 4. PROJECT REALIZATION PLANNING

Project realization includes identifying milestones, project time planning and detailed planning of activities.

The so-called **milestones** divide the project realization process into different phases and define important interim results that are supposed to be achieved in the course of project realization. These milestones have to be reached by certain deadlines and serve as checkpoints that help the project manager and his team to find out whether project work is on schedule.

Once the milestones are identified, a detailed project **activities plan** can be set up which determines


- ➔ which activities are to be performed
- ➔ by whom, and
- ➔ by when.

2.2.5. PROJECT PLAN ILLUSTRATION

In order to illustrate project schedules, tables and diagrams can be designed with the help of simple software programs (such as Excel) or complex, special-purpose project planning programs.

► Illustration of a project plan

Sample table showing time schedule and activities plan:

Example 


Steps	Sets of tasks Tasks Activities	Start date	Finish date	By whom (1)	By whom (2)	By whom (3)	By whom (4)
1	Business plan						
2	Negotiate bank loan						
3	...						

Often project activities

- ➔ have to be performed and completed simultaneously and
- ➔ are dependent on one another.

In order to start Activity 5, Activities 2 and 4 have to be completed.

A so-called Gantt chart is a type of bar chart that is drawn up to illustrate a project schedule. It shows which activities overlap and – with some restrictions – which ones are dependent on each other.

Example 

Simplified Gantt chart:

Activities	Months	1	2	3	4	5	6	7	8
	Activity 1		[Bar from month 1 to 8]						
Activity 2			[Bar from month 2 to 4]						
Activity 3				[Bar from month 3 to 7]					
Activity 4				[Bar from month 3 to 5]					
Activity 5							[Bar from month 6 to 8]		

Explanations:

- ➔ Activity 1 stretches over the entire project time of eight months.
- ➔ Activity 2 starts in month 2 and ends in month 4.
- ➔ Activity 5 starts in month 6 (after activities 2 and 4 have been completed) and ends in month 8.

2. 3. Mistakes made in Project Plan Design

2. 3. 1. REASONS WHY PROJECTS FAIL

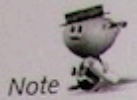
There are various reasons why projects fail:

- ➔ Mistakes are made in the early stage of defining the project targets.
- ➔ The creditors or other parties involved are insufficiently informed.
- ➔ The project does not receive full management support.
- ➔ The project manager does not have sufficient competencies to carry out the project and / or lacks the necessary qualifications such as technical know-how and social competence (to motivate the project team members, for example).
- ➔ The project team has been composed improperly. Some of the team members lack the technical know-how, while others are not sufficiently motivated (perhaps because they derive no personal benefit from the project and regard it as additional stress besides their regular job).
- ➔ Project planning has been unrealistic (timeframe, budget), which may cause a drop in motivation as the milestone deadlines are never met. Worse, schedules may not be adapted to the new situation.
- ➔ Projects are rejected and torpedoed by external parties who feel that their interests could be constrained.

➤ *Mistakes made in project plan design*

Success criteria for project planning

Additional information on the extensive issue of project management is offered in special courses and seminars, most of which focus on the following key elements:



Note

- Start of the project: what to pay attention to during the decisive starting phase of a project (instant involvement of the project team members, for instance)
- Staff aspects: which business and personal requirements a project manager is expected to have and how project teams can be motivated, monitored and directed
- Project marketing: how best to sell a project (prior to its start and in the course of project realization) so as to garner as much internal support as possible and persuade project opponents
- Project control: how to monitor whether the project is developing according to schedule and how to react in cases of crises
- Project finish: how to finalize a project in such a manner that its findings and conclusions benefit you in future projects

The following keywords and contexts (which are and examples in this business world – f

→ Explain the goals a For professional planning Such a plan is needed goals within a set sche

- Project plan structure:
- project goal
 - resource planning
 - project team, includ
 - project realization p
 - project time-plannin
 - financing party that

→ Explain the term " The project goals mu

- S specific, i.e.
- M measurable;
- A attractive; i
- R realistic; i.e.
- T time-bound, It may also make sense

→ Explain the term " In order to carry out a

- staff that has the rev
- physical assets, and
- financial assets.

The specific demand f appropriate budget..

→ Explain the term " A project team consists

- the project manager ;
- project team member

Before the start of a pre

- Success of the project la
- experience in project ma
 - business know-how
 - product know-how
 - perseverance and resili
 - social and communicat

EASY BUSINESS IN TELEGRAM STYLE

PROJECT PLANNING

The following keywords and concise descriptions give an overview of the EBC*L Level B learning objectives. They do not, however, offer detailed explanations of the business terms and contexts (which are required for Level B exams). For those, please see the business texts and examples in this book. In addition, we advise you to identify practical examples from the real business world – for further progress.

► Explain the goals and structure of a project plan.

For professional planning and preparation of a project a written project plan is indispensable. Such a plan is needed to optimize the input-output relationship and reach pre-defined project goals within a set schedule.

Project plan structure:

- project goal
- resource planning
- project team, including tasks and responsibilities
- project realization planning
- project time planning, including important milestones
- financing party that must accept the project and provide (financial) resources.

► Explain the term "target planning".

The project goals must meet the so-called SMART criteria, which are:

- S specific; i.e. the goals must be precisely formulated
- M measurable; i.e. it must be possible to produce and record quantifiable results
- A attractive; i.e. it must be worth supporting the goals
- R realistic; i.e. realizing the goals must be feasible, and
- T time-bound; i.e. a time must be identified by which objectives have to be reached.

It may also make sense to stipulate clearly what are not the goals of the project (= non-targets).

► Explain the term "resource planning".

In order to carry out a project, it is necessary to provide

- staff that has the required know-how and time
- physical assets, and
- financial assets.

The specific demand for and scope of these resources must be defined and secured by an appropriate budget.

► Explain the term "project team".

A project team consists of:

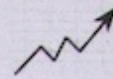
- the project manager and
- project team members.

Before the start of a project, competencies and tasks must be clearly defined.

Success of the project largely depends on the project manager who needs to have experience in project management

- business know-how
- product know-how
- perseverance and resilience
- social and communicative skills

Learning targets



➤ Explain the term "project realization planning":
Project realization includes project time planning and detailed planning of activities.

➤ Explain the term "milestones".
Milestones divide the project realization process into different phases and define important interim results. They help to find out whether project work is on schedule.

➤ Explain the terms "project activities planning" and "(project) time planning".
A project activities plan determines which activities are to be performed by whom, and by when.

➤ Explain methods of project plan presentation.

Tables and diagrams are used to illustrate project schedules.
Bar charts show which project activities overlap and which ones are dependent on each other.

Steps	Sets of tasks Tasks Activities	Start date	Finish date	By whom (1)	By whom (2)	By whom (3)	By whom (4)

➤ Explain what mistakes may be made in project plan design.

- The project targets are poorly defined.
- The creditors or other parties involved are insufficiently informed which results in project rejection.
- The project manager does not have sufficient competencies.
- The project team has been composed improperly.
- Project planning is unrealistic (timeframe, budget).

ACTUAL ANALYSIS



Overall Learning Objectives

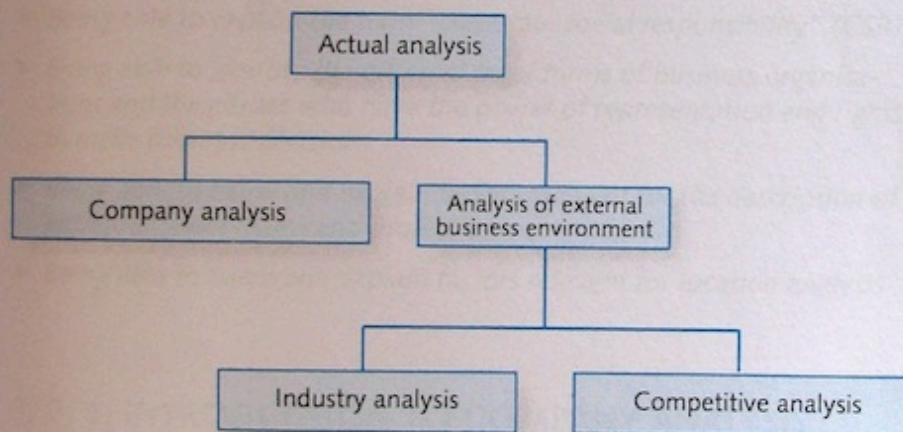
- ▶ *Being able to explain and analyse one's current (business) situation as a starting point of a business plan*
- ▶ *Being able to explain the goals and methods pertaining to a company analysis*
- ▶ *Being able to explain the goals and methods pertaining to an analysis of the external business environment including industry analysis and competitive (or competition) analysis*

3. 1. Actual Analysis - Overview

Any business planning process ought to start from solid actual analysis. Only a business person who knows about his present position can set realistic goals and take appropriate steps to realize them. There is little sense in setting the goal of conquering the global market if today your enterprise is still small, highly indebted and doesn't have an outstanding business idea.

Elements that are part of an actual analysis are

- Business analysis
- Industry analysis (= Analysis of the economic sector or subsector in which the enterprise operates)
- Competitive analysis (also: competition or competitor analysis)



The above are of interest for company promoters and company management as well as for all those who want to suggest a project to company management. Only if the project suggested fits into the overall strategic business framework of the enterprise, will there be the chance of realizing it.

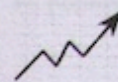
The proposal of an expensive investment project, for example, will have little chance of being accepted by a superior if the financial situation of the firm is tense at the moment.

3. 2. Company Analysis

Learning targets:

- Being able to explain the business idea and strategic business areas of an enterprise
- Being able to explain the term "USP" (unique selling proposition)
- Being able to explain the term "corporate identity"
- Being able to explain the term "corporate vision"
- Being able to name and explain strategic goals of an enterprise
- Being able to name and explain financial goals of an enterprise
- Being able to explain the criteria to be observed when setting goals
- Being able to explain the term "shareholder value"
- Being able to explain the term "stakeholder value"
- Being able to explain the term "corporate social responsibility" (CSR)
- Being able to identify the different legal forms of business organisations and the parties who have the power of representation and rights to make business decisions
- Being able to name and explain factors relevant for the description of entrepreneurial teams and project teams
- Being able to name and explain factors relevant for location analysis

Learning targets



3. 2. 1. INTRODUCTION TO COMPANY ANALYSIS

All the questions that need to be answered in the course of a **company analysis** can be categorized under four major focal points:

1. What actually determines a business organisation?
 - What is the basic business idea?
 - What are the critical success factors of the business? What is its USP? How does it distinguish the enterprise from other companies?
 - What are the strategic business areas of the enterprise?
 - What determines the enterprise's corporate identity, corporate vision and corporate mission?

- What are its strategic goals?
- What are its financial goals?

2. Who is behind the business organisation?

- Who are the owners / shareholders and what expectations do they have with respect to the enterprise?
- What other people / interest groups (= stakeholders) are directly or indirectly influenced by the enterprise? What are their expectations with respect to the enterprise?
- What legal regulations is the enterprise subject to (legal form of business organisation, power of representation, rights to make business decisions).

3. What are the enterprise's staffing and location prerequisites?

- What does the business team look like? Who is responsible for corporate management? What are the competencies of managers and staff?
- Where is the enterprise located? Is it the ideal location to meet all requirements?

4. Is the enterprise's financial situation sound?

- Is the enterprise permanently liquid? Is there sufficient (equity) capital in the business?
- Is there sufficient and long-term financial planning?

If plans are made to set up a business, all these questions are, of course, of future relevance, including:

What should the USP of the enterprise be? What will the owners expect from the business? Who should be in the business team? How will the enterprise be financed?

This chapter will now explain the technical terms and relationships that have been introduced above and then apply them practically in the two case studies "Bossi Pizzeria" and "Bossi's Pink Sauces", so as to demonstrate even more clearly why these basic questions are so vital.

(EBC*L Level A, "Accounting" and "Ratios" and EBC*L Level B, "Financial Planning" and "Financing" deal with corporate financial issues in greater detail)

3. 2. 1. WHAT ACTUALLY DETERMINES A BUSINESS ORGANISATION?

BUSINESS IDEA, GOALS AND VALUES

In order to have lasting success, any enterprise needs a **business idea** that constantly attracts interest. When you analyse your business idea and the products and services resulting from it, you always need to remember the needs of your customers and keep an eye on the competition.

➤ *Business idea*

The business idea (= products and services) should appeal not just to you, but there must also be **customers** willing to spend money on it, which is aptly expressed in the following proverb:

"The bait must please the fish – not the fisherman." (Of course this is only partially valid because a business person will be able to sell a product most convincingly only if he personally fully believes in it.)

The second most relevant criterion to be paid attention to is the **competition**. You can stand up to competitors only if you are better, faster, more attractive, more affordable, more modern, or friendlier than they are.

In a nutshell: The business organisation and its business idea, respectively, should be as unique as possible and distinguish themselves clearly from the competition. The technical term used to describe this uniqueness is **unique selling proposition** or **USP**.

➤ *USP*

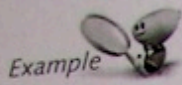
Management Talk: What is the USP of your product / project?

In most cases a business organisation wants to be unique in several areas: affordability, quality, friendliness, speed, etc. If you want to perform exceptionally well in several categories, however, you run the risk of mastering none of them. It therefore makes perfect sense to focus on one or a few success factors only: drop the idea of being the fastest in exchange for producing outstanding quality. In this case, your customers may have to wait a bit longer but will receive products of exceptional quality.

➤ *Success factors*

Most businesses offer not just one product, but entire product ranges which may comprise thousands of individual products. Within the entire product range, some groups of products may be of crucial importance for the enterprise. They are referred to as **strategic business areas** and require the company's full attention. Products that don't fall into these areas are at risk of being eliminated from the portfolio should their sales figures be disappointing.

➤ *Strategic business areas*



Strategic business areas of a car dealer could be:

- New car sales
- Used car sales
- Additional business activities could be car repairs and sales of car spare parts. These services are offered, however, only if they don't drain too many resources from the strategic business areas and thus reduce overall business success.

Corporate goals and values system

➤ Corporate goals and values system

In the past, not much thought was wasted on a corporate goals and values system. It simply came as a by-product of charismatic company leaders. What was perceived as the outstanding characteristic of a business leader reflected on the enterprise as well. If a managing director had the reputation of being innovative, this feature was also attributed to his enterprise. If an entrepreneur was known to be highly conservative, this attitude was transferred onto the business.

Today, more and more enterprises are formulating their own goals and values system that allows them to steer a certain course and to get all the involved persons moving in the same direction. In the absence of any pre-determined direction, the temptation will be huge to take the path of least resistance. The negative outcome may be a zigzag course that attempts to circumvent legal restrictions, violates the environment, exposes workers and employees to stress, puts suppliers under pressure, and more.

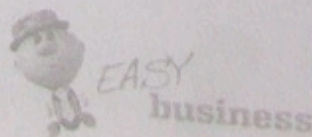
Such practices are ethically reprehensible and lead down the wrong track in the long run – particularly if any corporate misconduct becomes publicly known and causes damage to the corporate image. Enterprises that have made it into the headlines because of tanker accidents, child labour and illegal accounting practices are well-known examples.

Corporate scandals of that kind drive customers away and also cause negative reactions among employees. Who actually wants to work for an enterprise that makes profits at the expense of our children?


➤ Corporate vision

Such negative examples show that it makes a lot of sense to establish a system of corporate values. The technical term used most frequently is **corporate vision**.

- ➔ **Corporate vision:** comprises clearly defined common goals that should be achieved in a way that maintains set corporate value standards.



We want no other enterprise to offer better quality than we do. We would like our customers to smile when they think of us and remember each and every one of our employees as a helpful friend.

Example 


Of course, the company's focus is also on profitability, which should ideally be as high as possible. This should be achieved, though, by protecting the environment and respecting the needs of our employees whom we want to enable to lead a pleasant life outside of their jobs. We are aware of our social responsibility, and whenever the opportunity arises we will develop programmes that support disadvantaged groups of society.

➔ **Corporate Mission**

➤ Corporate mission

A corporate mission statement defines more accurately what business goals an enterprise wants to achieve.

Today we are one of the largest domestic suppliers. Our company and its products are known by 80% of the members of our target group, which is a position we intend to maintain.

Example 

We are convinced that our products can offer added value to customers world-wide and facilitate their lives. As a next step, we intend to approach target groups in all of Europe and give them the opportunity to enjoy the benefits of our products. With the support of our international distribution and marketing partners, we are planning to reach a market share of 30% within three year.

➔ **Corporate identity**

➤ Corporate identity

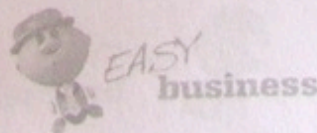
If the ideas of corporate vision and corporate mission are adhered to and pursued seriously, a company is likely to develop its own corporate identity that is perceived within the enterprise as well as by the outside world.

Its employees, customers and everyone else involved can instantly associate a certain feeling or image with the company's name. Ideally these associations should be of positive nature because it requires quite some effort and financial outlay to eradicate negative associations caused by inferior quality, unreliability and the like.

➔ **Corporate design**

➤ Corporate design

For an enterprise to be perceived as a unit within the company and by the outside world, some unique optical or other features are necessary prerequisites. These include the brand name, the logo, one or more company colours, and perhaps even a company uniform or a company song.



Now that the general image of the company is determined by corporate vision, mission, and design, the enterprise can set concrete goals, which can be subdivided into **strategic and financial goals**.

➤ *Strategic goals*

Typical **strategic goals** can be articulated as follows:

- ➔ We want to become the market leader within two years.
- ➔ Our market share should double within two years.
- ➔ We intend our company to be present in twenty countries two years from now.
- ➔ Our enterprise must expand its position as leader in innovation in its industry.
- ➔ We want to operate in emerging markets and withdraw from sunset markets in time.

➤ *Financial goals*

Things become even more concrete when companies set the **financial goals** they want to achieve. Major, superordinate goals enterprises focus their attention on are:

- ➔ to reach appropriate profitability
- ➔ to secure liquidity
- ➔ to secure competitiveness through high productivity

These goals are supported by relevant **key ratios**:

- ➔ The income-to-equity ratio should be at least 12%.
- ➔ Return on equity should not drop below 8%.
- ➔ The cash ratio should always be above 100%.
- ➔ The equity ratio should not be below 25%
- ➔ The return on sales should always be 15% higher than that of the immediate competitor.

These superordinate goals can be achieved by setting **subordinate goals**, such as:

- ➔ raising sales by 20%
- ➔ lowering labour cost by 15%
- ➔ lifting employee satisfaction by 30%

Corporate goals systems / Corporate goal interdependence

The items listed above clearly show that corporate goals are often related to each other, which can have different implications:

→ Competing goals

One goal is achieved at the expense of another one. It must be decided which goal is more important.

Lowering the labour cost is unlikely to go hand-in-hand with enhanced employee satisfaction.

→ Complementary goals

Achieving one goal supports the process of reaching another one.

Improvement of the corporate image results in higher employee satisfaction.

→ Independent goals

There is no relationship between the goals.

Lowering administrative expenses has no influence on cutting the cost of materials.



Examples

In addition, when setting and formulating goals, one can distinguish between

→ absolute goals,

where the objective is given in absolute figures, as in.

Our sales goal for next year is one million euros.

→ and relative goals,

which are measured in comparison to a benchmark, as in

Our costs should be 10% lower than those of our competitors.

▶ Setting goals

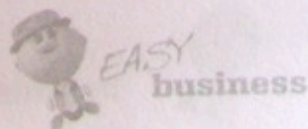
Furthermore, goals are of value only if they are appropriately defined and well-formulated. The abbreviation SMART, a mnemonic device used in project management, tells us which criteria must be observed when goals are set and worded. They must be

→ specific

Goals must be formulated as precisely as possible, ideally by linking the achievement to a number, rate or percentage.

→ measurable

A method or procedure has to exist which allows the tracking and recording of the results of the objective. They must be quantifiable.



→ **achievable**

People put in charge must be capable of reaching the objectives. Goals that are unachievable are not taken seriously and cause de-motivation.

→ **relevant**

The goals that are set must actually have an impact on superordinate corporate objectives. If they don't, they are irrelevant.

→ **time-bound**

A time frame needs to be set, stipulating by when an objective has to be reached.

Objectives are set by people or groups of people, which takes us to the second block of questions that concern the actual analysis of a business enterprise.

3. 2. 2. WHO IS BEHIND THE ENTERPRISE? INTERESTS OF VARIOUS PARTIES

This is an absolutely essential question because it makes a difference whether the owner of an enterprise is

- an individual who runs the business organisation in the fifth generation and considers it his life's work
- an investment fund, whose fund manager's task it is to achieve the highest return on investment within a minimum time or
- a not-for-profit organisation which measures its business success in terms of how many people's lives its business activities saved in Africa.

What they all have in common, though, is the **efficiency rule**, which says that one should attempt to

- achieve the maximum output with a minimum of input.

➤ *Shareholder value*

Today the owners of a business are frequently referred to as shareholders in the wider sense of the word. Their return, i.e. the profits from their investment, is known as **shareholder value**.

In recent years, the sole concentration on shareholder value has been widely criticized. Admittedly, shareholder value may be the best for the owners of a corporation, often represented by investment fund companies whose goal is the highest possible (short-term) return. One disappointing quarter may be enough for them to dump their stake in a certain company and add shares in another enterprise to their portfolio instead. Many management decisions therefore emphasize dividend payments to shareholders so as to maximize

shareholder value. The very same decisions, however, can threaten the long-term health of a company and jeopardize jobs and the economic future of an entire region.

As large companies have felt the pressure to shift emphasis away from the shareholder value principle, many of them are now including the interest of the so-called **stakeholders** in their considerations. The term stakeholder refers to people and institutions that are directly or indirectly affected by the activities of a business organization.

Stakeholders include

- employees who want a decent salary, a pleasant working environment and secured jobs
- customers who expect an optimal cost-benefit relationship
- works council members who want to be re-elected
- banks which want to earn interest income and rely on secured loans
- suppliers who prefer customers that pay their bills reliably
- the central and local governments that seek income through tax payments
- consumer organizations which want to protect customers against inferior products and improper business practices
- human-rights organizations which want to prevent child labor and exploitation
- local residents who want to live a life without noise and air pollution
- and many more.

Including social and ecological interests in corporate policy has become known as **corporate social responsibility (CSR)**.

It makes sense for more than just moral reasons to include the wishes and needs of the stakeholders in the strategic considerations of the company. Today's stakeholders may exercise significant influence on enterprises and even push them out of business.

There have been cases where world-wide pleas by environmental protection organizations (such as Greenpeace) and other NGOs (Non Governmental Organisations) not to buy products of certain companies that distort the ecological balance of the oceans or benefit from child labor and other forms of exploitation have shaken even global companies.

► Stakeholder value

► Corporate social responsibility (CSR)

► Legal forms of business organisation

The legal framework

Enterprises need a name, a legal business form, and people who represent it to the outside world. All these issues are more thoroughly dealt with in EBC*L Level A.

This unit focuses only on the implications which the legal business form of an enterprise has for the interests of those people who are behind it.

If the enterprise is a sole proprietorship, a general partnership or a limited partnership, it can be assumed that in case the firm runs into financial difficulties, at least one of the owners will have to put his head on the chopping block because he has full and unlimited liability for the debts of the enterprise. Thus he will do his utmost to secure the firm's success and to avoid bankruptcy.

In these business organizations the rights of decision-making and the power of representation are almost always restricted to the sole trader and (general) partners.

In a private limited company, the risk of liability is generally reduced. In small private limited companies, however, there will always be somebody who is fully liable at least for the money owed to banks.

In large, international private limited companies, which in many cases are subsidiaries of a group, personal liability is no longer an issue, and the same is true for public limited companies.

In small private limited companies, the largest and most influential shareholder will most likely be a managing director as well and thus make all important decisions and represent the firm to the outside world.

The managing directors of large private limited companies are most probably company employees who are in charge of the day-to-day business. When vital decisions have to be made, though, they must seek the consent of major shareholders by whom they have been appointed.

The issue of decision-making is even more complex in public limited companies, where three levels of authority may influence the decision-making processes: the annual meeting of shareholders, the supervisory board and the management board (that represents the company to the outside world).

We are now moving on to two more factors that can determine the success of an enterprise: the (business) team and the location.

3.2.3. WHAT A LOCATION

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3. 2. 3. WHAT ARE THE ENTERPRISE'S STAFFING AND LOCATION PREREQUISITES?

The business (or project) **team** is responsible for setting objectives and must ultimately be capable of realizing them. Business team analysis therefore carries great weight and is performed according to the following criteria.

- ➔ number of team members
- ➔ education
- ➔ business experience
- ➔ length of employment
- ➔ demographic variables (age, sex, nationality)

➤ Team

Whether or not the **location** of a business plays a major role depends on the industry in which the enterprise operates. If the enterprise caters to the casual customer, even a few meters can be crucial for the future of the firm.

➤ Location

A hairdresser, for example, whose salon is located in the middle of a pedestrian zone has a clear edge over his competitor whose shop is 30 meters off Main Street.

Example



For a manufacturing company, a location close to raw materials, energy sources or traffic arteries is advantageous.

For a software firm, however, location may play an inferior role, particularly because today's information technology enables firms to communicate with their employers and customers sight unseen over thousands of kilometres.

In many industries, cheap labour is the factor that determines the attractiveness of a location, as shown by the examples of low-cost computer programmers in India and cheap call centre staff in Eastern Europe.

Location factors that need to be taken into consideration may be:

- ➔ customer proximity
- ➔ qualification of employees
- ➔ payroll cost
- ➔ raw materials, energy cost
- ➔ traffic connections
- ➔ legal fees and tax burden
- ➔ environmental protection requirements
- ➔ political situations, and many more



BOSSI PIZZERIA: BUSINESS ANALYSIS

Together with Mrs Bossi, Mr Salt and Mr Pepper, Mr Bossi starts scrutinizing his firm. For this procedure, the catalogue of questions Mr Bossi received from the tax advisor is of great help.

What is Bossi Pizzeria's business idea, what is its USP and what are its strategic business areas?

The question about the business idea or the purpose of the business is answered quickly: We intend to make outstanding pizzas and thus concentrate entirely on this product. We should rather make perfect pizzas instead of offering a great variety of dishes of mediocre quality.

We want to offer our guests a pleasant atmosphere. They should feel comfortable at our restaurant. In addition, our pizza-catering service that was introduced three years ago should enable our customers to enjoy our delicious pizza at home as well.

Thus our two strategic business areas are:

- ➔ pizzas and beverages at the restaurant
- ➔ pizzas and beverages catering service

Our USP – what can we do that others can't – can be explained quickly: Because of our secret recipe, our pizzas have been acknowledged as the best ones in the world, which was also confirmed by a gourmet guide test.

Bossi Pizzeria's corporate identity, vision and mission

Even if nothing has been explicitly said or written down, everyone agrees that Mr Bossi himself accounts for a large part of Bossi Pizzeria's corporate identity.

His customers see him as the driving force behind:

- ➔ the permanently excellent taste of the pizzas
- ➔ the outstanding quality of all the ingredients
- ➔ the satisfaction of customer wishes – regardless of how unusual they may be
- ➔ the cleanliness of the business from the kitchen to the basement

What is more, Mr Bossi has also made a personal impression on his guests. He wears his unique chef's hat almost day and night and has been immortalized with it in local newspapers several times.

The regular employees have always supported corporate values. Still, after the business was expanded three years ago to include the catering service, it is questionable whether the loyalty of all the employees is going to last. After all, Mr Bossi no longer represents modern values, makes autocratic decisions, is stubborn and occasionally has choleric fits.

Shareholder value

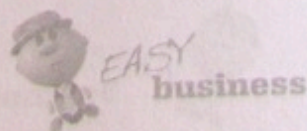
Mr and Mrs Bossi are the main shareholders in the enterprise. Another investor is Mrs Leek, who joined Bossi Pizzeria as an undisclosed partner five years ago, putting 100,000 euros into the business. Her expectations are easily explained: She would like to see her investment pay a decent return of about 10,000 euros per year, which is a yield of 10% – a modest expectation in her opinion. Mr Bossi disagrees: earning 10,000 euros without moving a finger is anything else but modest. Mrs Leek, however, has always made it clear that she would otherwise make immediate use of her contractually stipulated right to withdraw from the firm and to re-claim her original capital contribution. Under present circumstances, though, Mr Bossi cannot afford to let her go because he simply does not have the necessary liquid funds.

Up to now, Mrs Leek has always been completely satisfied. Every year Mr Bossi was in the position to pay her the amount of 10,000 euros and when things went really well it was even 15,000 euros.

This year, however, the situation is bleak as a result of the enterprise's losses. How will Mrs Leek react to this bad news? Will she actually withdraw her investment from the enterprise? This could certainly lead to the demise of the firm.

It is quite natural for the shareholders Mr and Mrs Bossi to expect something from the enterprise as well.

- ➔ They want the money they have put into the business to produce a reasonable yield.
- ➔ As they work in the business day and night, they want an appropriate reward. They could certainly make their valuable time and know-how available to another restaurant against decent pay – and there would be enough job offers for them out there.
- ➔ For the Bossis, however, their pizzeria is their life's work and, together with their children, their purpose in life. That is why they want to do everything to secure the business now and in the immediate and remote future.



Stakeholder value

There are quite a few stakeholders as you may see from the list below:

- customers, employees, the firm's bank, suppliers, the state and the community
- Unfortunately there are also the neighbouring residents who want peace and quiet (and definitely no outdoor dining area), no air pollution, sufficient parking space (and no blocked driveways). Furthermore, the police have no desire to be summoned every day because of disturbing noise.

Legal business form, legal representation

From the very beginning ten years ago, the legal business form of Bossi Pizzeria has been that of a private limited company.

The enterprise is represented exclusively by its managing director, Mr Bossi. He is the only one to sign contracts, place orders and accept them. It is also he who makes all important decisions.

He has never given his employees anything more than highly restricted commercial authority. They may, for instance, take pizza orders and have the right to collect money. General commercial power of attorney has never been considered.

Business team

Mr Bossi is the head of the enterprise. He is the owner and the managing director of the business. He is the driving force behind the vision and the goals of the firm. He is a professional cook. Although he himself refers to his knowledge in business management and administration as being rather poor, he believes he has sufficient managerial skills. Otherwise he would not have been so successful in running his business for ten years.

Mrs Bossi is a professional baker. In addition she has taken private continuing education courses in data processing and business management and administration.

Mr Salt is a waiter by profession and has a sound business education. As concerns the restaurant business, nobody can fool him. In addition to that, he is exceptionally popular with the guests and many regular customers come just because of him. If he left, they would not visit the pizzeria as regularly anymore.

All three have been with the enterprise from the beginning. They are all about 45 years old and work 60 hours a week and more. They are almost never ill and hardly ever consume their full vacation time.

The rest of the team consists of seven staff and most of them have been trained on the job. As usual for the restaurant and catering business, labour turnover is high.

In a nutshell: The core team is characterized by high motivation, loyalty, reliability and know-how and is indispensable for the enterprise.

All the other employees are only loosely tied to the enterprise. As a result, they mostly work to rule and turnover is high, which again and again leads to personnel shortages until new employees are found.

Location

Bossi Pizzeria is located in a small town – not in a prime location but certainly well situated.

➔ Advantages:

- People in this small town and its suburbs have above-average income and are quite affluent.
- The restaurant can easily be reached by public transportation.
- The restaurant can easily be reached by public transportation.
- All of its suppliers are from the immediate neighbourhood.

➔ Disadvantages:

- There is no pedestrian area.
- As the neighbours are highly noise sensitive, outdoor dining is not possible (=lower revenues in summer).
- There is a lack of parking space in the evening
- Because of low unemployment it is difficult to find qualified personnel that are willing to work in the restaurant business on the usual terms.

3. 3. Industry Analysis

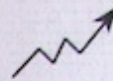
Learning targets:

- Being able to name and explain developments and trends to which an industry can be exposed
- Being able to name and explain factors relevant for an industry analysis
- Being able to explain the terms "market potential", "market volume", "market penetration" and "market share". Being able to explain the term "market niche"
- Being able to explain the term "market entry barrier"
- Being able to explain the term "substitute product"

After an actual analysis of your own enterprise (= internal environment) has been performed, it is crucial to look beyond your firm and analyse the external environment. The following media headlines clearly show how important it is to keep an eye on the **industry** and on **competitors**.

- Trend of outsourcing computer programming activities to low-wage countries continues.
- Acquisition of the XY Company by AZ has restructured telecommunications industry.
- Trade unions succeeded in claiming 3% raise for commercial employees.
- Accounting scandal affects entire banking industry of the country.
- Implementing environmental protection measures helped paper industry improve image.
- Insurance business still suffering from few agents' improper sales practices of insurance products. Measures have been taken.

Learning targets



3.3.1. TRENDS

► Trends

An increasing number of consumers think and act more economically (and from the viewpoint of enterprises more recklessly) and have no guilty conscience when they make use of the expensive advisory service at a specialist store but are unwilling to pay anything extra in exchange. For enterprises, this may be deplorable but there is no use in complaining about it or pitying yourself. If you don't adjust to this **social trend**, you will lose.

A noticeable **demographic trend** which affects almost all industries is the increase in the number of old people (= aging of society). Thus the demand for products for the elderly has been rising.

Socio-political trends are of equal interest. There is, for instance, greater wealth, which is, however, distributed unevenly. For companies, the resulting division into two large social groups may mean that they either concentrate on the affluent customers or on those who can spend only a little money and cannot afford to pay high prices (= discount pricing strategy).

Of course, industries are not unaffected by current **economic developments** either. A growing economy will have a generally positive effect on almost all industries. If the economy does poorly, most industries will be affected. Exceptions are those companies which operate in a business that somehow benefits from people's problems.

Example



The 9/11 events led to massive losses in the travel and tourism business and had an impact on the general economy as well. Suppliers of security systems for airports and airplanes, however, did well.

3.3.2. INDUSTRY CHARACTERISTICS

► Industry

Example



In spite of his high-quality products, even the world's best producer of traditional films cannot successfully compete with digital photography.

For that reason, analysing the industry in which a company operates is of utmost importance. The term "industry" (or "business") refers to a large number of enterprises which all manufacture similar products or offer similar services.

Industries are subcategories of three economic sectors into which a country's economy is generally subdivided:

- ➔ primary sector: agriculture, forestry and fishing industries
- ➔ secondary sector: manufacturing businesses
- ➔ tertiary sector: commerce and services

An industry can be assessed and analysed according to a number of criteria, some of which are:

- ➔ market structure and changes on the customers' side
- ➔ market structure and changes on the sellers' side
- ➔ roles of suppliers
- ➔ roles of retailers
- ➔ technological developments
- ➔ general social trends

Example of structural change on the customers' side: *More and more families own a second car because the wife is employed or mobility for / with children would otherwise be restricted.*

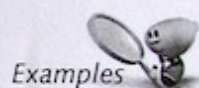
Example of structural change on the sellers' side: *Today food retail chains offer tourism and travel products, whereas previously the sales of these were restricted to travel agencies.*

An industry is subject to permanent change and cannot escape the influence of trends which are brought about by new technologies. The Internet, for example, poses completely new challenges to the retail trade. The number of consumers who first seek advice in a specialist retail store and then buy cheaply through the Internet is rising constantly.

The salient features of an industry analysis are a good estimate of

- ➔ the **market potential** (= the largest imaginable number of users who are capable of and willing to purchase a certain product)
- ➔ the **market volume** (= the proportion of the market potential that is being serviced by all suppliers at the moment)
- ➔ the **market share** (= the percentage or proportion of the total market volume that is being serviced by one company)

$$\text{Market share in \%} = \frac{\text{company sales}}{\text{market volume}} \times 100$$



Examples

➤ Factors relevant for an industry analysis

Example



- In the town of XY, 10,000 people are potential buyers of an off-road vehicle (= market potential).
- There are already 2,000 owners of such a vehicle (= market volume).
- Of those, 500 have decided to buy the AZ brand. The market share of this brand is 25%.

These variables are important for estimating the market potential of your own enterprise and also help you determine how successful you have been in comparison to your competitors.

Your enthusiasm about a rise in sales of 20% could, for example, be dampened if your competitors have been able to increase their sales by 50% - which means that your market share has dropped at the same time.

Furthermore, it is vital to know in which **life cycle stage** the industry is as a whole.

Is it an emerging market that is in its early growth stage or has the industry already passed its peak? In the former case, market penetration (= the number of target group members who already have or use the product) will still be low and there will be plenty of unused market potential for competitors to co-exist side by side. One supplier would probably not even be able to serve the market alone.

In an almost **saturated market**, though, unused **market potential** is very low. Enterprises face the problem of having built up capacity for which there is no longer any demand. Their alternatives are to reduce capacity or attempt to woo customers away from the competition.

What companies need the least in such a situation are newcomers who worsen conditions in an already tight market where customers are scarce. No wonder that newcomers are not necessarily greeted in a friendly manner. During the first couple of months they must expect the big players to tackle them with special pricing policies and aggressive advertising campaigns.

A market analysis should therefore find out what the present market volume is and how high it could possibly be in the future. The maximum future market volume is referred to as market potential. The crucial question is whether a large number of individuals (or companies) will express demand for the product or whether there instead exists a small market niche with few (but perhaps highly affluent) potential buyers.

Particularly for small and medium-sized businesses, markets with huge market potential are not necessarily ideal. These markets are often conquered by large enterprises which benefit from economies of scale (= high volume of procurement and production reduces cost per unit). Small firms can hardly compete, and their chances are restricted.

For small enterprises, **market niches** could therefore be ideal. A market niche is a small market segment with few potential buyers, (rather little market potential) but also with few competitors.

Examples of market niches are:

- ➔ shoes for people with shoe size 55 and up
- ➔ Braille cookbooks
- ➔ sweets for people suffering from extreme allergies

How easy or difficult life in a particular industry will be for an enterprise also depends on how difficult it is for other companies to enter this market. In some cases there are hardly any **market entry barriers** and a hot-dog stand, for example, can be opened very quickly. Other markets, however, can be characterized by significant entry barriers, such as the ones listed below:

- ➔ *technological barriers (extensive R&D activities in the pharmaceutical industry)*
- ➔ *legal barriers (existing patents, strict legal regulations for running a business)*
- ➔ *location-relevant barriers (above-average rent)*
- ➔ *and many more*

When an industry is analysed, one must remember that the competition does not just comprise firms that produce the same items. It is important to find out how easily a product can be replaced by a totally different one that offers the same benefit. Such a product is referred to as a **substitute product**.

Currently the best example of such a substitute product is the mobile phone. This small gadget is actually threatening the existence of entire industries whose products are being substituted by all the additional functions and features of the mobile phone. Apart from its major function as a telephone, the mobile is also a camera, a radio, an MP3 Player, an alarm clock and it can be used to measure your pulse. This is certainly a highly unpleasant development for all the producers of alarm clocks and cameras in this world, as well as for the retailers who want to make a living by selling alarm clocks, watches and cameras.

➤ Market niches

Example



➤ Market entry barriers

3. 4. Competitive analysis

Learning targets:

- Being able to explain the terms "monopoly", "oligopoly" and "polypoly"
- Being able to name and explain factors relevant for a competitive analysis
- Being able to explain goals and methods of and limitations to benchmarking

Every industry is influenced by the market behaviour of the sellers. This depends largely on how many sellers are sharing the market, i.e. which of the following market forms exist (See also EBC*L Level A):

- monopoly (= one enterprise dominates the market)
- oligopoly (= the market is divided among a small number of sellers)
- polypoly (= a large number of sellers operate in the market)

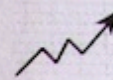
Still, the number of market participants alone doesn't allow any final conclusion about their behaviour. An oligopolistic market may be characterized by a peaceful coexistence of the suppliers if they agree on refraining from aggressive pricing policies and advertising campaigns. (If such agreements – like price fixing – are illegal and not in the public interest, the technical term cartel is often used to describe the association of enterprises that are involved. In some countries the banking industry is dominated by cartels.)

Oligopolies may also turn into battlefields, though, if one player intends to eliminate his competitors from the market. The result could be an outright price war, in the course of which products could even be sold below cost. Occasionally companies go as far as using defamatory promotional campaigns to harm a rival's reputation.

It is the consumers who often emerge as the winners from such cut-throat competition. Employees, however, on whose backs competitive price wars are fought, lose.

Normally the sellers in a market differ from each other in size. Some enterprises hold a large **market share** (= share in market volume expressed in percent), whereas others have to content themselves with market shares of only a few percentage points.

Learning targets



- Monopoly, oligopoly, polypoly

Large players frequently dictate what happens in a market: They determine the direction in which prices are heading and set quality standards. Strategic alternatives for smaller market participants are either to follow the market leader or to adopt an opposite policy so as to distinguish themselves from him.

3. 4. 1. BENCHMARKING

➤ Benchmarking

It is in the nature of a free-market economy that only the best survive and that mediocre players will not be able to hold their positions in the market in the long run. A company that wants to continue to exist must be superior to its competition in productivity, innovation, speed, or flexibility.

Direct rivals are therefore subject to suspicious scrutiny and are either looked down upon or dreaded. Every step the competitor takes is analysed and interpreted. What does he have up his sleeve now? How should we react?

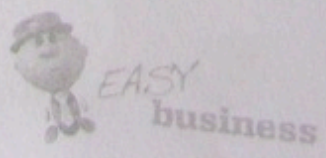
Expressions used in the media to describe such competitive situations often resemble those that refer to military conflicts ("battle for the customer", "guerrilla tactics", etc.).

It makes very much sense for an enterprise to analyse its competitors constructively, in particular if they are apparently more successful and regularly snatch away the company's customers. The situation resembles that of a tennis match in which a player is constantly pounded by his opponent. The former would be well-advised to analyse what accounts for the superior performance of the latter.

In business it is equally common to measure your enterprise's strengths and weaknesses against those of a more successful rival. As a benchmark is a point of reference for a measurement, the term **benchmarking** denotes a process used in strategic management, in which business organizations evaluate their own performance in relation to best practice, usually within their own sector.

Key questions in a benchmarking procedure are:

- ➔ How do we compare to others?
- ➔ Why are others better? What can we learn from them?
- ➔ What measures do we need to take to become part of the business elite?



Various features of an enterprise could serve as a benchmark: its product(s), staff, procurement strategies or production processes, its innovative strength, its management and more.

Financial and other ratios that measure productivity, profitability and liquidity are the tools that are used to compare one company with other enterprises.

"Don't compare apples and oranges" is an important rule of benchmarking that is unfortunately often ignored. When enterprises compare ratios, they must always know how these ratios have been calculated.

- *Media reports say that a competitor has a net operating margin of 20%. The margin calculated for your firm is only 10%.*
- *Panic could be unjustified if the competitor has used pre-tax profits (perhaps including exceptionally high revenues from real estate sales) whereas you used net profits.*
- *The same company is reporting that it has recorded sales-per-employee of 200,000 euros. Your own company's figures, however, amount to 150,000 euros only.*
- *Here also, appearances could be deceiving if the rival company has not included its leasing staff. If it had, the results would be quite different.*

Example



Not only can benchmarking be used to compare two enterprises with each other, it may also be applied within a company. Company divisions, branch outlets and employees should know where they stand and should be able to learn from the ones that performed better.

Benchmarking is especially vital for start-up businesses because it is indispensable for their owners and managers to analyse the mistakes market leaders have made and how to avoid them.



BOSSI PIZZERIA: ANALYSIS OF THE EXTERNAL BUSINESS ENVIRONMENT

Industry analysis

Bossi Pizzeria belongs to the restaurant and catering business, which is a traditional service industry that has been around for thousands of years and is here to stay. This industry doesn't provide a service that lasts, but one that is offered anew every time. More than any other service, this one is inseparable from the individuals, i.e. the staff, providing it. Mr Bossi and his team agree that it is the qualifications of the personnel that determine the ups and downs of their business.

What is typical of the restaurant and catering industry is its high bankruptcy rate, and enterprises that survive for more than ten years are the exception to the rule. There are various reasons for that, the major one being the lack of business management planning a large number of firms suffer from. Many former cooks and waiters simply underestimate the necessity of know-how in business management and administration and erroneously believe their professional skills are sufficient to run a restaurant.

Sales revenues in the restaurant and catering business largely depend on the economic situation as a whole, which is easily explained. If people have enough money to spend, they are more likely to enjoy a good dinner at a restaurant than at times when they have to make ends meet, in which case they of course resort to frozen pizza and don't eat out.

Another outstanding feature of this industry is its endless variety of different restaurant types, which can be categorized according to the following criteria:

- ➔ **Size:** small restaurants with as few as five tables, or large establishments with 500 seats or more
- ➔ **Type of cuisine:** local, Italian, Asian, or Mexican cuisine, just to mention a few
- ➔ **Pricing policy:** A broad range exists, from fast-food stands where a pizza slice sells for two euros, to exclusive restaurants where dinner for one person may well cost 200 euros.
- ➔ **Quality of food:** Many restaurants including affordable places are eager to offer good quality whereas others are not so particular.
- ➔ **Staff qualifications:** The lack of management skills of restaurant owners has already been referred to. In addition, the recruitment of quality personnel is difficult because payment is moderate in view of the work employees are expected to put in.

Another major criterion is the large number of black sheep in this industry who circumvent legal regulations and create an uneven playing field for law-abiding companies. Examples of illegal practices are:

- employment of cheap staff (mostly from abroad) without registration
- violation of working-time legislation
- failure to record business activities; tax fraud

Some of the general trends the restaurant and catering business is subject to:

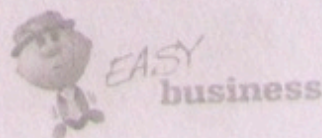
- **Social trends:**
 - There is a widening income gap between the growing number of affluent people and more and more poor people who can no longer afford to go to a restaurant.
 - Move towards healthy food
 - More women are employed and thus have less time to cook.
 - Consumers love variation and are becoming less predictable. Retaining regular customers has become more difficult.
 - Cooking at home with friends
- **Political / legal trends:**
 - Non-smoking rules and more stringent legal alcohol limits have already had an impact on the industry. New rules about alcohol consumption could be implemented.

In general, the restaurant and catering business is a highly dynamic industry which comes to feel any change in general trends immediately. Accordingly, restaurant businesses must be flexible and innovative if they want to survive.

Increasing rents are a major market entry barrier in the restaurant and catering business, and finding a suitable restaurant with affordable rental prices in a good location has become increasingly difficult. Existing restaurants that entered into relatively cheap rental agreements years ago have a significant competitive advantage over today's newcomers.

Competitive analysis

After this general analysis, Mr Salt suggests going into detail and figuring out the dimensions of their own, local market. The Bossi team is now trying to estimate the entire market volume of the restaurant business in their small town, from which they intend to calculate the market shares of the different competitors.

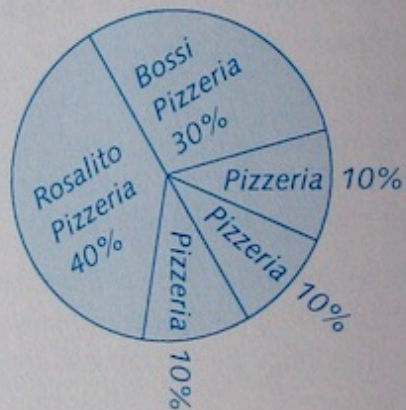


Their town has 50,000 residents, of which 30% regularly (i.e. once a week) go to a restaurant, according to a survey of the local newspaper. This is at least 15,000 people. Half of them, i.e. 7,500 people visit an Italian restaurant at least once a month. Assuming that every guest spends on average 20 euros per visit, total sales potential amounts to 150,000 euros per month.

The market volume is distributed among five pizza restaurants, with Rosalito Pizzeria proudly holding the largest market share of an estimated 40%.

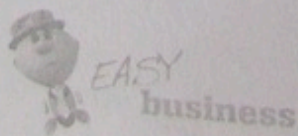
Bossi Pizzeria is ranked second with about 30%. The rest of the market is shared by three other pizzerias, two of which are known to be in trouble at the moment. The third one, however, is brand new and has managed to make a name for itself within quite a short time. It offers exclusively vegetarian pizzas and has discovered and occupied a market niche.

Market shares of five pizzerias:



The pizzeria market in this small town can be referred to as an oligopoly because a few sellers have divided the market among themselves. Should Rosalito Pizzeria continue to operate so successfully, however, it may soon be alone in the market and have a monopolistic position.

In the restaurant and catering business as a whole there is almost perfect competition (polypoly). The competitors know each other's product portfolios and price levels and their guests tell them everything else they need to know.



Rosalito Pizzeria as a benchmark
Rosalito Pizzeria is clearly the ma
last year, it managed to triple
very nervous. After some
in the meantime ev
capacity to host all its guests:
Rosalito Pizzeria purs
ago all prices were low
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Rosalito Pizzeria's smashing su
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Rosalito Pizzeria is a privat
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Bossi makes use of his righ
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much each of them contribut
employee is 40,000 euros.
Labour costs amount to 400,0
old was 200,000 or 25% of
EBC * L - Actual analysis

Rosalito Pizzeria as a benchmark

Rosalito Pizzeria is clearly the market leader in town. It combines prime location with outstanding quality. By renovating and extending its restaurant last year, it managed to triple output capacity, which naturally made its rivals very nervous. After some initial difficulties, it has learned from its mistakes, and in the meantime even the new restaurant sometimes has too little capacity to host all its guests.

In addition, Rosalito Pizzeria pursues a highly aggressive pricing policy. Two months ago all prices were lowered by 20% and the rivals unanimously agree: "Rosalito wants to finish us and kick us out of the market."

Furthermore Rosalito has had this great idea of starting a "Pay-as-much-as-you-want-on-Sunday" campaign. In other words, on Sundays it is the customers who decide what their meals are worth.

This campaign has been a complete success and customers as well as the media are enthusiastic. There have already been three long articles in newspapers and the restaurant is mentioned regularly on the local radio station. Reportedly, customers are extremely fair, and some of them pay significantly more than what they would have been billed for.

Recently there have been problems with personnel, though. Because of Rosalito Pizzeria's smashing success, the restaurant had to hire new employees who had neither appropriate education nor experience. Besides that, they made the mistake of entering into a long-term supply contract with only one brewery, whose beer is now suffering from major image problems. Rumours have it that the company added illegal chemical flavour enhancers to its products.

As Rosalito Pizzeria is a private limited company, the public has the right to look into its financial statements in the Register of Business Names. When Mr Bossi makes use of his right, he is dealt yet another blow: Rosalito's profit and loss account shows sales revenues of 800,000 euros and a net profit of 80,000 euros. This translates into a net operating margin of 10%. As Mr Bossi knows that Rosalito employs twenty people, he can figure out how much each of them contributes to the company's sales revenue: Sales-per-employee is 40,000 euros.

Labour costs amount to 400,000 euros, which is 50% of sales. Cost of goods sold was 200,000 or 25% of sales.

Mr Bossi immediately starts analysing his own financial statements in greater detail and compares his results with Rosalito's. He arrives at the following figures:

FINANCIAL INFORMATION / RATIOS	ROSALITO	BOSSI
Sales revenue	800,000	300,000
Net profit	80,000	-10,000
Net profit margin	10%	-3%
Sales-per-employee	40,000	30,000
Staff costs in % of sales revenue	50%	50%
Cost of goods sold in % of sales revenue	25%	35%
Equity ratio	40%	15%

This means that Rosalito Pizzeria is better in all categories. Whereas they retain 10% of sales revenues as net profits, Bossi Pizzeria needs to pay an additional 3 euros per hundred in sales in order to meet all expenses.

Rosalito's personnel is more productive and generates sales-per-employee of 40,000 euros although staff costs in both enterprises account for 50% of sales revenue. Rosalito Pizzeria apparently has another major advantage in procurement. Cost of goods sold consumes only 25% of sales revenue as compared to Bossi Pizzeria's 35%.

The bottom line is that Rosalito Pizzeria has both significantly higher sales and considerably lower costs.

Mr Bossi wants to do something about the procurement issue instantly. As he knows that the two companies buy certain products from the same suppliers, he contacts them right away.

What the suppliers tell him, though, is that they will be willing to grant him the same favourable terms as Rosalito Pizzeria only if the quantities he buys are similarly large as those of his competitor.

BOSSI PIZZERIA: ACTUAL ANALYSIS
 How many hours of analysing
 Bossi arrives at the following:
 • His enterprise's financial
 • The food and catering b
 • Rosalito Pizzeria, his m
 vative and likely to co
 vegetarian pizza restau
 • Unfortunately, the ente
 What will happen if
 time?
 • Losses must be expected
 that things must be change
 • Bossi Pizzeria closes
 • Attempts are made
 by means of new st
 For Mr and Mrs Bossi a
 Thus they agree on mak
 of their enterprise.

BOSSI PIZZERIA: ACTUAL ANALYSIS SUMMARY

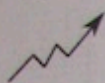
After many hours of analysing his firm's current situation with his team, Mr Bossi arrives at the following, sobering conclusions:

- ➔ His enterprise's financial situation is devastating.
- ➔ The food and catering business is affected by major changes.
- ➔ Rosalito Pizzeria, his main competitor is more productive and innovative and likely to continue its success story. Furthermore, a new vegetarian pizza restaurant has emerged as a serious rival.
- ➔ Unfortunately, the enterprise largely depends on one person (Mr Bossi). What will happen if Mr Bossi falls ill and is unavailable for a long time?

As losses must be expected in the years ahead as well, it is clear for everyone that things must be changed. There are two basic alternatives:

- ➔ Bossi Pizzeria closes down and is liquidated.
- ➔ Attempts are made to rejuvenate the firm and make it profitable again by means of new strategies.

For Mr and Mrs Bossi and their team liquidation is out of the question. Thus they agree on making every possible attempt to safeguard the future of their enterprise.



EASY BUSINESS IN TELEGRAM STYLE

ACTUAL ANALYSIS

The following keywords and concise descriptions give an overview of the EBC*L Level B learning objectives. They do not, however, offer detailed explanations of the business terms and contexts (which are required for Level B exams). For those, please see the business texts and examples in this book. In addition, we advise you to identify practical examples from the real business world – for further progress.

- Explain the **business idea and strategic business areas of an enterprise**.

A company's success rests on the products and services that result from its business idea. This business idea must always focus on the customers and their needs and there must be enough customers who are willing to spend money on the firm's products. All employees must be familiar with the basic business idea, identify with it and be able to communicate and sell it.

Core products and groups of products that are of crucial importance for the enterprise are referred to as strategic business areas.

- Explain the term **"unique selling proposition"**.

The uniqueness of a business organisation / a business idea / a product or service is referred to as "unique selling proposition" or USP. The enterprise or business idea should be as unique as possible and distinguish itself clearly from the competition.

- Explain the term **"corporate identity"**.

The term corporate identity refers to the feeling or image that is associated with the name of a company and describes how the company is perceived by the outside world (customers, suppliers, banks, etc.) and by its employees. A company's corporate identity is shaped by its products, employees, management and by set corporate values.

- Explain the term **"corporate vision"**.

Corporate vision comprises clearly defined common (long-term) goals that should be achieved in a way that maintains set corporate value standards.

- Name and explain **strategic goals of an enterprise**.

Strategic goals are medium-term and long-term goals that intended to be reached to realize corporate vision.

Examples of typical strategic goals:

- We want to become the market leader within two years.
- Our market share should double within two years.

- Name and explain **financial goals of an enterprise**.

Major, superordinate (financial) goals enterprises focus their attention on are:

- appropriate profitability.
- secured liquidity.
- high productivity.
- They help maintain and strengthen an enterprise's competitiveness.

► Explain the criteria to be observed when setting goals.

Goals must be appropriately defined and well-formulated. They should follow the SMART-principle and be:

- specific (= formulated as precisely as possible)
- measurable (= quantifiable)
- achievable (If they cannot be reached, they are not taken seriously and cause demotivation.)
- relevant (They must support superordinate corporate objectives.)
- time-bound (A time frame needs to be set.)

Goals may be related to each other (competing goals or complementary goals) or independent.

► Explain the term "shareholder value".

Today the owners of a business are frequently referred to as shareholders in the wider sense of the word. Their return is known as shareholder value.

In recent years, the sole focus on shareholder value has been widely criticized because it threatens the long-term health of a company and has other negative consequences.

► Explain the term "stakeholder value".

The term stakeholder refers to people and institutions that are directly or indirectly affected by the activities of a business organization. Stakeholders whose interests an enterprise also needs to pay attention to include employees, customers, banks, local residents, etc.

► Explain the term "corporate social responsibility" (CSR).

Enterprises should assume social responsibility which may include rejecting child labour and actively supporting development aid projects.

► Identify the different legal forms of business organisations and the parties who have the power of representation and rights to make business decision.

See EBC*L Level A

► Name and explain factors relevant for the description of entrepreneurial teams and project teams.

The business (or project) team is responsible for setting and achieving objectives. Business team analysis is performed according to the following criteria: number of team members, education, business experience, length of employment, demographic variables (age, sex, nationality, etc.)

► Name and explain factors relevant for location analysis.

Whether or not the location of a business plays a major role depends on the industry in which the enterprise operates. Important location factors are: customer proximity, qualification of employees, payroll cost, raw materials, energy cost, traffic connections, legal fees and tax burden, environmental protection requirements, political and social stability, etc.

► Name and explain developments and trends to which an industry can be exposed.

Examples of trends (= permanent, long-term changes) an industry is subject to

Social trend:

- Consumers think and act more economically
- Demographic trend: Increase in the number of old people in western society (= aging of society)

- Socio-political trend: Greater wealth which is distributed unevenly
- Economic trends: Times of recession, recovery or economic growth
- Technological trend: Increase in Internet purchases

➤ Name and explain factors relevant for an industry analysis.

An industry can be assessed according to a number of criteria, including:

- market structure and changes on the customers' side
- market structure and changes on the sellers' side
- roles of suppliers and retailers
- technological developments
- general social trends

➤ Explain the terms "market potential", "market volume", "market penetration" and "market share".

- market potential (= the largest imaginable number of users who are capable of and willing to purchase a certain product)
- market volume (= the proportion of the market potential that is being serviced by all suppliers)
- market share (= the percentage or proportion of the total market volume that is being serviced by one company)

$$\text{market share in \%} = \frac{\text{company sales}}{\text{market volume}} \times 100$$

➤ Explain the term "market niche".

A market niche is a small market segment with few potential buyers but also with few competitors. It is ideal for small, specialised enterprises.

➤ Explain the term "market entry barrier".

Market entry barriers determine how difficult it is for new companies to enter a particular market. Examples include:

- technological barriers (extensive R&D activities in the pharmaceutical industry)
- legal barriers (existing patents, strict legal regulations for running a business)
- location-relevant barriers (above-average rent).

➤ Explain the term "substitute product".

A substitute product can replace another product because it offers the same benefit.

➤ Explain the terms "monopoly", "oligopoly" and "polypoly".

- monopoly (= one enterprise dominates the market)
- oligopoly (= the market is divided among a small number of sellers)
- polypoly (= a large number of sellers operate in the market)

See EBC*L Level A.

➤ Name and explain factors relevant for a competitive analysis.

- Number of competitors
- Profitability, liquidity, and productivity ratios
- Absolute and relative market share
- Behaviour of competitors: aggressive vs. cooperative
- Customer stock profile
- Number and qualifications of employees
- Suppliers
- etc.

➤ Explain goals and methods of and limitations to benchmarking.

The term "benchmarking" denotes a process used in strategic management, in which business organizations evaluate their own performance in relation to best practice.

Key questions in a benchmarking procedure are:

- How do we compare to others?
- Why are others better? What can we learn from them?
- What measures do we need to take to become part of the business élite?

Various features of an enterprise could serve as a benchmark: its product(s), production processes, staff, management and more.

Productivity, profitability and liquidity ratios are used to compare one company with other enterprises.

MARKETING



General Learning Objectives

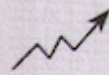
- ▶ Being able to explain the term "marketing" and the significance of marketing for an enterprise, a project or a service, as well as for a private person
- ▶ Being able to explain the basic conditions marketing activities depend on (customers, competition, costs)
- ▶ Being able to explain and apply the instruments of marketing

4. 1. Basics of Marketing

Learning targets:

- Being able to explain the term "marketing" and the goals of marketing
- Being able to name and explain the tools of marketing (Overview)
- Being able to distinguish between "external marketing" and "internal marketing"
- Being able to explain the term "self-marketing"
- Being able to explain the term "marketing mix"
- Being able to explain the structure and design of a marketing plan

Learning targets



4. 1. 1. GOALS OF MARKETING

In order to present the extensive subject of "Marketing", we will continue the Bossi Pizzeria case study. The idea of "Bossi's Pink Sauces" introduced in the chapter "Creativity techniques" marks the enterprise's new start.

BOSSI'S PINK SAUCES – A NEW START

You may remember: During her vacation in Thailand, Mrs Bossi discovered a spice that gives the tomato sauce for their pizzas an incomparable taste. As the Bossis want to draw the guests' attention to this taste and want their pizzas to be distinctive from others, they decide to colour the sauce pink. Furthermore, they intend to fill it into bottles and sell it under the name of "Bossi's Pink Sauces".



Unfortunately the spice comes from a globally protected plant that cannot be cultivated outside its natural habitat. For this reason Mrs Bossi can obtain only very limited quantities which hardly suffice to satisfy their own pizzeria's demand. It would therefore be ideal if the plant extract could be produced in a chemical laboratory. Out of curiosity, Mrs Bossi has inquired at the University of Natural Resources and Applied Life Sciences about whether this would at all be possible. After his first analysis, Professor Sour is quite sure – although he can't guarantee it – that lab production would indeed be possible. It would take some intensive research and lab work, but with a budget of about 30,000 euros he could see himself doing it.

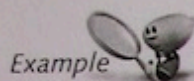
This is certainly a huge amount of money – particularly in view of the highly unfavourable business situation the enterprise is in – and so Mr Bossi does not even want to give the project a chance. Mrs Bossi, however,

considers selling their Pink Sauces in large quantities such a unique idea that she wants to draw up a marketing plan against all eventualities.

➤ Marketing

Marketing is a corporate policy that is directed strictly towards needs satisfaction, with the market being determined by customers and competition. The customer must be in the focus of attention because customers create business opportunities, business opportunities create sales and sales create profits.

Still, what sounds perfectly logical is not necessarily practiced in everyday business life, as demonstrated by the following examples:



Example

- ➔ *Manufacturers produce products nobody really wants.*
- ➔ *On the other hand, there are products nobody ever hears about because no money has been set aside for promoting them. The best idea does not serve anyone if no one is aware of it.*
- ➔ *When demand decreases, prices are often raised so as to maintain profit levels. What is overlooked is that a drop in demand is a crucial signal from the customer and requires an entirely different strategic response.*

➤ Goals of marketing

Today, business blunders of this sort are quickly punished by customers who abandon the company as well as by competitors who have been waiting for just such mistakes.

The basic purpose of marketing must be to contribute towards the overriding goals of an enterprise, which ultimately are: achieving acceptable profitability and maintaining reasonable liquidity levels.

Marketing should therefore never be self-serving. What good does the most creative commercial do if it fascinates the advertising community but doesn't attract the customers who are supposed to buy the product?

Marketing efforts can be directed towards

- ➔ winning new customers (by sending out promotional circulars with attached order forms, for example)
- ➔ making a company or a certain product more popular and
- ➔ improving the image of a company or of a product.

4. 1. 2. MARKETING TOOLS

In order to achieve their goals, marketers can use a number of tools which include:

- ➔ market research
- ➔ product policy
- ➔ pricing policy
- ➔ distribution policy
- ➔ promotional policy and
- ➔ sales strategy

➤ Marketing tools

The fundamental dogma of marketing typically refers to product, price, place (i.e. distribution) and promotion as the four Ps. These four tools will be analysed in detail in separate chapters of this book. All that should be mentioned at this point is that they must be adjusted to each other with great precision. A durable, high-quality, and expensive product, for example, will attract hardly any buyer if its advertising messages suggest it is a cheap mass product.

The four Ps are commonly known as the 'marketing mix' and adjusting them to each other, i.e. optimizing the **marketing mix**, is the primary responsibility of marketing.

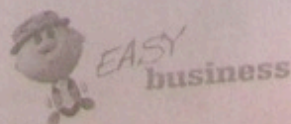
➤ Marketing mix

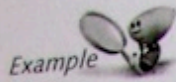
4. 1. 3. EXTERNAL AND INTERNAL MARKETING

The idea of marketing has been greatly expanded over the past few years and today comprises more than just directing a company's efforts towards the final consumer. It became apparent that the basic principles of marketing and its tools are relevant for anyone who wants to sell something in a market. That could be a product, a service, a project, an idea or even the person himself and his/her skills.

➤ External and internal marketing

One needs to distinguish between external and internal marketing. Whereas the traditional form of **external marketing** is directed towards the final customer of an enterprise, **internal marketing** addresses the different target groups within the enterprise itself. The purpose of internal marketing is to convince the employees, the superior or other company divisions of something you want to offer.





Example

Examples include:

- ➔ The company management wants to introduce a more flexible working-time schedule. How can this idea be "sold" to the enterprise's employees?
- ➔ This year the company's education and training division has put together a comprehensive continuing education program. How can it convince the department managers to sign up as many of their workers as possible for the seminars?
- ➔ The EDP division has installed a new security system. How can it make sure that the new system is respected by everyone?
- ➔ The works council has organized a works outing. After last year's poor attendance, more employees should be motivated to participate this time. How can this be achieved?

4. 1. 4. SELF-MARKETING

► Self-marketing

Furthermore, a person can also "market" himself. Although this form of **self-marketing** may be typical of politicians, actors and supermodels, it is actually important for each and every one of us. Whereas some people have a natural talent for marketing themselves, others don't have the slightest idea of how to go about it. Some manage to present themselves in a positive light and climb the career ladder although they have comparatively little to offer. Others, who would actually be capable of doing well, are left behind only because they don't dare move into the fast lane. They may not trust themselves, underestimate their skills or simply not be the kind of person who draws other people's attention to his accomplishments.

The following example presenting Mr Leek will demonstrate what focused self-marketing may accomplish.

IN ORDER TO BUILD A CAREER, MR LEEK MAKES WELL-DIRECTED USE OF MARKETING TOOLS:	
<p>1. Mr Leek completed his apprenticeship in industrial mechanics ten years ago and has been employed with one and the same enterprise ever since. To advance in his career, he would need additional education, which his employer requires from people who seek promotion. This is what Mr Leek has experienced again and again, when his company filled vacancies for leading positions with colleagues of his or even new employees who had better qualifications. For the same reason, Mr Leek has not been successful in his search for a job with other companies.</p> <p>He admits to himself that he needs to do something so as to make himself more attractive for the job market.</p>	MARKET RESEARCH
<p>2. Mr Leek chooses a tough option and decides to take A-level classes at an evening college. In addition, he selects Chinese as a special subject because he knows that there is high demand for industrial mechanics in China. What is more, he adds a finishing touch by attending two EBC*L business courses and taking the level A and B exams.</p>	PRODUCT POLICY
<p>3. After he has taken his A-level exams with distinction, he starts inquiring in the labour market about wage and salary levels for workers with his (new) qualifications. The information he receives serves as a guideline and he decides to ask for a salary that is 20 percent above the market average. He believes his expectations are justified because:</p> <ul style="list-style-type: none"> ➔ he has 14 years of practical experience ➔ he has a decent command of Chinese ➔ he has proven that he is ambitious, goal-oriented and can work under stress and ➔ he has a sound business knowledge because of the EBC*L exams. 	PRICING POLICY
<p>4. He is prepared to accept a lower base salary in exchange for appropriate performance-based premium pay at the end of the year. Any overtime work, however, must be paid in full.</p>	TERMS AND CONDITIONS
<p>5. He draws up a CV and a letter of application in which he presents himself as an ideal employee. He sends these documents to all the enterprises of his choice and, in addition, submits them to the on-line job market as well.</p> <p>Furthermore, as he knows that he is only one of many applicants, he decides not to wait for responses from particularly attractive companies. Instead, he contacts them directly and – with reference to his application – he requests a job interview.</p>	PROMOTIONAL POLICY ADVERTISING

<p>6. He is exceptionally well prepared for the interview appointment. He has informed himself about his potential employer and makes a good impression from the very beginning. He skilfully asks questions and thus manages to involve even terse personnel managers in lively discussions and increase their interest in him.</p>	<p>SALES</p>
<p>7. Mr Leek's thoroughly planned marketing strategy leads to almost instant success, and he clinches the job of his dreams only three months after finishing evening college.</p>	

► Marketing-mix

Among other things, Mr Leek's perfect marketing mix strategy becomes evident when he adjusts his earnings expectations to his personal market value. He is smart enough not to ask for a top-management salary; neither does he sell himself below his value, which could be considered an indication of a hidden weakness. (See Chapter "Pricing policy - signalling function of prices")

4. 1. 5. MARKETING PLAN

► Marketing plan structure

Any marketing activity requires a well-designed marketing plan that is ideally put into writing.

It should contain the following major points:

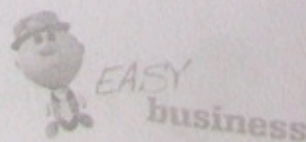
1. Actual analysis

Before any marketing project is initiated, the starting position must be thoroughly analysed. After all, the reason for taking marketing measures must be precisely defined and documented.

2. Setting goals

Based on the actual analysis, tangible goals that should be achieved through the marketing activities can be set. These goals could be of **quantitative nature**, such as:

- ➔ Sales of a certain product should be raised by 10%.
- ➔ At least 10% of the target group members should remember a commercial.



Goals that focus on **quality aspects** may include:

- The image of the enterprise must be enhanced.
- The product must become more popular.

3. Activities and time schedule

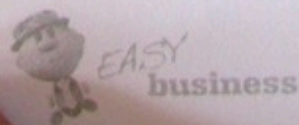
All the planned activities and steps that need to be taken to achieve goals are described. In order to proceed quickly, a schedule is drawn up, in which desirable interim results or "milestones" that are to be reached by a certain time are identified. (See Chapter "Project planning")

4. Budget plan

As marketing measures may be quite expensive – an advertisement in a national newspaper may cost 10,000 euros or more – establishing a budget plan is absolutely indispensable.

5. Constant monitoring and final review of the marketing project

There must be constant monitoring of whether interim results and eventually the final goal have been reached. Among other things, suitable monitoring instruments include sales figures analyses, market research tools, etc.

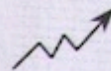


4. 2. The Customer is King

Learning targets

- Being able to name and explain customers' buying motives
- Being able to explain Maslow's hierarchy of needs
- Being able to explain the terms "need" and "demand"
- Being able to explain the different stages in a buyer's decision-making process
- Being able to explain the term "cognitive dissonance"
- Being able to explain the term "customer segmentation"
- Being able to explain the criteria according to which customers can be categorized
- Being able to explain the term "customer relationship management" (CRM)
- Being able to explain the term "glass consumer"
- Being able to explain the term "data mining"
- Being able to name and explain tools of customer retention
- Being able to explain the term "complaints management"
- Being able to explain the term "cross selling"
- Being able to explain the term "full-range customer"

Learning targets



4. 2. 1. CUSTOMERS' BUYING MOTIVES AND NEEDS

Ultimately it is the customer who decides whether an enterprise flourishes and whether its employees are secure in their jobs. Thus it certainly pays off for a firm to anticipate each and every one of its customer's wishes. This can be done only by looking upon him as a human being who has desires and fears. These desires and fears must be precisely identified, as they are the driving forces behind his decision of whether or not to buy a product. These forces are referred to as buying motives.

- Buying motives

If you want to practice doing research on buying motives, just look at yourself and answer the following questions:

- ➔ What did you spend money on in the past week? Did you buy any goods which you originally had not intended to purchase?
- ➔ What major item (that cost more than 200 euros or so) did you buy recently? What prompted you to decide in favour of this particular product – and against others?

A possible "shopping list" could look as follows:

1. Milk, bread, some sausage, a sweater
2. Life insurance, a safe door lock, a course in self defence
3. Dinner at a restaurant with some friends, flowers for your spouse
4. The most popular cell phone, a management course abroad, a designer dress, an apartment in an upper-class neighbourhood
5. An Avatar seminar, a donation to a charity organization

Maslow's hierarchy of needs

The shopping items listed above cover all the needs that are included in **Maslow's hierarchy of needs**. According to this theory, we can distinguish between five different categories of people's wishes and needs.

Level 1 – Basic physiological needs: warmth, food, water, sleep, sex

Level 2 – Safety needs: shelter, security of employment, health and well-being, legal security, insurance policies, orderly environment

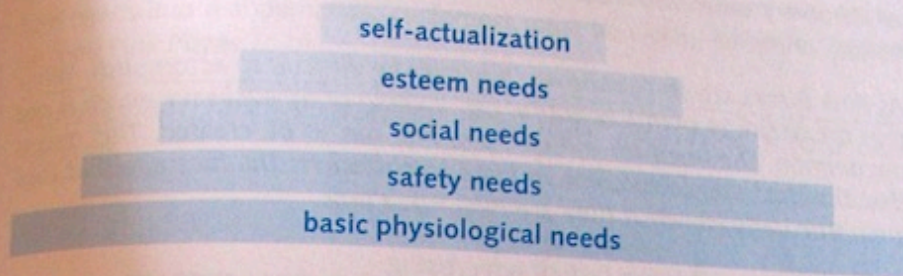
Level 3 – Social needs: friendship, partnership, family, love, communication and care

Level 4 – Esteem needs: status, wealth, money, power, career, success in sports, awards

Level 5 – Self-actualization: individuality, talent enhancement, altruism, kindness, art, philosophy, faith, ethics

➔ Maslow's hierarchy of needs

Maslow's hierarchy of needs



These needs are represented as a pyramid, which is intended to demonstrate that higher needs come into focus only when the lower needs in the pyramid have been satisfied.

- ➔ A person who has hardly enough money to satisfy his basic need for food is not likely to spend any money on insurance.
- ➔ You will care about questions of ethics only when you have enough to eat, a place of accommodation, a spouse who loves you and a job that gives you satisfaction and recognition.

Bossi's Pink Sauce: At which level in Maslow's hierarchy of needs may we find Bossi's Pink Pizzas?

Mrs Bossi wants to figure out which of their customers' needs their Pink Pizzas satisfy, which is not an easy task at all.

Even though it is a food item, a Pink Pizza is not necessarily what people consume when they want to fill their basic need for food (= Level 1). Neither does a Pink Pizza satisfy a person's need for safety (= Level 2).

Social needs (= Level 3) can be met in so far as you can go out and "have some Pink Pizza" with friends or if Pink Pizza becomes the subject of a conversation: "We had something absolutely crazy for dinner yesterday – Pink Pizza. Have you tried it yet?"

If this prompts some sort of recognition ("You are really a trend setter, aren't you?"), Level 4 has been reached.

In order to climb the peak of the pyramid of needs, however, and give their guests moments of greatest self-fulfilment, Mrs Bossi would most certainly have to use additional (and probably illegal) Pink Pizza ingredients.

These findings have given Mrs Bossi an initial idea of which marketing strategy to apply with respect to their Pink Pizzas. Pink Pizzas are not supposed to attract attention because of any particular size (Level 1) but should in any case become a topic of conversation (Level 3). It would be ideal, of



course, if Pink Pizzas could be turned into some kind of cult food item which everyone who has a certain level of self-esteem should recognize and eat. (Level 4)

As Pink Pizzas are still unknown, this may be difficult to accomplish. Whereas the desire to own a beautiful car, a yacht or an exclusive watch is not uncommon, the need for a Pink Pizza first has to be created. This means that the Bossis have to communicate to customers the message that they are particularly trendy if they are Pink Pizza fans.

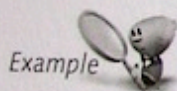
Creating this need is the task of advertising.

At the same time, the above findings allow the Bossis to conclude what customers they should target. They have to address people who have already satisfied the needs of the first two levels of Maslow's pyramid. In other words, their target group consists of customers who have above-average incomes.

Needs and demands

► *Need and demand*

Recognizing needs, however, is only the beginning, because there is a crucial difference between a general need and real demand. Each and every one of us has hundreds of needs but only a fraction of them become concrete demands that can be and will be satisfied.



- ➔ *Almost everyone wants to speak as many languages as possible. Only few people actually attend a language course.*
- ➔ *Almost every man wants to have six-pack abs instead of a beer belly. Only few go through the trouble of achieving their goal in a fitness studio.*
- ➔ *Almost everyone wants a sports car but only few people can afford one.*

The reason is obvious: either people have too little money or too little time to satisfy all needs. Consequently, the decision must be made which ones to satisfy. What is more, many needs directly compete with each other: Recognition as a successful manager in your job or as a hobby marathon runner may cost you dearly, as you pay less attention to the need for love from your spouse, your children or friends.

What this means for Pink Sauces is that the basic need for them has to be created first. Then strategies have to be designed that enable the Bossis to turn needs into real demands: customers must be willing to spend money on their Pink Pizzas.

Management Talk: A potential need must be turned into a real demand.

4. 2. 3. CUSTOMER BEHAVIOUR AND DECISION-MAKING PROCESSES

As mentioned before, customers are human beings – and as such often demonstrate highly unreasonable buying behaviour, although hardly anyone wants to admit that.

► *Customer behaviour and decision-making process*

Still, any buying process follows a certain pattern and in order to become aware of it, it may be best to analyse yourself again.

Do you recall your entire decision-making process when you made your last major purchase (such as a television set, a car or an apartment)?

BOSSI PIZZERIA: MR SALT TREATS HIMSELF TO A NEW CAR

When Mr Salt, one of Bossi Pizzeria's employees, decided to buy himself a new car, things happened as follows:

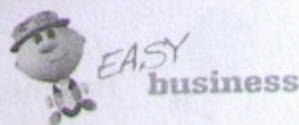
Phase 1: Problem awareness

Mr Salt's car is already eight years old and has obediently served its owner for over 180,000 kilometres. During the past few months, however, more and more repairs have become necessary and the car has spent more time at the repair shop than on the road.

Phase 2: Information search

For that reason, Mr Salt is looking for a new car and as it is a major expense, he gathers as much information as possible.

Of course, Mr Salt contacts his regular car dealer, with whom he has always been perfectly satisfied, but he also reads through car magazines and road test reports, does internet research and asks friends and relatives how happy they have been with their cars. As all of them tell him, though, that they have been absolutely satisfied with their choices, this source of information does not offer much help.



Phase 3: Evaluation of alternatives

In this phase, Mr Salt compares the car models he likes and evaluates them according to various criteria:

Rational criteria:

- price
- size
- number of seats
- gasoline consumption
- taxes

Emotional criteria:

- design
- colour
- more horsepower than necessary
- environmentally friendly
- image of the brand

These are just some of the criteria and it is not surprising that Mr Salt's head is spinning. He has sleepless nights and is irritated and unfriendly towards other people. After a number of test drives, the number of possible choices is reduced to three.

Phase 4: Purchase decision

The moment has come when Mr Salt finally makes his choice and selects the XY brand car.

Full of determination, he contacts the car dealer that sells cars of that kind. All he wants in order to be completely satisfied is an additional one to two percent discount. The car dealer, however, is stubborn and not willing to let Mr Salt have this ultimate triumph. Besides that, he becomes exceptionally unfriendly.

Mr Salt refuses to put up with that and remorsefully returns to his former car dealer. How could he ever have thought of buying a car from another place? He now buys a car that costs more than he has planned to spend, has more horsepower than necessary and is not available in the colour he would have liked best.

Phase 5: Post-purchase evaluation

At this point (if not sooner) it becomes obvious that human beings, including Mr Salt, very often don't act rationally. When Mr Salt makes his ultimate decision, he is convinced that it is the right thing to do and he is the happiest man on earth. Neither his wife nor the snide comments of his friends make him change his mind. Admittedly, the car is slightly more expensive than planned but its interior design and greater power justify the premium price. Besides, its shocking green colour goes much better with this brand than his favourite colour would have.

4. 2. 4. COGNITIVE DISSONANCE

Mr Salt's less than rational post-purchase behaviour is best explained by the cognitive dissonance theory.

In general, human beings strive to achieve a psychological state that is in balance and free of conflicts. In the course of a decision-making process, however, this inner balance is at risk because any decision that has to be made does not come with only positive aspects but has some negative side effects as well. Such side effects could create discomfort for a person who has made a decision that cannot be reversed anymore and make him doubt that what he did was the right thing to do. The expression used to describe conflicting thoughts or beliefs that occur at the same time is cognitive dissonance. Not only does it sound discomforting, it is. Nobody likes to be out of balance.

If Mr Salt gave in to "his" cognitive dissonance, he would retrospectively doubt his buying decision and become annoyed at having spent far more money than planned and admit to himself that he is not happy with the car's colour after all.

Conclusion: In order to avoid cognitive dissonance, a person will emphasize all positive sides of his decision and sweep all negative aspects under the carpet. That is precisely why you cannot expect to receive any neutral and rational answer to your question of how happy someone is with the new car he has just bought.

According to Heribert Meffert, one of Germany's first marketing experts, we can distinguish four different behavioural patterns of a buying decision:

- rational buying behaviour: The buyer acts rationally and – after a lengthy phase of information search – applies economic criteria to evaluate his alternatives. He wants to achieve the best result at the best price possible.

➤ Cognitive dissonance

Example



- ➔ impulse buying behaviour: The buyer lets himself be guided by feelings and intuition. He acts spontaneously without any prior information search.
- ➔ habitual buying behaviour: The buyer is not interested in making a new decision whenever he buys something but relies on past experience.
- ➔ social buying behaviour: The buyer's decision does not depend on his information or experience. He allows himself to be guided by moral and value concepts of his social environment (friends, colleagues, or celebrities).

4. 2. 5. CUSTOMER SEGMENTATION

Customers are different from each other because human beings in general differ from each other. For that reason there is hardly any universal product that sells equally well to all people, regardless of whether they are young or old, rich or poor, healthy or sick, introverted or extroverted, Europeans or Asians.

➤ Customer segmentation

Enterprises will be successful if they specifically address different customers. In order for them to do so, customers must first be subdivided into different customer segments. Some of the criteria according to which customer segments can be determined are:

- ➔ Demographic criteria
 - ➔ age
 - ➔ sex
 - ➔ education
 - ➔ occupation
 - ➔ income
 - ➔ family size
 - ➔ family life cycle
 - ➔ nationality
 - ➔ language
- ➔ Geographic criteria
 - ➔ country
 - ➔ region
 - ➔ district
 - ➔ population density

- climate
- Psychographic criteria
 - rational / emotional / impulsive
 - conservative / modern
 - introverted / extroverted
- Private and corporate customers

These segments can be combined with each other and / or further subdivided.

An example of such a sub-segment could be "female senior citizens in Vienna with pets". This target group will have highly specific needs that have to be researched. Marketing activities which are based on research results are far more highly focused than in cases where customers have been segmented superficially or not at all.

Corporate customers – private customers

Corporate customers differ from private customers for the following reasons:

1. **Larger quantities and sales.**
You can expect a corporate customer to place larger orders and thus to contribute to your sales more significantly than a private customer.
2. **More people are involved in the decision-making process. They could be:**
 - the people / employees who want the product
 - their immediate superior (department manager)
 - the procurement department
 - the company management, or
 - perhaps even the controller or the works council may have a say in purchasing decisions.
3. **Decision-making processes take longer.**
Particularly when many decision-makers are involved, time-consuming meetings and voting procedures that go beyond departmental levels must be expected.
4. **In general, companies are more rational than private customers.**
Corporate purchasing decisions have to meet business criteria such as profitability, liquidity, budget targets, etc.

5. Companies are more demanding.

Corporate customers demand and expect higher quality and greater reliability because poor quality and delays in delivery may cost them some of their own customers.

Still, one must not forget that even in the world's largest groups of companies and behind the most impressive facades of glass and steel, there are people of flesh and blood who seek safety, social contacts and recognition.

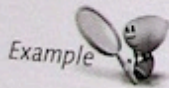
Special key account managers who are responsible for their company's corporate customers have had years of experience and thus know

- ➔ the business requirements of their corporate clients and
- ➔ the people who have the biggest influence in the decision-making chain.

Internal customers – external customers

Companies are beginning to realize that it is not exclusively the external final customer who should enjoy the privilege of friendly and competent customer service but that their different departments should treat each other like customers as well.

What has supported this development was that departments have lost their monopoly as their companies' sole suppliers. In the past it was unthinkable to purchase a service from an external supplier as long as the same service was provided internally as well.



Example

If a company had its own IT department, it was understood that it would take care of all of the company's data processing problems. – Such an IT department was usually very much aware of its monopoly position and behaved accordingly (= focusing on itself instead of on the internal customer).

Today many enterprises see things differently and their departments may very well purchase services from external sources.

For the above-mentioned IT department, this means that an external software supplier who can offer a solution to the company's data processing problem may all of a sudden appear as its competitor. Particularly if the IT department cannot make a competitive offer, the situation can become crucial and result in the complete outsourcing of IT services. As this cannot possibly be in the interest of the IT department, it should have a suitable marketing concept that has answers to the usual questions: Who are my customers, what are their needs and how can my product satisfy those needs?

Good customer – bad customer

Is there actually such a thing as a bad customer? There are indeed customers who

- create greater costs than benefits
- make life unnecessarily difficult for you (deliberately or indeliberately) or
- are so unpleasant that a lengthy business relationship would inevitably cause ulcers.

Enterprises are best advised to terminate such customer relationships simply because time, energy and financial means must focus on those customers who really make a difference for a company.

Attention, though

Still, enterprises have repeatedly had the experience that customers who initially require a lot of attention turn out to be the best clients. For that reason customer analysis ought to be conducted rationally and systematically. The chapter "ABC analysis" of this book has already highlighted methods of how to categorize customers.

4. 2. 6. TYPES OF CUSTOMERS

Customers don't make your life easy. Even if narrow customer segments have been selected (such as '40-year-old male university graduates who are residents of Main Street and vicinity) customers may still require different treatment.

➤ Customer types

Among them there will be impulse buyers who don't do much thinking and act instantly, as well as customers who weigh things carefully and think twice before they make any buying decision.

Everett Rogers, U.S. university scholar and pioneer of the 'diffusion of innovations' theory, suggested dividing customers into five categories: innovators, early adopters, early majority, late majority and laggards.

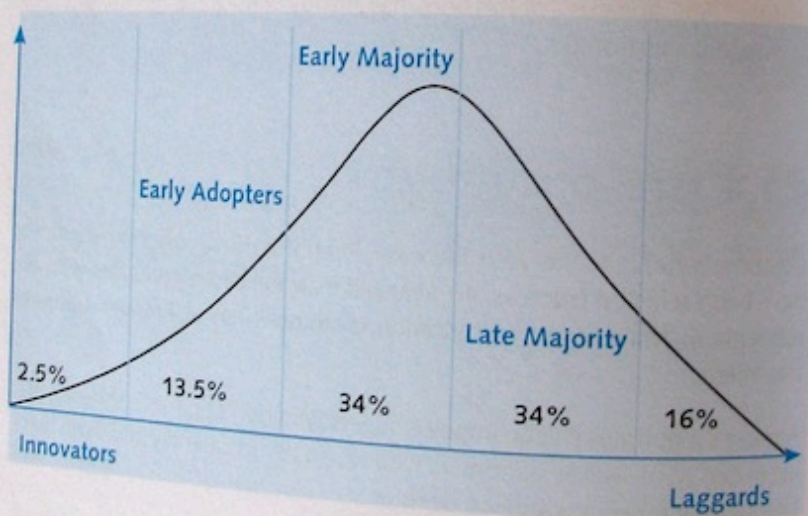
Early adopters are trendsetters who want to be the first to own and proudly present a product. In order to satisfy their curiosity and / or their desire for prestige, they accept a product, even while they acknowledge that it is immature, has flaws and can be purchased at half the price only a few weeks later.

You probably know people who owned a cell phone, a flat screen TV, an MDA, a GPS device or a hybrid car when others didn't even know how to pronounce these expressions.

The high-tech business is particularly fond of early adopters for above-mentioned reasons. In addition, it can be assumed that early adopters are mostly extroverts who love to tell everybody about what a great product they have just bought. Thus they are ideal word-of-mouth marketers of the product and opinion leaders.

Laggards act completely differently. They are probably still thinking about buying their first cell phone, carefully weighing the advantages and drawbacks.

Between the early adopters and laggards you find the **early majority** and **late majority** of buyers. The latter decide to purchase at a time when the product has established a foothold and has been thoroughly tested by the market.



What this means for a company's marketing efforts is clear: the more innovative a product, the more active a firm has to be in its search for early adopters and in its attempts to attract them. Strategies that signal the specific status of those premium customers include sending out information on latest product developments and inviting them to innovative product presentations.

Once a product has entered the saturation stage have been defined customer types (majority and well-established).

It is doubtful whether

4.2.7. CUSTOMER RELATIONSHIP MANAGEMENT (CRM)

Have you ever received a recommendation for a restaurant or the hotel at your best friend totally?

If so, you were a 'victim' of the instrument of customer relationship management.

As this expression implies a long-term relationship in such a way as long as possible.

Cultivating customer relationships in reality things are often happens that a customer's efforts, becomes less important on the firm's customer relationship management.

This kind of behaviour of an entire company's checked off as a business. Such an attitude is son of an effort to keep a customer.

Mr Term is an insurance he has to

- make dozens of presentations
- present himself with trust
- know how to exploit
- record the customer's
- put together an individual

Once a product has established itself and after all the flaws of its introduction stage have been overcome, a company may address the more reluctant customer types (majorities). The message is that the product is now reliable and well-established.

It is doubtful whether or not a separate strategy for laggards will pay off.

4. 2. 7. CUSTOMER RELATIONSHIP MANAGEMENT (CRM)

Have you ever received a 'Happy Birthday' card from your insurance representative or the hotel at which you once spent your summer vacation (whereas your best friend totally forgot about your birthday)?

If so, you were a 'victim' of a CRM system. Such a birthday card is only one instrument of customer retention.

► Customer relationship management (CRM)


As this expression implies, the goal of customer retention is to cultivate customer relationship in such a way that a customer remains loyal to the company for as long as possible.

Cultivating customer relationships seems the most logical thing to do but in reality things are often quite different. It may sound absurd but it frequently happens that a customer, whose acquisition has cost a company enormous efforts, becomes less interesting and is ignored as soon as his name can be put on the firm's customer list.

This kind of behaviour is typical of many sales people and can even be part of an entire company's culture: Once a customer has been won, he is simply checked off as a business success who doesn't require any further attention. Such an attitude is somehow illogical because it obviously takes much less of an effort to keep a customer than to win a new one.

Mr Term is an insurance representative. In order to attract a new customer he has to

- make dozens of phone calls in order to arrange a first appointment
- present himself well at the appointment so as to build the customer's trust
- know how to explain the product in detail
- record the customer's personal data and identify his needs
- put together an insurance product that can satisfy those needs, and

Example 

- present this product at a follow-up meeting and, with any luck, conclude the contract.

Whether or not he will succeed remains doubtful because the potential customer will certainly look for alternative offers as well.

In order to retain an existing customer, it may be sufficient to

Example



- pay a routine annual visit at which customer data are updated and at the same time take the opportunity to introduce a new product, for which a loyalty discount is offered.

If you look into customer relationship management in greater detail, you can distinguish the following phases:

4. 2. 7. 1. Customer identification

Potential customers must be identified and perhaps filtered from a databank, through use of sophisticated data processing systems with highly complex data filtering functions. The results, however, will only be as good as the data that are available in such systems. It is therefore important to store as much information as possible on potential or existing customers in your databank. Customer data may include:

- address, telephone number, e-mail account
- past purchases or inquiries
- complaints
- written records made in the course of talks with the customer (also about his interests, hobbies, etc.)
- birthday and family status

The glass consumer

There are professional organisations and publishing houses which collect publicly available information and offer it for sale. Sometimes the information that has been compiled (about each and every one of us) takes on legally alarming dimensions in terms of personal data protection. Today this compilation of data is possible because whatever we do, for example in the Internet, leaves trails from which others can draw conclusions about what our interests are. Here are some further examples:

- Credit cards: Whoever pays by credit card allows conclusions to be drawn about his buying preferences.
- Search engines: Any term you enter into your search engine may attract the attention of sellers of products which you may be interested in at

→ Glass consumer

some future point.

- Online auctions: A person who bids on the Internet also leaves a trail of his buying preferences.
- Online book sales: Once you have bought a book online or have merely expressed an interest in buying one, you are registered and will be supplied with special offers next time when you enter the site.
- Cell phones / GPS: Here you can be observed even from space. Theoretically every step you take with your cell phone turned on can be traced and recorded.

This enormous accumulation of data is enabled by ever-growing storage capacity (terabytes) and software programs that can administer and evaluate data. This technology also allows all telephone calls made today to be recorded and stored for years for possible future analysis.

It is almost unimaginable how much information could be compiled if all data were collected in one single databank for subsequent evaluation. It would be quite possible that those analysing the data know more about the needs and the specific customer's behaviour than the evaluated person knows about himself.

No wonder that such data represent a goldmine for those who want to target a specific customer or market segment with their sales efforts – hence the term **data mining**.

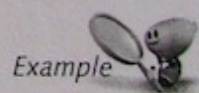
Neither is it surprising that we as "glass consumers" no longer feel comfortable. Welcome to the world of Big Brother. (See Orwell's "1984" bestseller)

Geomarketing

Geomarketing is a discipline based on geographical information that allows a highly accurate targeting of market segments.

Let us assume a newspaper publisher wants to introduce a new, exclusive magazine in the metropolitan area of Vienna, with the high society being the target group. This means that the company is not interested in the majority of the people living in and around Vienna and therefore sending them a free sample would be a waste of money.

Organisations that operate in the geomarketing business can inform the newspaper publisher about the districts, streets, perhaps even houses in which high-society residents live whom they can then target directly with their marketing activities.



4.2.7.2. Customer acquisition

Having a lot of data about a customer does not mean that you have already won the customer. In order to do that, an enterprise needs to apply and skillfully combine the marketing instruments which have been introduced so far and will be further dealt with in the following chapters of this book (Product policy, Pricing policy, Sales strategy etc).

4.2.7.3. Customer retention

Over the years quite some imagination has been necessary to design so-called customer retention instruments. Typical examples are customer cards of all kinds (club cards, sales cards, bonus cards, etc.) which offer a number of advantages:

- loyalty discounts
- quantity discounts for purchases exceeding a certain value
- preferential treatment (like no waiting times)
- presents (on birthdays and at Christmas)
- invitations to company events
- free flights or bonus miles

Complaints management

In order to retain customers it is sometimes necessary to reconcile displeased customers with the company. Few employees, however, have the skill to react calmly to whining complaints or even angry insults that arise when something goes wrong. Still, although unpleasant, customer complaints do have their positive sides:

- They offer feedback and tell you what you can do better in the future. (For such information business consultants charge horrendous amounts of money.)
- They give you the opportunity to win a satisfied and loyal customer if you take the complaint seriously and offer a proper adjustment.
- Precisely those customers whose complaints are dealt with generously and in a friendly manner are the ones who will become your best advertising agents – through positive word-of-mouth marketing.

➤ Complaints management

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Cross selling

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Finally, if you respond to a complaint with the proper adjustment, you are likely to avert even greater damage: negative publicity. Remember that disappointed customers are known to be exceptionally vocal.

Cross selling

Do you have car insurance with one company, home insurance with a second one and health insurance with yet another insurer?

On the other hand, it may have happened that you wanted to buy skis and ended up leaving the store with skis, a new snowsuit, a matching cap and ski underwear besides. In this case you probably fell victim to a cross-selling expert. The term cross selling is used to describe the sale of additional products to a customer who has already bought products from you.

► Cross selling

It is certainly highly lucrative for an enterprise to be in a position to satisfy all the needs of a customer for products of a particular category. An enterprise might therefore decide to structure its entire marketing strategy towards this goal. In the case of insurance, the goal would be met when a customer concludes all his contracts with the same insurance company (= **full-range customer**).

► Full-range customer

4.2.7.4. Winning back customers

If an enterprise has lost a customer to one of its competitors, it should analyse the customer's reasons, which could be rational or emotional.

- Rational reasons: The competition offers a superior product or a more attractive price or guarantees faster delivery. If that is the case, it will be difficult – if not impossible – to lure the customer back, unless you can make a new, more competitive offer.
- Emotional reasons: The customer has been disappointed by the enterprise or one of its salespeople. If this is so, then chances of winning him back may actually be quite good. By straying, he may simply have signalled that the company should have paid greater attention to him.

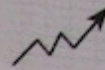
This chapter has now thoroughly explored the 'customer phenomenon'. How to do detailed research on the wishes, needs and fears of customers will be the focus of the following chapter on "Market research".

4. 3. Market Research

Learning targets:

- ▶ Being able to explain the goals of market research
- ▶ Being able to explain the quality criteria of validity, reliability and objectivity in market research
- ▶ Being able to explain the term "sample" / "sampling"
- ▶ Being able to explain the different phases of the market research process
- ▶ Being able to explain the terms "primary market research" and "secondary market research"
- ▶ Being able to explain the primary market research methods of survey, observation and market test
- ▶ Being able to explain the problems of and limitations to market research
- ▶ Being able to explain the factors pertaining to a competitive analysis.

Learning targets



4. 3. 1. GOALS OF MARKET RESEARCH

If you intend to introduce a product to a market, you first have to do thorough market research. If you don't and rely on your feelings alone, you need quite some luck to be successful.

- ▶ Goals of market research

Enterprises may quickly fail in their attempts to introduce new products because:

- ▶ the products don't attract any interest / there is no demand for the products
- ▶ they may be too expensive or too cheap
- ▶ the design may be too dazzling or too boring, or
- ▶ the advertising campaign was too provocative or uninspiring.

The more thoroughly a market has been investigated, the more precisely marketing activities (product policy, advertising, etc) can be planned and implemented.

In particular, two components that determine the market need to be explored:

- the customers ('King Customer')
- the competition (= competitors / rivals)

Furthermore, attention must be paid to the so-called input market, which comprises the labour market, the suppliers and the market for raw materials.



Bossi Pizzeria: Mrs Bossi does market research

After lengthy discussions, Mr and Mrs Bossi and Mr Salt have agreed on the daring colour of pink for their pizza sauce. As a man of action, Mr Bossi has discarded all the objections he previously had and doesn't want to wait any longer to give all pizzas served in his pizzeria the new pink colour. Meanwhile he has grown sure that his guests will like it and tough luck for those who don't. This is his new motto.

Mrs Bossi, however, is stepping on the brakes, even though she was the one who suggested the colour of pink originally. She can, in fact, convince her husband to start a small pilot project in order to find out whether 'pink' actually creates greater benefit than it causes damage. She suggests inviting 120 regular customers for a special pizza meal, after which they will be asked specific questions. Although Mr Bossi believes that it would be sufficient to invite and ask only ten of his most loyal guests, his wife manages to convince him that ten would be clearly too few in order to receive really valid results. Besides, as all these guests would be over fifty years of age, they would not be a representative sample. Ultimately they agree on 80 people. When selecting them, they make sure that all age groups are represented and – as they intend to charge a premium price – they invite only people who have above-average income.

After Mrs Bossi has got her husband that far, she faces another delicate task. She has to convince him that it wouldn't be a good idea if he were in any way involved in the interviews. She can very well imagine the situation when he starts to apply his natural charm and asks questions like:

- What do you think: Isn't this something totally different for a change? Not the same boring red which you get all over the world?

If guests weren't thrilled and didn't instantly react enthusiastically to this question, they would risk being looked down upon by Mr Bossi as conservative. Besides, Mrs Bossi knows that the guests would praise the new idea to the skies simply in order to please Mr Bossi, regardless of what they really thought about it.

Mrs Bossi actually succeeds in persuading her husband to stay away from the interviews and moves on to designing a questionnaire. In this questionnaire, the test subjects (= respondents, interviewees) are supposed to write down the first impressions they had when they saw the Pink Pizza. After they have consumed the pizza, they should evaluate the Pink Pizza's taste.

In addition, Mrs Bossi is planning to have the guests taste a pizza that uses the traditional red sauce. This pizza differs from the Pink Pizza only in so far as the food colouring has been left out. The test subjects will be asked to judge which of the two pizzas they liked better – although objectively there cannot possibly be a difference in taste.

Afterwards the test subjects should tell how much they would be willing to spend on a Pink Pizza. This is Mrs Bossi's real acid test, because regarding a new product as good and interesting is one thing, but spending money on it is something completely different.

Finally, Mrs Bossi wants to find out whether the respondents would be willing to use the Pink Sauce in their own kitchens and how much they would be willing to spend on it.



This is what her questionnaire looks like:

"Pink Pizza and Pink Sauce" research questionnaire

Dear Test Subjects,

Thank you for taking the time to participate in our research project. Please complete all sections of this questionnaire. All the information provided will be treated confidentially.

PERSONAL DATA:

Sex:

Age:

under 21	<input type="radio"/>
21–25	<input type="radio"/>
26–30	<input type="radio"/>
31–35	<input type="radio"/>
36–40	<input type="radio"/>
41–45	<input type="radio"/>

male	<input type="radio"/>
female	<input type="radio"/>

Education:

Apprenticeship	<input type="radio"/>
A Levels	<input type="radio"/>
College/University	<input type="radio"/>
Other	<input type="radio"/>

Please describe in one to three sentences what your first impression was when you saw the Pink Pizza

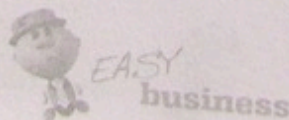
.....

Please rate your first impression according to the following criteria:

interesting	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	uninteresting
appetizing	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	unappetizing
up-to-date	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	traditional

On a scale from 1 to 5, how would you rate the taste of the Pink Pizza?
 (1 = highest rating, 5 = lowest rating)

.....



As compared to regular pizzas with a red sauce, the Pink Pizza tasted:

<i>much better</i>	<input type="radio"/>
<i>better</i>	<input type="radio"/>
<i>equally good</i>	<input type="radio"/>
<i>worse</i>	<input type="radio"/>
<i>much worse</i>	<input type="radio"/>

Would you be willing to pay more for a Pink Pizza than for a regular pizza?

Yes	<input type="radio"/>
No	<input type="radio"/>

If so, how much more would you be willing to pay?

.....	euros
-------	-------

Do you make pizzas and pastas at home?

Yes	<input type="radio"/>
No	<input type="radio"/>

If so, would you be interested in a Pink Sauce for your home-made pizzas and pastas?

Yes	<input type="radio"/>
No	<input type="radio"/>

In one to three sentences, what would you expect from a Pink Sauce for your home-made Italian dishes (as concerns quality, price, packaging etc.)?

.....

.....

Thank you for participating in our research project.

The Bossis conduct the survey, which is a success in every respect. Firstly, their regular customers feel honoured because they are asked for their opinion. Secondly, after the survey data have been entered into Mr Salt's special excel sheet and then analysed and interpreted, the results are highly interesting:

In summary, the results are as follows:

- ➔ The first impression of most of the guests was scepticism and some of them – in particular those over forty-five years of age – even felt offended by the colour. Others, however, were so curious that they could hardly wait to taste the pizza. This was the case with the majority of the 20 to 40-year-old males while there was no clear tendency in the group of females.
- ➔ As concerns the taste, though, the response was overwhelmingly positive. Almost all guests (93%) were thrilled.
- ➔ 70% thought that the Pink Pizza tasted significantly better than the traditional red one (although there was no difference in taste). They also said that they would be prepared to pay two euros more on average.
- ➔ 35% would also want to buy a Pink Sauce, which were almost all those who said that they made pizzas or pastas at home at times.

A more detailed analysis of the data allows Mrs Bossi to draw the following conclusions with respect to a specific target group. It will comprise guests who

- ➔ are between 25 and 40 years old
- ➔ have a high income and
- ➔ belong to the customer type of early adopters and would want to buy a Pink Pizza so as to satisfy their need for social contact and recognition.

4.3.2. CRITERIA FOR MARKET RESEARCH

Mrs Bossi has applied a very complex method of market research: an experiment followed by a survey. She has taken a number of things into consideration which are crucial if she wants the results of her market research project to be meaningful. She has made an effort to meet the key criteria of any market research process, which are validity, reliability and objectivity.

Validity

Validity means that you measure what is actually intended to be measured / what your research target actually is.

► Validity

In order to meet this criterion, you have to word your questions precisely. The two sample questions below are intended to demonstrate what would not have led to a valid result.


- Do you like to eat pizza?
- Do you like to wear pink clothing?

Both questions are unsuitable if your research target is to find out whether a pink pizza is well received by your customers. You cannot unconditionally assume that

- a person who likes pizza will also like to eat a pink pizza and
- a person who likes to wear pink clothing will also like to have a Pink Pizza. It may very well happen that pink pizzas will appeal to people who hate pink clothing.

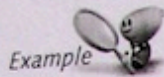
To design proper questions is certainly not easy and requires some practice. This is true not only in market research, but also in everyday life situations, as demonstrated by the following examples:

- *If the question: "May I invite you for a drink?" is answered positively, one cannot necessarily conclude that the person invited will also accept further offers.*
- *A "Yes" to the question, "Are you happy?" need not mean that the respondent is happy to be married to the person who asked the question.*
- *From a positive answer to the question: "Do you like this jewellery (in the shop window)?" one cannot draw the conclusion that the person who asked would also be prepared to buy it as a present – or (vice versa) the person asked would wear it.*

Example 

Problems in business and private communication often arise from questions with imprecise wording. A so-called leading question, for example, is phrased in such a way that it more or less forces the desired answer.

Examples:



Example

- *Do you share the opinion of all the other interviewees asked before you that a person who does not like the colour of pink on pizzas has a general aversion towards new things?*
- *Don't you think that this fish dinner which has taken me hours to prepare and which I have made especially for you has turned out to be exceptionally delicious?*

In our story Mrs Bossi asked the crucial question of how much a person would be willing to pay for a Pink Pizza. This question is particularly important because it takes into consideration that there is a difference between what a person likes (= need) and what he would pay money for (= demand).

Reliability

► Reliability

Reliability means that there is a high chance that the research results are actually in accordance with reality.

In our case, this would mean that the research results allow the conclusion that in addition to the Bossi's eighty test subjects other people will like the Pink Pizza, and, more importantly, buy it as well.

Factors that have an impact on the reliability of the research process are:

- the **size of the sample**, which is the number of test subjects who participate in the research. The larger the sample, the greater is the chance that the research results are in accordance with reality. A one-person sample, with the researcher being his own test subject, is not very likely to show reliable research results.
- the **sample quality**, which depends on the criteria according to which the respondents have been chosen. The selected sample should be representative for those people who form the target group of the product. If you want to know which radio station plays the best music for young people, interviews should be held at schools and on university campuses but not in a home for the elderly.

Objectivity

Objectivity means that the research result will be the same regardless of who is responsible for running the project. This criterion is most difficult to meet because the survey results must also be interpreted – and the outcome of an interpretation naturally depends on an individual's personal view. It is common knowledge that a glass that is half empty can also be referred to as being half full.

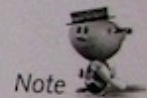
► Objectivity

Whenever a party has a strong interest in a research project's outcome being negative or positive, obtaining an objective result is most difficult.

If Mr Bossi had in any way been involved in his own projects, objectivity could not have been granted. It was therefore the right decision of Mrs Bossi to keep her husband out. The question must be raised, though, whether Mrs Bossi was objective enough?

In order to meet the criterion of objectivity, it is best to have the project run by external experts who have no personal interest whatsoever in any particular outcome.

News reports on biased research results are presented to us almost on a daily basis. Again and again we find reports that play down the effects of smoking and alcohol, or claim that eating chocolate has major benefits and that car exhausts have nothing to do with global warming. At closer look it may turn out that tobacco, alcohol, chocolate, or car producers have commissioned the survey.



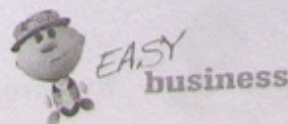
Note

4. 3. 3. PHASES OF MARKET RESEARCH

We can distinguish between four different phases of the market research process.

► Phases of market research

1. Defining the problem
 - "Is pink a good colour for (pizza) sauces?"
2. Selecting the research method and performing the research
 - Survey, market test or observation
3. Evaluation of the results
4. Interpretation



4.3.4. PRIMARY AND SECONDARY MARKET RESEARCH

► *Primary and secondary market research*

Mrs Bossi applied the instrument of market test followed by a survey of the participants or test subjects. She could, however have made her life easier by using existing sources of information, such as

- specialist literature and journals or
- the Internet.

Perhaps somebody else conducted similar research on this subject matter or a related topic somewhere else at some point in the past.

Ever since the Internet was introduced, research has become easier, and one can expect to find information about people's acceptance of pink in general and as a food colouring (for beverages, for example) in particular. From those results a first conclusion can be drawn on how likely people are to accept the colour of pink on pizzas.

At the same time, however, the question must be asked whether the research results are actually meaningful. Can one really draw the conclusion that Bossi's Pink Sauce for pizzas will become popular in Europe only because a pink sauce for fugu is the latest sensation in Japan?

Market research that is conducted by using information that already exists somewhere and has been collected for a different purpose is referred to as **secondary research**. It is to be distinguished from **primary research**, where information is collected for the specific purpose at hand.

► *Market research methods*

When primary research is conducted, different **research methods** can be used:

- **Observation:** The observer watches openly or under cover how people behave: Are they thrilled? Do they ask for more? Are there complaints?
- **Survey:** Here an interviewer obtains and records information from respondents, or questionnaires are handed out or sent to people. We can distinguish between
 - **open-end questions** (such as: "What do you think of the colour of shocking green for a limousine?"), which allow the respondents to answer in their own words, and
 - **closed-end questions** (such as: "Do you prefer the colour of red or shocking green for a limousine?"), where the respondents can select from all the possible answers.

- **Market test / experiment:** Here the subjects are given the opportunity to test a product and are then asked for their opinion.

Evaluation

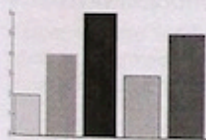
The respondents' data and the answers received are electronically stored and then evaluated. In the case of a simple research procedure, an Excel sheet may suffice to calculate and record what percent of the test subjects regarded the Pink Sauce as excellent.

If you want to figure out, however, what

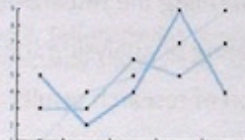
- those people who are under 30, have no children, and have an income of 2,000 euros at the most think of the Pink Sauce, as compared to
- diabetics who are older than 60 and have more than twelve grandchildren,

an Excel calculation will no longer do. In order to present cross tabulations or pivot tables, the use of highly sophisticated software such as SPSS and the services of a professional market research institute are recommended.

The evaluated research results are most often presented in tables first, which are then converted into more easily comprehensible charts or graphs. The following charts are used most frequently:



bar chart



line chart or line diagram

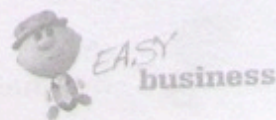


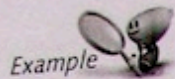
pie chart

Interpretation of results

Ultimately, the evaluated research results have to be interpreted and the correct conclusions have to be drawn. In the course of such an interpretation, the key quality criteria of market research (validity, reliability and objectivity) have to be applied. Otherwise all previous work may have been for nothing.

Even in highly sophisticated market research projects with several thousand test subjects, mistakes may be made in this last phase of the procedure and wrong conclusions may be drawn.





Here is our example again:

What can be concluded if 33 percent of interviewees think that the Pink Pizza looks awful? People who have a positive attitude towards the Pink Pizza project are likely to interpret this as an undisputed sign of acceptance. "Only one third have judged the Pink Sauce negatively."

People who have been rather critical towards the project from the beginning will probably see things differently: They will say that the reactions of as many as 33 percent have been devastatingly negative and conclude that the Pink Pizza is doomed.

From the above it is obvious that you may interpret statistical data in a way that confirms what you want to have confirmed. Whenever you watch discussions among politicians, you will notice that they are, in fact, artists in drawing precisely those conclusions from market research results and opinion polls which support their case.

4. 3. 5. SOURCES OF ERROR IN MARKET RESEARCH

➤ *Market research: problems and limitations*

In every phase of the market research process mistakes may be made:

- ➔ inadequate problem definition
- ➔ selection of wrong research method
- ➔ mistakes made in performing the research (lack of objectivity)
- ➔ mistakes made in entering or analysing the data
- ➔ improper interpretation of research results

4. 3. 6. COMPETITION

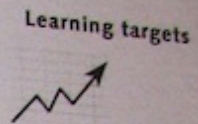
The second important component that determines a market – the competition – needs to be explored as well. The chapters "Industry analysis" and "Competitive analysis" deal with this issue in detail.

Once a market has been explored and all the basic conditions are known, the company can start to realize its marketing project.

EASY BUSINESS IN TELEGRAM STYLE

MARKETING – Part 1: Basics / Customers

The following keywords and concise descriptions give an overview of the EBC*L Level B learning objectives. They do not, however, offer detailed explanations of the business terms and contexts (which are required for Level B exams). For those, please see the business texts and examples in this book. In addition, we advise you to identify practical examples from the real business world – for further progress.



- ▶ Explain the term "marketing" and its goals.

Marketing is a corporate policy that is directed strictly towards market needs satisfaction. Marketing efforts can be directed towards

- winning new customers
- making a company or a certain product more popular, or
- improving the image of a company or of a product.

- ▶ Name and explain the tools of marketing (Overview).

- market research
- product policy
- pricing policy
- distribution policy
- promotional policy and
- selling / sales (strategy)

- ▶ Distinguish between "external marketing" and "internal marketing".

- External marketing is directed towards the final customer of an enterprise.
- Internal marketing addresses the different target groups within the enterprise itself (employees, superiors, company divisions).

- ▶ Explain the term "self-marketing".

A person can also 'market' himself. Self-marketing is not meant to be used by politicians, actors and supermodels only. It is actually important for each and every one of us to present oneself in a positive light.

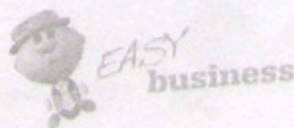
- ▶ Explain the term "marketing mix".

The four Ps – product, price, place (i.e. distribution) and promotion – are commonly known as the 'marketing mix' and adjusting them to each other, i.e. optimizing the marketing mix, is the primary responsibility of marketing.

- ▶ Explain the structure and design of a marketing plan.

A well-designed marketing plan that is ideally put into writing should contain the following major points:

- Actual analysis: Analyse the starting position and define the reason for taking marketing measures.
- Setting goals: They can be of quantitative nature or focus on quality aspects.
- Activities and time schedule: Draw up a schedule of activities in which desirable interim results or 'milestones' are identified.
- Budget plan: Determine a marketing budget.
- Constant monitoring and final review of the marketing project.



➤ Name and explain customers' buying motives.

- Rational buying behaviour: The buyer acts rationally and wants to achieve the best result at the best price possible.
- Impulse buying behaviour: The buyer lets himself be guided by feelings and intuition and acts spontaneously.
- Habitual buying behaviour: The buyer relies on past experience.
- Social buying behaviour: The buyer allows himself to be guided by moral and value concepts of his social environment (friends, workmates, or celebrities).

➤ Explain Maslow's hierarchy of needs.

According to this theory, we can distinguish between five different categories of people's wishes and needs.

- Level 1 – Basic physiological needs: warmth, food, sleep, etc.
- Level 2 – Safety needs: shelter, security of employment, health, etc.
- Level 3 – Social needs: friendship, partnership, family, etc.
- Level 4 – Esteem needs: status, wealth, career, etc.
- Level 5 – Self-actualization: individuality, talent enhancement, art, etc.

This hierarchy is intended to demonstrate that higher needs come into focus only when the lower needs in the pyramid have been satisfied.

➤ Explain the terms "need" and "demand".

People have hundreds of needs most of which are not filled because of a lack of time and / or money. Needs become concrete demands when people are prepared to buy products and have the money to do so.

➤ Name and explain the different stages in a buyer's decision-making process.

- Problem awareness
- Information search
- Evaluation of alternatives
- Purchase decision
- Post-purchase evaluation

➤ Explain the term "cognitive dissonance".

In general, human beings strive to achieve a psychological state that is in balance. Knowing about negative side effects of a decision that cannot be reversed any more (= cognitive dissonance) creates discomfort and imbalance. This is why the decision-maker will emphasise the positive aspects and try to ignore the negative side effects.

➤ Explain the term "customer segmentation".

Customers are subdivided into different customer segments according to various criteria:

- Demographic criteria: age, sex, education, etc.
- Geographic criteria: country, region, climate, etc.
- Psychographic criteria: rational / emotional, conservative / modern, etc.
- Private and corporate customers

➤ Name different customer categories.

- good customer – bad customer
- internal customer – external customer
- private customer – corporate customer
- early adopters – majority – laggards

► Explain the term "customer relationship management" (CRM).

The goal of customer retention is to cultivate customer relationship in such a way that a customer remains loyal to the company for as long as possible. CRM phases:

- Customer identification: It is important to store as much information as possible on potential or existing customers in a databank.
- Customer acquisition: To win a customer an enterprise needs to apply various marketing tools (product policy, pricing policy, advertising).
- Customer retention: Customer retention instruments include loyalty discounts, preferential treatment, etc.
- Winning back customers: If an enterprise has lost a customer to one of its competitors, it should analyse the customer's reasons, and attempt to re-attract him by making a better offer or improving customer service.

► Explain the term "glass consumer".

Professional organisations collect and compile publicly available information about individuals. Compilation of data is possible because whatever we do (use credit cards, do Internet shopping, use search engines) leaves trails from which others can draw conclusions about what our interests are.

► Explain the term "data mining".

'Data mining' refers to the process of accessing and evaluating information about customers and customer behaviour. Data mining identifies typical buying behaviour to which companies adjust their marketing strategies.

► Name and explain tools of customer retention.

- loyalty discounts
- quantity discounts for purchases exceeding a certain value
- preferential treatment (like no waiting times)
- presents (on birthdays and at Christmas)
- invitations to company events
- free flights or bonus miles

► Explain the term "complaints management".

- Professional complaints management will help a firm retain a customer / win a satisfied and loyal customer.
- A complaint gives a company the opportunity to do things better in the future.
- complaint seriously and offers a proper adjustment, it may avert even greater damage: negative publicity.

► Explain the term "cross-selling".

The term cross selling is used to describe the sale of additional products (of a different product category) to a customer who has already bought products from you.

► Explain the term "full-range customer".

Ideally, enterprise would want to be in a position to satisfy all the needs of a customer (for products of a particular category) and might therefore decide to structure its marketing strategy towards this goal.

► Explain the goals of market research.

The more thoroughly a market has been investigated, the more precisely marketing activities (product policy, advertising, etc) can be planned and implemented.
Market research focuses on:



- the customers ('King Customer')
- the competition (= competitors / rivals)
- the so-called input market (the labour market, the suppliers and the market for raw materials)

➤ Explain the quality criteria of 'validity', 'reliability' and 'objectivity' in market research.

- Validity means that you measure what is actually intended to be measured / what your research target actually is.
- Reliability means that there is a high chance that the research results actually correspond to reality. Reliability is influenced by the size of the sample and the sample quality.
- Objectivity means that the result will be the same regardless of who is responsible for the research project.

➤ Explain the term "sample" / "sampling".

The term "sample" refers to the number of test subjects who participate in the research.

- Sample size: The larger the sample, the greater is the chance that the research results correspond to reality.
- Sample quality: The selected sample should be representative of those people who form the target group of the product.

➤ Explain the different phases of the market research process.

We can distinguish between four different phases of the market research process.

- Defining the problem
- Selecting the research method and performing the research. Methods include survey, market test and observation.
- Evaluation of the data
- Interpretation of the results

➤ Explain the terms "primary market research" and "secondary market research".

- Market research that uses data that already exists somewhere and has been collected for a different purpose is referred to as secondary research.
- It is to be distinguished from primary research, where information is collected for the specific purpose at hand.

➤ Explain the primary market research methods of 'survey', 'observation' and 'market test'.

- Survey: An interviewer obtains and records written or oral information from respondents. A standardized questionnaire may be used.
- Observation: The observer watches openly or under cover how people behave.
- Market test / experiment: The subjects are given the opportunity to test a product and are then asked for their opinion.

➤ Explain the problems of and limitations to market research.

Sources of error in marketing research:

- inadequate problem definition
- selection of wrong research method
- mistakes made in performing the research (lack of objectivity)
- mistakes made in entering or analysing the data
- improper interpretation of research results

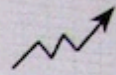
➤ Explain the factors pertaining to a competitive analysis.
See Chapter Actual Analysis

4. 4. Product Policy

Learning targets:

- ▶ Being able to explain the term "product policy" and possible product policy strategies
- ▶ Being able to explain the terms "product life cycle"
- ▶ Being able to explain the term "product mix policy", "product mix width" and "product mix depth"
- ▶ Being able to explain the terms "product innovation", "product variation", "product diversification" and "product elimination"
- ▶ Being able to explain a product portfolio analysis

Learning targets



4. 4. 1. PRODUCT POLICY STRATEGIES

Before a company starts implementing its product policy, it has to have clear answers to the following two questions:

- ▶ How should a product be designed so that it appeals to the needs of the target group?
- ▶ What must be done so that product development and launch are financially feasible and that the product is profitable in the long run?

▶ Product policy

In practice, enterprises very often pay too little attention to these two fundamental questions. Many producers design things which they like and initially don't do sufficient research to find out whether potential customers are similarly enthusiastic about the product.

Other businesses or their departments demand that their products fulfil excessively high quality standards. Meeting this requirement often makes the product so expensive that no customer is willing to pay the exorbitant price that is charged for it. 'Less perfection but greater affordability' would certainly be a more reasonable, i.e. economical policy.

In larger enterprises the production, marketing, sales and controlling departments often argue precisely about these issues and because of their different views, heated discussions are the norm.

Of course the product policy must be a firmly integrated part of the enterprise's entire marketing mix and thus be adjusted to the other marketing mix elements.

➤ Product policy strategies

In their strategic product policy planning process enterprises have to make a number of decisions:

- ➔ Is it advisable to emphasize product innovation and constantly offer new products or copy good ideas and successful products quickly?
- ➔ Is it reasonable to offer high-quality products at a correspondingly high price or are lower-quality but affordable products the better option?
- ➔ Should the product mix comprise as many products as possible or should the company concentrate its efforts on few products only?
- ➔ Should additional services such as delivery, installation or financing be offered in addition to the core product?

Innovator or imitator

There are enterprises that have become known for generating new product ideas which constantly keep their entire industry in motion. Regardless of whether it is the car, mobile phone, or semiconductor business, there are especially innovative firms in all sectors **Innovators** can also be found in the services industry: Some restaurants constantly create exotic dishes, there are hotels which come up with brilliant ideas of how to caress their guests, and some insurance companies will always be the first to offer sophisticated forms of insurance coverage.

These enterprises are willing to spend huge amounts of money on product research and development and have high expenses promoting their innovations. Furthermore, they are prepared to assume the risk that a product whose development has been quite costly will not be accepted by the market at all. Market rejection of a product can have various reasons:

- ➔ There is actually no need for this product.
- ➔ The market has been entered prematurely. There is no customer acceptance yet.
- ➔ The market has been entered too late. Another producer has won the race and introduced the same or a similar product before you.

These risks are compensated by the length of time during which the innovative producer may enjoy the product's benefits. Throughout its entire life cycle – in particular during the lucrative growth phase – a successful product may generate profits that far exceed its initial R&D costs.

Furthermore, innovators benefit from their positive image, which allows them to charge higher market prices.

An additional risk they have to bear is potentially fierce competition by product **imitators**. Those are companies that adopt an innovator's product idea and unscrupulously produce often astonishingly perfect copies. As with innovators, there are also known imitators in almost any sector and they copy watches, sneakers, software as well as clothing.

Particularly enterprises from East Asia have perfected this art. More and more often, however, products are copied without the prior consent of the original manufacturer and today millions of illegal copies of music and movie DVDs, T-shirts and exclusive watches are flooding the markets.

The imitators' advantages are obvious: They have lower expenses and assume less risk than the innovators and can thus charge a price that may be considerably lower than that of the original product. Their highly affordable copies may make life for the innovators truly difficult.

Their only major risk is that they may enter the market at a point when the product has already reached a less profitable point in its life cycle.

Shorter product life cycles

In the course of globalization the risk of products being copies has become much greater as innovative enterprises now face imitators from all over the world.

Survival in such a fiercely competitive environment is only possible if new products enter the market at much shorter intervals.

Thus many of the recently introduced products may have life cycles of a few months only. Something that is introduced today may soon see itself in the saturation phase.

Through **product variation**, i.e. amending an existing product, the end of the product life cycle may be postponed. A formerly round product may be offered in a new angular design, more gigabytes may enhance the performance of an electronic device, and additional features such as TV reception on your mobile phone may also rekindle interest.

You cannot postpone **product elimination** indefinitely, though, and at some point, which may come sooner than you think, every product will be dropped from a company's portfolio. (See: product life cycle and product portfolio in the chapter on "Analytical and planning instruments").

► *Product variation*

► *Product elimination*

How can innovators protect themselves?

From a legal viewpoint, innovators may apply for patent protection and may have their brands registered. A patent is granted to anyone who develops a completely new and useful product or procedure. As very few products meet the criterion of being 'entirely new', and as the administrative expense of having a patent registered is quite high, the number of small and medium-sized enterprises which apply for patent protection is low. Large groups of companies, on the other hand, file hundreds of patents every year.

Brand registration, however, is far easier. A brand or that part of the brand which is protected by law is called trademark and gives its producer the exclusive right to use it. Brands / trademarks may be

- a name or word (such as Bossi's Pink Sauce)
- a symbol or design (Mr Bossi's image)
- or a combination of the above (Mr Bossi's image in combination with the words "Bossi's Pink Sauce")



Bossi Pizzeria: Patent and brand protection for the Pink Pizza?

The secret recipe of the delicious pizza sauce could very well be regarded as an innovation. It is not all that certain, though, whether it meets all requirements for patent registration.

Simply colouring the sauce pink is most definitely not eligible for any form of protection because it is a procedure that can be copied easily and the Bossis can't do anything about it.

Mrs Bossi wants to have at least their name protected so that nobody else can use it for promotional purposes. As she intends to sell the sauce abroad as well, she wants to have the name "Bossi" protected internationally.

The business consultant at the Chamber whom she contacts for this purpose damps her ambitions, however. This is what he explains to her:

- The name "Bossi" is not eligible for protection. Perhaps the brand name "Bossi-Sauce" or "Bossi's Pink Sauce" would qualify. A trademark that combines the brand name "Bossi's Pink Sauce" with a picture or a design would even have better chances.
- Domestic registration costs about 700 euros. Having the trademark registered for all of Europe would amount to 5,000 euros. For world-wide registration at least 7,000 euros would have to be paid.

This information helps Mrs Bossi to look at things more realistically and she decides to have a trademark-design combination registered domestically. After six months her application is accepted.

High or low quality

Whether to offer products of high or low quality is another basic decision that is determined by general company policy. Enterprises which put emphasis on high quality must also communicate this to the outside world (by means of proper brand promotion) and charge sufficiently high prices. Otherwise all the efforts that are necessary to produce high-quality merchandise would not be justified.

Many enterprises pursue a dual approach strategy. In addition to high-quality brands, they also offer products that don't carry a brand name and thus signal that they may be of lower quality (= no-name products). Very often, though, these no-name products are of similar or the same quality as the brands and simply hide in less impressive packaging.

4. 4. 2. PRODUCT MIX POLICY

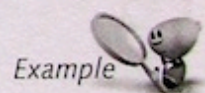
Another strategic decision a company has to make is whether to offer its customers a wide range of products (wide product mix or assortment) or to concentrate on few products only.

For the Bossi Pizzeria this would mean whether they should focus on Italian cuisine only or also offer French and Austrian dishes and perhaps cookery courses as well.

What speaks for a **wide product mix** is that it takes little effort to sell an additional or new product to your regular customer. The customer enjoys the benefit that he needs to address only one party to satisfy several of his needs. It is not necessary to shop around and contact dozens of other suppliers.

The major drawbacks of such a policy are equally obvious: Many of today's customers have high quality expectations and it is difficult to satisfy them even if you specialize in one product category only. If you offer a wider product mix and your marginal products sell badly because of lower quality, your core business may suffer as well. Your customers may turn their back on you and buy from your competitors instead.

► Product mix policy



Besides, your business may develop the reputation of being a corner shop that tries to do everything but does nothing right.

The opposite policy is to offer only one or very few products but in all kinds of variations. In other words, you turn into a specialist in a particular product category and run a narrow but **deep product mix**.

The apparent disadvantage / risk that comes along with any form of specialization is that the company depends on one or few products. If they become obsolete or uncompetitive, the entire enterprise is jeopardized.

Example



For the Bossi Pizzeria this would mean that they concentrate on pizzas only (and even eliminate their lasagne and other pastas from their product range). They do, however, offer 125 variations of pizzas of incomparable quality.

Additional services – augmented product

If you buy a bedroom wardrobe from a furniture store, the seller may offer you additional services: You may have the (room) plan drawn and the furniture delivered and set up. Payment on deferred terms, as for instance six months from the moment of purchase, could be another attractive feature that is intended to enhance the attractiveness of the core product.

Product augmentation, however, means a risk for the provider of additional services and benefits as he may not have the necessary know-how and capacities. For this reason many sellers no longer offer additional services but buy them from specialists such as transportation firms, carpenters, glaziers, electricians or plumbers.

Product policy – a summary of technical terms

In summarized form, the table below provides a concise list of the most important technical terms of product policy:

Technical term	Explanation
Product innovation	Bringing a completely new product to the market
Widening of the product mix (Product mix diversification)	Offering different kinds of products or product lines
Deepening of the product mix (Product differentiation)	Building or lengthening a product line, i.e. a group of products that are closely related to each other in terms of features, purposes, functions, etc.
Product variation or modification	Creating sub-products from primary products. Sub-product vary only slightly from primary products (in packaging, for instance)
Product elimination	Dropping a product from your product portfolio

Bossi Pizzeria: Product policy for "Bossi's Pink Sauce"

As the results of Mrs Bossi's customer survey are indisputably positive, she has quickly made up her mind not to use the Pink Sauce in their pizzeria only but sell it as their own product in grand style.



The product fundamentals are:

- Mrs Bossi's secret recipe
- the colour pink

Mrs Bossi intends to reach the following target groups:

- the guests of their pizzeria
- other pizzerias that also want to offer the Pink Pizza
- customers of delicatessen stores

As Mrs Bossi is planning to position the Pink Sauce as an exclusive product, it must fulfil the following criteria:

- ➔ high quality
- ➔ ingredients from sustainable production
- ➔ careful preparation
- ➔ few calories
- ➔ appealing packaging design
- ➔ extended freshness

Initially the Pink Sauce is intended to be used for pizzas only. As a high-quality innovative product it should build a good reputation. (Phase 1: Innovation and specialization).

After a successful launch, Pink Sauces will be offered for other dishes such as spaghetti and pastas as well. (Phase 2: Differentiation; building a product line).

In addition to the sauce itself, also the packaging should come in noticeable pink. Mrs Bossi is thinking ahead: As she is planning to sell the sauces to delicatessen stores, she knows that the sauces must be clearly distinguishable from other products and really stand out on the store shelves.

Furthermore, Mrs Bossi must decide into what kind of container to fill the sauces. There are a variety of alternatives including glass and plastic bottles, aluminium cans and plastic-lined cartons, each of which has its advantages and drawbacks. Plastic-lined cartons are certainly less expensive to produce but cannot be recommended for marketing reasons as they signal cheapness. Glass, on the other hand, implies quality but production and transportation cost more.

Using aluminium cans guarantees extended freshness but is environmentally questionable.

Mrs Bossi's tentative decision is to fill the sauce into large aluminium cans for their corporate customers (pizzerias) but into exclusively designed glass bottles for the retail customers (Phase 3: Product variation). Still, as using two different filling methods may not be cost effective, this may not be the ultimate solution.

As concerns the delivery of the sauces to other pizzerias, there may also be a minor problem. Mrs Bossi knows from her own experience that many restaurant owners plan only for the short term. They often place orders when it is almost too late and expect a high degree of flexibility from the suppliers, i.e. instant delivery when they run out of stock.

This service, however, cannot be offered for free and the costs that arise have to be added to the price of the product, making the sauces more expensive. Thus Mrs Bossi is thinking about eliminating his problem by offering the pizzerias an additional service. She intends to send them a weekly e-mail reminder in the form of an inquiry about their inventory levels.

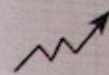


4. 5. Pricing Policy

Learning targets:

- ▶ Being able to explain the basic conditions for an enterprise's pricing policy
- ▶ Being able to explain the term "price-demand curve" (or function)
- ▶ Being able to explain the term "signalling effect of prices"
- ▶ Being able to explain the term "price elasticity of demand" and calculate it
- ▶ Being able to explain different strategies of pricing policy
- ▶ Being able to explain the terms "skimming strategy" and "discount or penetration strategy"
- ▶ Being able to explain the term "price differentiation"

Learning targets



Product decisions are strategic decisions which do not have to be reconsidered on a daily basis. With decisions on prices, however, things are completely different, and the agonizing question of what price to charge for a product bothers a business person every day. What good does the greatest product do if it is just slightly too expensive for the customers and therefore turns into a non-seller? Even after a successful sale, the question about the price may not let go of you. Would the customer have been prepared to pay much more? Didn't you give away the product?

Bossi's Pink Sauces: Pricing problems

With Mr Salt's help, Mrs Bossi succeeded in convincing her husband of the idea to sell the Pink Sauce in glass bottles as well. After having agreed on a product policy, they must now make a decision about the price. How much should they charge for the Pink Sauce?

Mr Salt has no doubt about what to do: He suggests calculating their own costs and adding 50 percent, which results in a price of 1.50 euros per bottle. If the product sells well, prices could be raised gradually.

Mr Bossi, however, is of the opinion that customers should pay a reasonably higher price for a product that follows a secret recipe. He visualizes a price of at least 4.00 euros per bottle. Considering the huge risk they are assuming, he believes that the 300 percent mark-up is absolutely justified.



Charging a premium price would allow them to generate profits early on, and if necessary, prices could be gradually lowered at a later stage.

With such a wide gap between the two suggested price levels, a heated dispute is inevitable. It is Mrs Bossi who again calms down her husband and Mr Salt and takes a reasonable approach. Which important aspect of pricing a product do you think she will point out to them?

She reminds them that throughout their entire discussion they have ignored the simple question of what price the market would tolerate. How much would the customers be willing to pay and what prices do their competitors charge for comparable products?

This takes the Bossis back to their market research project, in the course of which the test subjects were asked what price they would be willing to pay for the Pink Sauce. The consensus was that approximately 3.00 euros would be acceptable.

A price of 3.00 euros would actually be justified in view of what competing products cost. It would be three times as much as the prices of the cheapest sauces that are currently available on the market but similar to what one of their rivals charges for his exclusive sauce. The latter, however, can certainly not match the quality and uniqueness of Bossi's Pink Sauce.

4. 5. 1. BASIC CONDITIONS FOR AN ENTERPRISE'S PRICING POLICY

► Pricing policy:
basic conditions

The above example demonstrates how difficult it can be to determine the price of a product. The most important principle is to adjust to the conditions set by the market.

Of course the **total production cost or cost of goods sold** also plays a vital role. Normally total production cost plus a mark-up represents the lowest price level at which it still pays to offer a product to the market. Should the market price of a product be or drop below this level, it no longer makes much sense to sell this product.

Let us first focus on those who actually decide whether or not the price of a product is appropriate: the customers.

Customers – the most significant price determinant

How do customers react to an initial price, to a rise in prices or to a price cut? There are plenty of business models that attempt to explain price-related customer behaviour, some of which will be referred to below. Still, be

forewarned: There is no guarantee that customers will actually behave as they are expected to.

The competition as price determinant

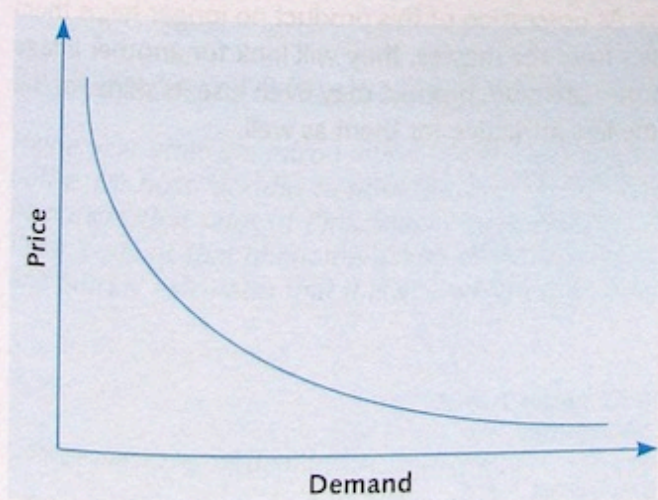
The enviable monopoly position for a supplier ("water vendor in the desert") is a dying species. Because of globalization of business and communication (Internet), more and more markets have taken on a polypolistic character, i.e. there are a large number of suppliers buyers can choose from. This means that rivals as well as consumers know precisely which products are currently available at which prices and sellers who charge uncompetitive prices will quickly lose their customers.

Before businesses set their prices, they also have to observe their rivals for any typical pricing policy. Is there perhaps a supplier who seeks to push other competitors out of the market by applying a particularly **aggressive pricing policy**? On the other hand, all sellers in a particular market may charge similar prices and there is hardly any movement on the price front (**defensive pricing**).

4. 5. 2. PRICE-DEMAND FUNCTION OR CURVE

The relationship between price and demand is quite simple:

- ➔ the higher the price, the lower the demand for the product (= the quantity sold)
- ➔ the lower the price, the higher the demand



➤ Price-demand function

According to this model, a price cut is supposed to result in an instant increase in the number of products sold. The extent of this increase can be shown by calculating the so-called price elasticity.

4. 5. 3. SIGNALLING FUNCTION OF PRICES

Occasionally it happens that a change in prices has just the opposite effect of what should happen according to the price-demand curve. A decrease in prices results in a significant drop in customer interest and sales, whereas a higher price actually stimulates demand.

➤ *Signalling effect of prices*

The reason for this admittedly surprising customer reaction is the so-called signaling effect of prices. This means that customers associate

- ➔ superior quality and a better image with higher prices, and
- ➔ poorer quality and a bad image with lower prices.

Especially premium brands are subject to the snob effect. For designer clothing, designer watches and luxury cars it would be lethal if the price dropped below a certain level. The signal this price change would send out could prompt reactions such as:

- ➔ "If they lower their prices, there must be something wrong with the quality."
- ➔ "If that is so cheap now, anyone can afford it – but I don't want to be just anyone."

This way a lower price may quickly render a formerly desirable luxury product unattractive for the rich. As possession of this product no longer helps them to distinguish themselves from the masses, they will look for another image product. Worse, the former premium product may even lose its shine for the middle class and become less attractive for them as well.

4.5.4. PRICE ELASTICITY OF DEMAND

Customers very often react to even the slightest change in price by buying more or less of a given product. A 3 percent price rise may actually cause demand to drop by as much as 20 percent. Vice versa, if prices are lowered by 5 percent, sales may jump 20 percent or more.

► Price elasticity of demand

In both cases there is **elastic demand**. This means that customers react to the price change in such a way that the percentage change in quantity demanded is greater than that in price. If prices rise, the customers buy less, buy the product at a more attractive price elsewhere or don't buy the product at all.

In contrast, there is **inelastic demand** for a good if the percentage change in quantity demanded is smaller than that in price.

The formula for calculating price elasticity of demand is as follows:

$$\text{Price elasticity of demand} = \frac{\text{Percentage change in quantity demanded}}{\text{Percentage change in price}} \times 100$$

- ➔ If the result is higher than 100, customers are sensitive to price changes and demand is elastic.
- ➔ If the result is lower than 100, customers are not sensitive to price changes and demand is inelastic.

Bossi's Pink Sauces: Price elasticity of demand

Half a year after the introduction of the Pink Sauces at a price of 3.00 per bottle, Mr Bossi decides to raise the price by 5% to 3.15 euros. Very soon he notices that sales of Pink Sauces have dropped an alarming 20%. Mrs Bossi explains that phenomenon by referring to price elasticity of demand and quickly calculates that it is at a worrying level of 400.

$$\text{Price elasticity of demand} = \frac{20\% \text{ Change in quantity demanded}}{5\% \text{ Change in price}} = 400$$



In order to counteract this development, the Bossis decide to run 'Tuscany Weeks', during which the Pink Sauce is offered at 2.70 euros, i.e. 10% lower than the original price of 3.00 euros. The customers are thrilled and buy 30% more of the product during these weeks.

Use your pocket calculator to figure out the price elasticity of demand in this case.



Your solution



If you arrived at 300, your calculation was correct. In both cases described above, demand for the Pink Sauce is elastic. Both the rise and the cut in prices resulted in a greater percentage change in quantity demanded.

After the 'Tuscany Weeks' the price of the Pink Sauce is raised by roughly 10% back to 3.00 euros again. The Bossis are pleased to note that the quantity of Pink Sauces sold drops by only 5%, which means that price elasticity of demand is a mere 50. Apparently the price change has had little effect on the quantity demanded.

If an enterprise has justified fears that its customers are price sensitive, it must think twice before it raises its prices. Leaving its prices unchanged is particularly difficult if the business organization itself faces increased costs of production or distribution that are due to higher wages or higher transportation costs.

Customers cannot really be expected to react positively if increased business costs are passed on to them.

4. 5. 5. PRICING STRATEGIES

Especially when an enterprise launches a new product, it is difficult to make the right pricing decision. The alternatives are

- to charge a high price
- to offer the product at a discount price (= to charge a low price), or
- to steer a middle course and follow the guidelines set by the market leader.

➤ Pricing strategies

You may remember the dispute Mr Salt and Mr Bossi had when a price for Bossi's new Pink Sauce had to be set. They suggested two opposing strategies.

Mr Salt's suggestion of introducing the new product at a low price which would be gradually raised later on is referred to as **discount or penetration pricing**.

➤ Discount or penetration pricing

Mr Bossi's opposite strategy of setting an initial high price which could be lowered gradually over time is known as **price skimming**.

Many firms also use the instrument of **price differentiation** (also known as discriminatory pricing) which means that they charge different prices for the same product to different target groups or sectors of the market.

➤ Price differentiation

Bossi's Pink Sauce, for example, could domestically be sold at four euros per bottle, in Eastern Europe at two euros and in Switzerland at six euros. This is regional or geographic price differentiation.

When different groups of customers like students or pensioners are offered the same product at a lower price, the term 'customer specific price differentiation' is used.

4. 6. Terms and Conditions Policy

Learning targets:

- Being able to explain the term "terms and conditions policy"
- Being able to explain the term "discount" and name and explain different types of discounts
- Being able to explain the term "cash discount"
- Being able to explain the term "default interest"
- Being able to explain the terms of delivery "free of charge to address of buyer" and "ex works"

Enterprises always try to influence customer behaviour by offering special conditions and incentives. Among them there are discounts, special terms of payment (cash discounts, default interest) and terms of delivery.

4. 6. 1. DISCOUNT

Discount is defined as a reduction in a list or invoice price. It is expressed as a percentage of the amount the buyer has to pay.

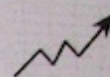
A 10% discount means that a product that would normally be sold at 100 euros can be bought at 90 euros.

Occasionally the term 'discount' is also used when the buyer receives a larger quantity, better quality or additional service (= discount in kind). The purpose of discounts is to increase short-term sales, move out-of-date stock, encourage distribution channel members to perform a function or provide incentives or rewards to customers.

An enterprise may want to entice customers to

- ➔ buy as soon as possible
 - ➔ *For purchases before the end of the month we grant a 10% discount."*
 - ➔ *Early-booking discount: "If you book by 30 March, you will get a double room at the price of a single room."*

Learning targets



- Terms and conditions policy

- Discounts

Example



Example



- buy during a slack period
 - Seasonal discount: "Before 20 December the ski pass costs 30% less."
 - Happy hour (on a shorter time scale): "Get any drink at half the price between 7:00 and 9:00 p.m."
- buy more of a certain product
 - Quantity discount: "Buy ten, get one free."
- remain loyal to the enterprise
 - Loyalty discount (which can be seen as some form of quantity discount): "Bonus miles and free flights for frequent fliers."
- collect the merchandise instead of having it delivered
 - Cash and carry discount (See also "Cash discount" below)

4. 6. 2. CASH DISCOUNT

► Cash discount

A cash discount is an incentive for customers to pay as early as possible. It is usually quoted in percent and can be deducted from the invoice price if payment is effected instantly or within a stated period of time.

Example



The terms of payment "2/7 net 30", for example, indicate that only 98 euros out of a 100 must be paid. Two euros can be deducted from the invoice price if payment is made within seven days. Otherwise payment of 100 euros is due within 30 days.

Invoice price	100 euros
– 2% cash discount	2 euros
= payment of	98 euros

A cash discount can also be seen as a short-term, interest-free **supplier credit** that is offered at highly favourable terms. A 2% cash discount for eight days translates into an annualized interest rate of 32%.

Customers should therefore always avail themselves of a cash discount and in some cases it may even pay to overdraw your credit line to make the early payment.

The reason why enterprises offer such generous cash discounts is easy to explain: Instant or early payment is desired but often customers don't pay at all or must be chased for months before they finally pay. This takes time, costs money and is nerve-wracking for those who must run after their money or use the services of a collection agency.

A 2% cash discount is little in view of the costs of collection and the risk of payment default.

4. 6. 3. DEFAULT INTEREST FOR DELAY IN PAYMENT

Whereas a cash discount is a reward for instant or early payment, default interest is a punishment for a delay in payment.

"The invoice amount is payable without any discount within 30 days. For delay in payment default interest of 5% per month will be charged."

Customers who effect payment after the due date will face horrendous (annualized) interest charges. Any bank loan would be more favourable.

► Default interest

Example



Debt collection practice and corporate image

Although it makes perfect sense for enterprises to insist on in time-payment for services rendered, caution is advised: Aggressive debt collection practice could alienate even a company's regular customers.

Mr Bossi and the collection agency

One morning Mr Bossi finds a letter from the 'Brutalo' collection agency in his mailbox with the final demand for payment of his telephone bill. Unless he instantly transfers 17.90 euros which he owes the telephone company, legal action will be taken.

In addition to the invoice amount of 17.90 euros, collection fees and default interest of 7.00 euros and legal fees of 100 euros must be paid. The total amount due is 124.90 euros.

Mr Bossi's reaction is predictable: He rushes to the telephone and yells at the poor woman at the call center for 15 minutes. As she cannot offer him any satisfying solution, Mr Bossi pays the entire amount but is so infuriated that he terminates his contract with the telephone company. He swears that he will never again do any business with them, displays the collection letter highly visibly in his restaurant and tells every customer how badly this terrible company has treated him.

This example is intended to demonstrate that it may be worth treating dilatory customers with patience and respect. Remember that it takes quite some time and effort to win customers to begin with.



4. 6. 4. TERMS OF DELIVERY

Some firms try to attract and impress customers by offering especially favourable terms of delivery.

- "Free domicile" and "ex works"

Free domicile or **Free of charge to address of buyer**, for example, means that the seller pays all the transportation and other charges to the buyer's premises. This is delightful for the customer but represents a major cost item for the seller, particularly if a product sperrig ist must be transported over a long distance.

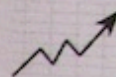
In such a case it would probably be better to offer the product at the more attractive **ex works** price and charge the customer separately for shipment or have them collect the goods. ("Ex works" means that the seller's only responsibility is to make the goods available at his premises.).

4. 7. Distribution Policy

Learning targets:

- ▶ Being able to explain the term "distribution policy"
- ▶ Being able to explain the term "direct selling", methods of direct selling as well as its advantages and drawbacks
- ▶ Being able to explain the term "indirect selling", methods of indirect selling as well as its advantages and drawbacks
- ▶ Being able to explain the term "franchising"

Learning targets



An enterprise's distribution policy focuses on the wide range of activities that are concerned with getting the goods from the firm to its customers. In other words, distribution provides a link between production and consumption.

- ▶ Distribution policy

Bossi's Pink Sauce: Distribution policy

Mrs Bossi is facing a new problem. When their business activities were confined to serving pizzas at their pizzeria, their customers were coming to the product. Now that they are selling the Pink Sauce, the product has to be taken to the customers and Mrs Bossi has to think about different solutions for different target groups.

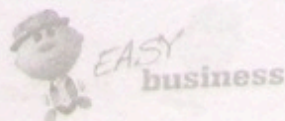


As concerns their corporate customers (pizzerias within a range of 100 kilometers), Mrs Bossi will personally visit them to present the Pink Sauces. In the future the Bossis will use their own small company truck to effect delivery.

If their plans work out, though, and pizzerias all over the country buy the sauces, they have to consider additional channels of distribution.

One alternative would be to hire a sales representative. Mrs Bossi soon notices, however, that in the restaurant and catering business good salespeople are rare and expensive. Potential candidates who already have good contacts to customers ask for a commission of up to 20 percent of the sales generated by them in addition to their fixed salary. The drawback is that the (fixed) salary has to be paid even if there are no sales at all.

For that reason, Mrs Bossi contacts a commercial agent for pasta with whom they have been doing business for quite some time and the agent agrees to add the Pink Sauce to his assortment. He will not receive a salary but asks



for a hefty 35% commission on sales generated through him. Although Mrs Bossi regards 35 percent as extremely high she accepts..

As Mrs Bossi intends to sell the Pink Sauce to retail customers as well, she contacts the popular retail chain "Luxury Food". She believes that their sauces will perfectly fit into the chain's product mix and will be welcomed with open arms. Reality looks different, though, and Mrs Bossi doesn't get the impression that Luxury Food had been waiting for Bossi's Pink Sauces. It takes ages to make an appointment with Luxury Food's procurement executive, and when they finally meet, he has a mere ten minutes to spare, during which he dictates Luxury Food's conditions:

"First the good news: If we come to an agreement, we want you to supply us with 10,000 bottles a month. Terms of delivery are "Free domicile" with you assuming the sales risk. This means that you have to take back any bottles that haven't been sold after three weeks at your own expense.

If the product sells well, we can include it in our brochure for which we will charge an advertising fee of 7,000 euros. By the way, 60 percent of the turnover will be ours."

This talk has certainly been an eye-opener for Mrs Bossi, but when she does more research, she finds out that the conditions quoted by Luxury Food are quite common in the food retail business.

She is about to discard the idea of selling to the retail customer when she happens to come across an interesting newspaper article. The article is about a beekeeper who successfully sells his special honeys via the Internet and the telephone. Some of his products are sold to customers in places as remote as Saudi Arabia. Mrs Bossi can imagine doing something similar and intends to have their www.bossis-pinksauces.com homepage installed soon.

When it comes to distribution, one can distinguish between **direct** and **indirect selling**.

4.7.1. DIRECT SELLING

When goods are sold directly, ownership is passed on only once: from the producer to the final consumer. Direct selling is a popular form of distribution when enterprises sell to corporate customers but there are also producers who run their own outlets from which they sell to retail customers (shoe stores, chocolate shops).

► Direct selling

The classic method of direct selling is through a firm's own **sales force**. This term denotes those employees who are engaged in selling an enterprise's products.

The key advantage of this method is that no commissions on sales have to be paid, which could amount to 30, 50 or even 70% of sales when commercial agents are used. In addition, an enterprise has better control over its own sales representatives (= commercial travellers, field executives). It can establish rules, train its sales force members properly, and raise the level of motivation by offering special incentives.

The greater the need for explanations and additional service, the more sense it makes to sell your goods through your own, well-trained sales representatives.

The disadvantage of this method is that fixed costs are high. Sales representatives are employees whose salaries have to be paid regularly regardless of whether or not they generate sales.

Another method of direct selling is **mail order** (= **catalogue retailing**). Customers receive and order from a firm's catalogue. The purchased goods are sent to them by mail.

Direct selling over the Internet is the latest method of offering products to retail customers. It has created a vast range of opportunities for even the smallest enterprise. Provided its online store or web shop is well designed, it can attract the attention of its target groups worldwide. In most cases goods are sent to the retail customers directly. (See also Chapter "Advertising")

Telephone selling is yet another method of direct selling. It takes well-trained sales engineers, though, to engage absolute strangers in a telephone conversation and convince them to buy a product (or at least to test it without any obligation). Enterprises selling over the telephone run so-called telephone call centers that require highly sophisticated equipment and well-trained staff to operate successfully.

Other direct channels of distribution include **fairs** and **exhibitions**.



4. 7. 2. INDIRECT SELLING

► *Indirect selling*

When enterprises sell their goods indirectly, they use the services of at least one intermediary or middleman to bring their products to the final buyer. The retail business is probably the best-known form of indirect selling. **Retailers** operate their own stores in suitable locations and re-sell the goods they bought from the producers to the final consumers.

A so-called **wholesaler** is an intermediary between the producer and the retailer. Typically, wholesalers buy in large quantities from producers and re-sell the merchandise in smaller quantities to retailers.

For producers the huge advantage of selling indirectly through the retail channel is that it takes little effort to address large customer groups. Fixed costs are greatly reduced because of the infrastructure and specialised services the intermediaries offer the producers. These services include delivery, storage, market information, promotional activities and more. It is the know-how of the retail businesses that helps producers win customers.

The major disadvantage is the cost of selling through the wholesale and retail channel. The commissions and trade discounts the producers must offer to the intermediaries often depend on the sales volume and – if the market is dominated by powerful trading houses – may amount to 60% or more of the turnover.

Another drawback is that retailers deal in a great number of products (often from competing producers). If a product does not automatically sell well and is not given priority by the retailer in terms of shelf space, etc., it may become a non-seller and be eliminated from the retailer's assortment quickly.

Other typical examples of indirect selling are **franchising** and agreements with **agents** (insurance agent, real estate agent).

4. 7. 3. FRANCHISING

Franchising is a distribution agreement in which a business person, the so-called franchisor, does not have any major financial expense and can eliminate the risks that are normally associated with direct selling.

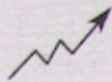
► Franchising

The franchisee, who is legally independent, is granted the rights to use the franchisor's business concept and to produce and/or sell a product for his own account. He can use a well-tried production and marketing system and benefits from the franchisor's brand, know-how and reputation. Furthermore, the franchising network creates economies of scale in procurement.

In exchange, a franchisee must strictly abide by the rules laid down by the franchisor in the multiple-page franchise agreement. They have to accept the franchisor's overall business concept, including quality requirements, service rules, store layout and decoration, promotional policy, recommended prices and more.

In other words, the entrepreneurial freedom of the franchisee may be greatly restricted.

Learning targets



EASY BUSINESS IN TELEGRAM STYLE

MARKETING – Part 2: Product policy / Pricing policy / Distribution policy

The following keywords and concise descriptions give an overview of the EBC*L Level B learning objectives. They do not, however, offer detailed explanations of the business terms and contexts (which are required for Level B exams). For those, please see the business texts and examples in this book. In addition, we advise you to identify practical examples from the real business world – for further progress.

- Explain the term "product policy" and possible product policy strategies.

Basic questions of product policy:

- How should a product be designed so that it appeals to the needs of the target group?
- What must be done so that product development is financially feasible and that the product is profitable in the long run?

Product policy strategies:

- Emphasize product innovation and constantly offer new products, or copy good ideas and successful products quickly?
- Offer high-quality products at a correspondingly high price or lower-quality but affordable products?
- Should product mix comprise many products or hold few products only?
- Should corollary services such as delivery, installation, etc. be offered in addition to the core product?

- Explain the term "product life cycle".

- See Chapter Analytical and Planning Instruments

- Explain the terms "product mix policy", "product mix width" and "product mix depth".

A product portfolio or product mix includes all products a company offers.

- Wide product mix: company offers a number of different products or product lines.
- Narrow but deep product mix: company offers few products or product lines but the products come in many different variations and designs.

- Explain the terms "product innovation", "product variation", "product diversification" and "product elimination".

- Product innovation: bringing a completely new product to the market
- Product variation or modification: creating sub-products which vary only slightly from primary products
- Product (mix) diversification: offering different kinds of products or product lines
- Product differentiation: lengthening a product line (= a group of products that are closely related to each other)
- Product elimination: dropping a product from the product portfolio

- Explain a product portfolio analysis.

- See Chapter Analytical and Planning Instruments

- Explain the basic determinants of an enterprise's pricing policy.

- Market: customers and competition
- Total production cost plus a mark-up (= lowest price level)

- Explain the term "price-demand curve".

The higher the price, the lower the demand for the product (= the quantity sold). The lower the price, the higher the demand. Thus an increase in price will lower demand and a price cut will result in an increase in the number of products sold.

- Explain the term "signalling effect of prices".

In general, customers associate superior quality and a better image with higher prices, and poorer quality and a bad image with lower prices.

- Explain the term "price elasticity of demand" and calculate it.

Elastic demand means that customers react to price change in such a way that the percentage change in quantity demanded is greater than that in price.

- Price elasticity of demand formula:

$$\text{Price elasticity of demand} = \frac{\text{Percentage change in quantity demanded}}{\text{Percentage change in price}} \times 100$$

- If the result is higher than 100, demand is elastic.
- If the result is lower than 100, demand is inelastic.

- Name and explain different strategies of pricing policy.
Explain the terms "skimming strategy" and "penetration strategy".
Explain the term "price differentiation".

Pricing decision alternatives:

- to charge a high price
- to offer the product at a discount price (= to charge a low price), or
- to steer a middle course and follow the guidelines set by the market leader.
- Pricing strategies (for innovative products)
- Penetration pricing: introducing a new product at a low price which would be gradually raised later on
- Price skimming: setting an high initial price which could be lowered gradually over time
- Price differentiation means that a firm charges different prices for the same product to different target groups markets.

- Explain the term "terms and conditions policy".

Enterprises try to influence customers by offering special conditions and incentives. Among them are discounts, special terms of payment (cash discounts, default interest) and terms of delivery.

- Explain the term "discount" and name and explain different types of discounts.

Discount is defined as a reduction in a list or invoice price. It is expressed as a percentage of the purchase price.

The term 'discount in kind' is used when the buyer receives a larger quantity, better quality or additional service.

Types of discounts: cash discount, early-booking discount, seasonal discount, quantity discount, loyalty discount, cash and carry discount.

- Explain the term "cash discount".

A cash discount is an incentive for customers to pay as early as possible. It is usually quoted in percent and can be deducted from the invoice price if payment is effected instantly or within a stated period of time.

- Explain the term "default interest".

Default interest is charged for delay in payment.

- Explain the terms of delivery "free of charge to address of buyer" and "ex works".

"Free of charge to address of buyer" means that the seller pays all the transportation and other charges to the buyer's premises.
"Ex works" means that the seller's only responsibility is to make the goods available at his premises. Costs and risks of transport are assumed by the buyer.

- Explain the term "distribution policy".

An enterprise's distribution policy focuses on the activities that are concerned with getting the goods from the firm to its customers.

- Explain the term "direct selling", methods of direct selling as well as its advantages and drawbacks.

When goods are sold directly, ownership is passed on only once: from the producer to the final consumer. There is direct contact between the producer and the final consumer and no intermediary.

Direct selling methods:

- company sales force
- company outlets
- mail order
- Internet selling
- telephone selling
- fairs and exhibitions

Advantages of direct selling: no commissions on sales, no trade discounts, better control
Disadvantages of direct selling: high fixed costs, fewer customers can be reached

- Explain the term "indirect selling", methods of indirect selling as well as its advantages and drawbacks.

When enterprises sell their goods indirectly, they use the services of at least one intermediary or middleman, to bring their products to the final buyer.

Methods / intermediaries:

- retailers
- wholesalers
- (commercial) agents
- franchising

Advantages: little effort to address large customer groups, greatly reduced fixed costs
Drawbacks: high commissions and trade discounts, no contact to final consumer

- Explain the term "franchising".

Franchising is a distribution agreement in which a business person, the so-called franchisor, grants the franchisee the rights to use his business concept and to produce and/or sell a product / products for his own account.

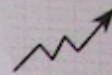
The franchisor can reduce his financial risk significantly, whereas the franchisee benefits from the franchisor's know-how and reputation. In exchange, the franchisee must strictly abide by the rules laid down by the franchisor in the franchise agreement.

4. 8. Communications Policy

Learning targets:

- Being able to explain the term "communications policy"
- Being able to explain the term "corporate image"
- Being able to explain the terms "brand", "logo" and "slogan" and their role in a company's communications policy
- Being able to explain the term "corporate design"

Learning targets



It is almost a nightmare: An entrepreneur has discovered a need, developed the perfect product to fill it, is willing to sell at an attractive price ...

... and nobody knows about it.

Every day this nightmare becomes reality for enterprises which have no idea about the art of communications policy or no money for sometimes expensive promotional activities in the last stage of market introduction.

These are the different instruments of the so-called communications or promotional mix:

- ➔ advertising
- ➔ sales promotion
- ➔ public relations (PR)
- ➔ personal selling (which will be dealt with in greater detail in the chapter on 'Sales')
- ➔ A special form of public relations is **investor relations**. In private and public limited companies it is the field of corporate communication that specializes in disclosing information to existing or potential shareholders.

➤ Communications policy



Elements of communications policy

The core elements of communications policy that any promotional activity should include (or at least pay attention to) are an enterprise's

- corporate image
- brand, logo and slogan
- corporate design, and
- corporate wording.

4. 8. 1. CORPORATE IMAGE

► *Corporate image*

From the moment an enterprise is established, it should be the goal of corporate policy to create, maintain and cultivate a certain image. In order to do so, clear ideas and an image strategy that is supported by everyone in the firm are required. There are a number of options of how an enterprise may want to be perceived by the general public. It may want to be associated with

- quality
- reliability
- affordability
- innovation
- environmental responsibility, or
- social responsibility.

Any promotional activity should be in line with the enterprise's image.

4. 8. 2. BRAND, LOGO, SLOGAN

As brands, logos and slogans help to identify a company and its products and to differentiate them from competitors, they are also core elements of a company's communications policy.

► *Brand, logo, slogan*

The more sophisticated a logo is and the more memorable the words of a slogan are, the more easily a product is recognized, which increases the value of the company's commercial brand as a whole.

What companies come to your mind when you see or think of

- ➔ *a red bull*
- ➔ *a star on a car*
- ➔ *a yellow elk, or*
- ➔ *stuck-out tongue*

Example



What comes to your mind when you hear or read one of the following expressions?

- ➔ *"... gives you wings"*
- ➔ *"Unlike any other."*
- ➔ *"Make yourself at home."*
- ➔ *"It's only rock 'n' roll, but I like it."*

Example



Each of the above logos and slogans is associated with a well-known company, its brands or its brand names, and each of them is worth millions of euros.

Even if your small enterprise never rises to fame, it is worth following the example of larger business organizations and equipping yourself with a memorable name, a beautiful logo and a catchy slogan. What you choose must be well-considered, because your firm may have to live with it for the rest of its corporate life. A poor logo and a bad or misleading slogan may hamper the future of your business.

the chapter on "Product policy" for brand and brand protection.

Note

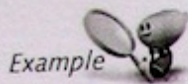



4. 8. 3. CORPORATE DESIGN


► Corporate design

The term **corporate design** refers to the official graphical design of the logo and name of a company or institution which is used on letterheads, envelopes, forms, folders, brochures, etc. In its wider meaning, corporate design also encompasses elements of product design and corporate architecture.

Which companies do you associate with the following letters?



→ this 

→ this 

→ this **B**

These unusual characters are all part of the corporate design concepts of particular enterprises. The design of such graphical elements is well planned, and often companies develop their own **corporate logotype**.

Regardless of whether they are red, blue, yellow or silver, **corporate colours** play an important role as well. As any colour or colour combination may be associated with certain emotions, designers select one or more corporate colours that go best with the company and its corporate policy. Caution is advised, though, because the wrong choice may have a negative impact on the company.

The effect of different **fonts or typefaces** may not be underestimated. There is a big difference whether you use

- Tahoma
- Papyrus or
- Times New Roman

Whereas one font is clear, modern and easily legible, others may appear antiquated or playful.

All corporate design elements are adjusted to each other for the purpose of enhancing the recognition effect and supporting corporate uniformity. At major company events, for instance, corporate uniformity is signalled and supported by a company's brand name, logo, slogan, typeface, colours, etc.

Elements that reflect a company's corporate design to the general public include

- ➔ stationery, envelopes and business cards
- ➔ brochures, image and presentation folders and display material
- ➔ advertisements in print media and on television
- ➔ advertising campaigns
- ➔ corporate web appearance
- ➔ power point presentations
- ➔ company uniforms, and
- ➔ architecture and interior design of company buildings.

4. 8. 4. CORPORATE WORDING

Some companies are on first-name terms with their customers. Others take a more traditional and conservative approach and make sure to include all their customers' titles when they address them in writing. This is only one example of corporate wording, which is broadly defined as the language or language style used by a company to communicate internally as well as with the external environment. (In this context, the term 'language' does not refer to the language spoken by the people of a certain place or country.)

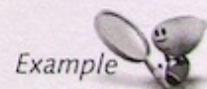
The use of euphemisms is another example of corporate wording. Some companies use complicated job titles which sound more impressive than the common name would imply.

In many banks, the formerly common term 'bank clerk' is no longer used. Instead, employees are referred to as financial services advisors or retail client consultants.

Gender mainstreaming, whose goal is to achieve gender equality, has also left its imprint on corporate wording. Today many enterprises are scrupulous about avoiding any form of discrimination and use a language that explicitly addresses male **and** female customers and employees.

At this point, we ask our female readers to understand that this book uses the universal 'he' exclusively for the sake of simplicity and easier comprehension.

➤ Corporate wording





Bossi's Pink Sauce: Corporate image, corporate design, brand, logo and slogan

Mrs Bossi is absolutely sure about what their firm's corporate Image should be. People should instantly think of the unique, delicious pizza sauce when they hear the brand name "Bossi's Pink Sauce". The name alone should make their mouths water. At the same time, they should associate the colour of pink with quality and sophistication.

The corporate design is determined by the color pink, the trademark-trade name combination comprising the product name "Bossi's Pink Sauce" in its unique print and the picture of Mr Bossi wearing his typical cooking hat. These three elements appear everywhere: on the firm's stationery, on its packaging and on the windows of the pizzeria. The font the company uses for all its written communication is 'Verdana'.

The last thing that is missing is a catchy slogan. The Bossis invite some friends for a creative brainstorming session at which various suggestions are made. Finally the following four slogans are left to choose from:

- ➔ Bossi's PinkSauce – Like a walk in the clouds.
- ➔ Bossi's PinkSauce – It's addictive.
- ➔ Bossi's PinkSauce – Topping your expectations.
- ➔ Bossi's PinkSauce – A revolution need not be red.

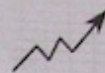
Which one would you choose?

4. 9. Advertising

Learning targets:

- ▶ *Being able to explain the term "advertising" and its tools*
- ▶ *Being able to name and explain the different steps of an advertising campaign*
- ▶ *Being able to name and explain advertising goals*
- ▶ *Being able to explain the terms "advertising budget" and "cost factors of advertising"*
- ▶ *Being able to explain the terms "advertising tool or vehicle" and "advertising media"*
- ▶ *Being able to explain the significance of advertising expense per customer*
- ▶ *Being able to explain the term "losses from non-selective advertising"*
- ▶ *Being able to explain the significance of measuring promotional success*
- ▶ *Being able to explain the terms "advertising effectiveness" and "reminder advertising"*
- ▶ *Being able to explain basics of advertising psychology*
- ▶ *Being able to name and explain strategies of advertising design*
- ▶ *Being able to name and explain points of advertising criticism*

Learning targets



"It's a company's demise if it does not advertise."

This popular quote has a lot of truth in it. If customers don't know that a product exists and which benefits it offers, the producer will inevitably be stuck with it. The purpose of advertising is to motivate customers to buy a new product, to buy more of a certain product or simply to remain loyal to a product.

It has become increasingly difficult, though, to reach customers with advertising messages. The reasons are obvious for anyone who opens a newspaper, strolls along streets that are lined with billboards, watches television or listens to the radio, or surfs the Internet: We are confronted with hundreds of advertising messages every day.



It takes a huge portion of imagination, creativity and a sizable budget if an enterprise wants to stand out from the crowd and be heard. In particular, it must have the necessary know-how to plan and run a successful advertising campaign.

4. 9. 1. HOW TO PLAN ADVERTISING

➤ Advertising planning

When a company plans an advertising campaign it has to

- ➔ make an actual analysis (See chapter on "Actual analysis")
- ➔ define its advertising goals
- ➔ set up an advertising budget, and
- ➔ select suitable advertising tools and an advertising medium.

To make sure the goals of an advertising campaign have been accomplished (within the set budget), steps must be taken to measure promotional success.

4. 9. 2. DEFINING ADVERTISING GOALS

➤ Advertising goals

As soon as the results of an enterprise's actual analysis are available (Examples: Product A is little-known and accounts for only 5% of sales; its major rivals run successful advertising campaigns), it has to define precise advertising goals.

A firm's ultimate goal is most likely to be an increase in sales and revenues. It wants to create demand for a new product, stimulate the demand for an existing product, encourage a target group to buy more or attract new target groups. Additional goals could be to enter a new target region and to produce certain results within a particular time period.

A quantifiable goal of an advertising campaign could be "to raise sales of product XY by 25% within the next six months."

Measuring the success of any advertising activity in such exact numbers, however, is extremely difficult if not impossible. As other promotional instruments support advertising, a positive result cannot be attributed to advertising alone.

Instead of setting clearly quantifiable goals, companies often define goals that focus on quality aspects such as popularity and image. A company could aim to

- ➔ increase the degree of popularity of its XY brand in a particular region by 25% or
- ➔ enhance its image with the Generation Y by 10%.

As soon as clear advertising goals have been set, experts create general **advertising messages** which they hope will be well received by the target group. Examples of such messages are:

- ➔ *XY jeans are a cult product*
- ➔ *In Vienna, the most affordable and customer-friendly discount food retailer for people of Turkish origin is ...*
- ➔ *You are 'out' unless you read magazine QRS.*

Bear in mind, though, that the above-mentioned advertising message must not be confused with the ultimate advertising slogan. The latter requires more creativity and is a concise, memorable phrase or sentence which the enterprise wishes to be remembered by and which presents the advertising message in a nutshell.

Example



4.9.3. DETERMINING THE ADVERTISING BUDGET

The size of the advertising budget is a highly important determinant of any advertising campaign. It makes little sense to set advertising goals if you don't know what your budget will be. The goal to raise a brand's popularity with all target groups throughout the country is unreasonable if your advertising budget is a paltry 10,000 euros.

➤ Advertising budget

Especially start-up companies are notorious for underestimating advertising expenses and believe that 2,000 to 3000 euros suffice to finance a major advertising campaign. They are not aware that

- ➔ a one-time, one-page colour advertisement in a national newspaper costs around 15,000 euros, or
- ➔ a national TV station charges 20,000 euros or more for a 20-second commercial.

► *Cost factors*

What is more, these amounts must be paid only for placing the advertisement. Before a firm can actually do that, it spends huge amounts of money on

- advertising agencies and creative experts who know how to realize good ideas
- graphic artists who have the necessary skills to design an advertisement, i.e. select suitable photographs and illustrations, choose the right colours and fonts, etc.
- copywriters who are capable of turning a dull product description into a catchy advertising slogan
- photographers who show products in a favourable light, and
- people who have the necessary media contacts to make sure the ad is placed favourably and does not languish on page 87.

When it comes to television and radio commercials, there are additional expenses for narrators, actors, film directors, film crew, technicians, cutters, lighting crew, etc.

In conclusion, nationwide radio, television and print media advertising is out of the question for small firms and start-ups.

Still, they should not be totally discouraged and may choose to focus their efforts on clearly defined target groups (such as pensioners within a radius of three kilometres or technical engineers in manufacturing businesses in Lower Austria). With the help of modern technology, they have much greater opportunities than twenty years ago, when designing and printing advertising brochures and letters was an expensive chore. Today's computers, software, colour copiers and printers are reasonably priced and facilitate the production of graphically attractive folders and mailings. Greater details will be provided in the following chapter on advertising tools and media.

4. 9. 4. SELECTION OF ADVERTISING TOOLS AND MEDIA

► *Advertising tools and media*

The term **advertising tool** or vehicle refers to the form in which the advertising message is communicated. Messages can be communicated by using advertising letters, classified advertisements, fliers, brochures, radio spots, infomercials, etc.

Advertising media are the institutions and communication channels through which the messages move from sender to recipient. Every major medium is used to deliver advertising messages, including television, radio, movies,

magazines, newspapers, video games, the Internet and billboards. Advertisements can also be seen on the sides of buses and taxis, on grocery carts, and on the walls and roofs of buildings. Even private individuals carry advertising messages when they use plastic bags and pens (= advertising tools) of companies and institutions in public

The Internet as advertising medium

As computers and online tools have become indispensable in modern society, the Internet is one of today's most important advertising media. Regardless of which industry enterprises operate in, those which do not have their own home page (= advertising tool) are considered old-fashioned and cannot utilize the unique benefits the Internet has brought to corporate marketing.

The Internet carries corporate promotional messages from the smallest and most remote places right into the homes of consumers in the E.U., the U.S.A., China and elsewhere. What firms need to create their home pages is some support from graphic designers and technical experts and some advice on how to market their sites.

The total cost may amount to as little as 2,000 to 3,000 euros, which means that on-line presence has become affordable even for the smallest firm. In the past, international groups needed million-dollar budgets to reach the world.

4.9.5. ADVERTISING EXPENSE

Which advertising tool and medium to choose will be different from case to case and depends on the general advertising goal, the target group (its size and how easily it can be reached), the target region and the cost of advertising or advertising expense. The so-called **advertising expense per (potential) customer** is probably the most important criterion for decision-makers and is calculated by dividing the cost of a particular advertising activity by the number of people reached by the advertising message.

► Advertising expense

$$\text{Advertising expense} = \frac{\text{Cost of advertising tool}}{\text{Number of people reached}} \times 1,000$$

Example



A weekly magazine has a circulation of 100,000 copies. On average, each copy is read by three people, which means that 300,000 people are reached. Assuming the price charged for the advertisement is 30,000 euros, it will cost 100 euros to reach 1,000 readers.

$$\text{Advertising expense} = \frac{30,000 \text{ euros}}{300,000 \text{ readers}} \times 1000 = 100 \text{ euros for 1,000 readers}$$

There is no guarantee, however, that the advertisement actually attracts the attention of everyone who reads the magazine.

In comparison, a much smaller special magazine has a circulation of 20,000 copies. Each copy is read by four people and the price of the advertisement is 2,000 euros.

What is the advertising expense per 1,000 people in this case? In which of the two magazines would you place your ad?

Your solution



Answer: The expense per 1,000 people is 25 euros, which is only a quarter of the cost compared to that of the weekly magazine.

The advertising expense per customer is likely to be lower when you place your advertisement in a special magazine which is highly selective in terms of its reach. It targets a narrowly defined group of customers only. Placing your ad in a newspaper or general weekly magazine, on the other hand, means that there will be higher **losses from non-selective advertising** because numerous target groups are addressed.

► Losses from non-selective advertising

Losses from non-selective advertising arise because you also spend money on contacting people who will never be your customers.

Losses from non-selective advertising are particularly high with mailings that are sent to households indiscriminately. A firm that sells dog food and has its ads mailed to all households should know that only those people who actually have a dog (roughly 10% of the population) will show interest. In other words, of all the money spent on production and distribution of the advertisements, 90% is wasted.

A company can minimize losses from non-selective advertising by using electronic databanks that help filter out target group members.

4. 9. 6. MEASURING PROMOTIONAL SUCCESS

In order to find out whether an advertising campaign has been successful, a company needs to analyse the answers to the following questions:

- ➔ Has the campaign really reached the desired number of people?
- ➔ Were these people actually aware of the advertising campaign or activity? (advertising impact)
- ➔ If so, do they still remember the advertisements after a month? (advertising retention)
- ➔ Has the company's image improved among the people who were aware of its advertising activities? (image enhancement)
- ➔ Has the advertising campaign raised sales figures

➤ Measuring promotional success

➤ Advertising impact

➤ Advertising retention

The answer to the last question is most crucial and can be found out by the enterprise itself. It requires the expertise of market research institutions, however, to give satisfactory and valid answers to the first four questions. They have developed special methods with which advertising impact, people's attention to ads, advertising retention and image enhancement can be measured.

When the founder of the Ford Motor Company and father of modern assembly lines was asked whether it was actually worth spending all those millions on advertising, he reportedly responded:

"Of all the ad money we spend, 50% is well applied, 50% is wasted. I don't know, however, which 50% we waste."

It has become increasingly difficult for companies to reach their advertising goals, simply because their target groups are bombarded with too many advertising messages every day. It is believed that we are exposed to as many as 3,000 advertising messages per day, which is quite a realistic assumption if we consider all the billboards we pass by in urban areas and all the radio and television commercials we encounter.

An increasing number of people are annoyed rather than positively attracted by advertisements and therefore do everything they can to defend themselves against the promotional deluge. They switch to another TV channel when a movie is interrupted by commercials or put 'No-ads' stickers on their apartment doors and letter boxes.

Competing against too many other advertisers is not the only problem enterprises are facing today. It is also the large number of high-quality ads that makes corporate life difficult. International conglomerates put millions into promotion, resulting in thousands of brilliantly executed ideas. Even if you

have a healthy budget, topping these ideas is not an easy task – for small firms with little money it may be impossible.

In order to stand out from the crowd, some enterprises resort to highly unusual, loud, provocative or even tasteless messages. It doesn't matter to them how they attract attention as long as they are remembered (advertising impact).

4. 9. 7. ADVERTISING PSYCHOLOGY

In order to increase the effectiveness of advertising, the advertising industry makes use of the findings of psychology. Advertising is successful if it effectively addresses the different cerebral hemispheres. The example which follows is an advertising success story.

What do you associate with a lilac-coloured cow?

When Austrians (and probably many consumers in other Central European countries) are asked this question, they spontaneously think of a popular chocolate brand name. In addition, they remember TV commercials which all follow the same pattern:

- ➔ The well-known lilac-coloured cow grazes on a lusciously green Alpine pasture.
- ➔ In the foreground of this Alpine scenery lies a handsome couple. The man passes a lilac-wrapped chocolate bar to his companion, who is clothed slightly seductively.
- ➔ To a simple but memorable tune, a pleasant voice ends the commercial by singing the words, " ... *the most tender temptation, ever since chocolate was invented.*"

If you too remember these advertising elements, this commercial has managed to do something exceptional. It has succeeded in distinguishing itself from hundreds of other commercials and dozens of other TV spots for chocolate. Perhaps it has even created positive feelings towards the cow and the couple. If this is the case, the chance of your buying this chocolate is quite high – certainly higher than that of a chocolate whose name you have never heard.

Why have the advertisers of this chocolate been successful? They selectively **target both sides of the human brain.**



➤ Basics of advertising psychology

Simply speaking, the human brain consists of two hemispheres or sides, each of which specializes in certain functions.

The **right side of the brain** is responsible for **emotions**. It assimilates and processes pictures, sounds, music and scents and links these sensory impressions with feelings ranging from intense love to hatred, from strong liking to antipathy, and from attraction to the need to escape.

The right hemisphere is also the faster one and processes impressions in split seconds. Moreover, it decides whether an impression will be processed further or put aside. It is something like the janitor of the brain.

Reasoning and logical functions are lateralized to the **left side of the brain**. It processes information further and is responsible for drawing conclusions, analysing texts and numbers and doing mathematical calculations.



From the viewpoint of promotional psychology, good advertising must therefore abide by the following principles:

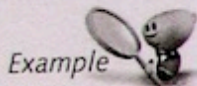
1. Conquer the right side of the brain with beautiful pictures, music and anything else that arouses positive emotions. To be noticed at all, however, the impression must be strong enough to stand out from hundreds of other advertising messages that have been received. In addition to pictures, colours and sounds play an important role.
2. Conquer the left side of the brain, where the emotions from the right hemisphere can become associated with practical information such as a brand name, a trademark or a slogan. If this second step fails, the advertising goal cannot be reached. The recipient of the message may enjoy the spectacular pictures of a car commercial but fail to identify or remember the type of car that has been promoted.
3. Repeat the messages frequently. The human brain has a wonderful skill: it can forget things and thus create room for new information. This represents a problem for advertisers. They have to repeat their messages again and again so that they are remembered and leave a lasting impression in the brain.

The above is of course a highly simplified description of brain functions, and in reality cerebral lateralization is far more complex. If you watch and analyse commercials more carefully in the future, however, you will notice that advertisers do take their clues from psychological findings. As their main strategy is to attract and conquer the right side of the brain, the vast majority of advertisements are no longer of highly informative value.

By the way, advertising psychology is not restricted to television commercials and print ads but should be applied with any form of promotional activity, including personal selling.

A sales person must know that first he is analysed by the right side of the customer's brain. The famous "first impression" he creates is determined by his physical appearance (including clothing), his voice, scent and friendliness. If you fail to impress the customer as soon as he lays eyes on you, you will find it difficult to appeal to the left side of his brain and convince him solely with rational and factual arguments about the product you want to sell.

The same is true of mailings. Text-only fliers that present information without stimulating any emotions will have little effect on the reader. Graphics, illustrations and a language that arouses emotion greatly improve the chances of ad mail being read and not ending up in the waste paper basket instantly.



Example

Example: How to woo and conquer your partner('s brain)

How did your spouse court and conquer you? Even in this case, success was probably due to advertising psychology.

- 1. Was it perhaps 'love at first sight'? Did his / her appearance, the pleasant scent, the attractive voice, the sex appeal convince you?*
→ *The right side of the brain is conquered.*
- 2. Why did you keep paying attention to him / her? You were listening to what he /she had to say and perhaps to offer: good job, secure income, good education, or shared interests and hobbies.*
→ *The left side of the brain analyses the information.*
→ *Advantages and drawbacks are weighed.*
- 3. Again and again he / she was trying to present convincing arguments which were supported by amazing creativity: flowers, books, movie invitations, jewellery, etc.*
→ *The advertising message is constantly repeated.*
- 4. Finally you gave in and married your partner.*
- 5. In many cases it may happen that his / her promotional efforts drop drastically towards zero after the wedding. Department store vouchers for the spouse's birthday are the only highlights and all of a sudden you are again receptive to external advertising signals which you ignored during all those years. Coincidentally you run into an attractive person with a pleasant voice and start a conversation ...*
→ *Waning attention and decreasing advertising activity create opportunities for the competition.*

4.9.8. FREQUENTLY APPLIED STRATEGIES IN THE ADVERTISING BUSINESS

Creative advertising designers must find a style, format or words for executing the advertising message.

- ➔ **Celebrity endorsement:** Movie or sports stars endorse a product. They would not use it if it were not of outstanding quality. People who identify with or admire the celebrity trust the product.
- ➔ **Expert testimonial:** (Actors who appear as) dentists and other professionals guarantee the quality of a product (a certain toothpaste etc).
- ➔ **Quality or technical certification:** A product that has been tested and received a quality certificate (based on certain norms) from a technical institution or a consumer organization is well received.
- ➔ **Pretended shortage:** Messages such as 'Short time only', 'Final sale week' and 'Buy now' attempt to talk customers into buying quickly.
- ➔ **Pleasant setting:** The product is presented by an attractive model, placed in a beautiful natural environment or shown in a luxury home.
- ➔ **Personality symbol:** It is always the same memorable character (animated or real) that presents the product and communicates the advertising message. The product is personified by a bald body builder, a fluffy, animated lion, or a friendly, green bear.
- ➔ **Product placement in movies:** The special agent's car is a ..., at the bar he always orders a certain type of drink, and he wears suits designed by...

➤ Strategies of advertising design

4.9.9. ADVERTISING CRITICISM

As consumers can easily be manipulated by advertising, advertising practices are often highly disputed and criticised. The points brought forward are that advertising

- ➔ creates a desire for things nobody actually needs
- ➔ uses unfair tricks in that it targets people's subconscious, over which they have no direct control
- ➔ seduces and manipulates people
- ➔ turns defenceless children into mindless consumers (by benefiting from children's desire for brands)

➤ Advertising criticism

- is a daily nuisance which one cannot escape (series of commercials that are shown during movie intermissions), and
- distracts people and takes away valuable time.

The last point particularly applies to undesired advertisements which we encounter in the form of

- mailings in our post box
- telephone calls from call centres, and
- spam messages (which promise instant money-making jobs and advertise erectile dysfunction pills).

The volume of spam mail has reached especially annoying dimensions. Billions of these unsolicited messages are sent out every month and create enormous costs as it takes valuable time to sort them.

Criticism is also justified because the level of aggressiveness in advertising has been rising. More and more often advertising messages appeal to people's low instincts, and negative characteristics such as greed, selfishness, envy and resentment are made more socially acceptable as they are linked with positive advertising messages.

In order to attract attention, advertisers also resort to shock effects. The best known examples are probably the billboard advertisements of an internationally popular textile group which stirred emotions because they showed prisoners in the death cell, newborns that were still covered with blood and similarly disputable scenes.

Supporters of advertising argue that commercials

- inform people about how to satisfy their needs and solve their problems
- help companies increase sales figures, reduce fixed costs per unit (fixed cost depression) and thus make products affordable for lower-income classes as well
- have become part of contemporary art and culture (Many film directors and movie stars are involved in the production of advertisements.)
- help finance social, cultural and sports events which otherwise could not take place, and
- stimulate economic development and thus secure jobs.

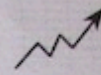
Ultimately, responsibility lies with the mature consumer and it is he who has to judge and respond to (in which way ever) the advertising activities which he is exposed to. In addition, though, this two-sided issue has to be dealt with in the media, in the course of our children's education at school and also within the family and among circles of friends.

4. 10. Specific Methods and Instruments of Communications Policy

Learning targets:

- Being able to explain the term "direct mail marketing"
- Being able to name and explain the basic rules for and the most frequent mistakes made in direct mail design
- Being able to explain the AIDA formula
- Being able to explain the term "telephone marketing"
- Being able to explain the term "call centre"
- Being able to explain the term "sales promotion"
- Being able to explain the term "event marketing"
- Being able to explain the term "public relations"
- Being able to explain the term "sponsoring"
- Being able to explain the term "online or internet advertising"
- Being able to explain the term "merchandising"

Learning targets



When enterprises court their customers, they are exceptionally resourceful and use various methods and instruments of communications policy:

- ➔ direct mailing
- ➔ telephone marketing
- ➔ sales promotion
- ➔ event marketing
- ➔ public relations (PR)
- ➔ sponsoring
- ➔ on-line or internet advertising

4. 10. 1. DIRECT MAILING

► *Direct mail marketing*

Direct mail, also known as junk mail or ad mail, is advertising material that is sent in bulk to both households and businesses. It is the most popular and significant sub-discipline of **direct marketing** with which customers can be reached quickly, at low cost and often personally (if it is addressed to pre-selected individuals). The number of copies of advertising material may number a few dozen or in the millions.

Direct mail may be sent through the postal service or electronically as e-mail. As e-mails cost hardly anything and reaching millions of recipients is ridiculously cheap, so-called spam mail (=unsolicited bulk e-mail) has grown out of control. It has discredited the practice of direct mailing in general and makes it difficult for reputable providers of information to get through to their potential customers.

Regardless of whether it is traditional mail or e-mail, its success depends on whether the recipients can be personally addressed. In order to reach a customer personally, one needs his name and his regular or e-mail address, which can be bought from address agencies that specialize in this business.

Direct mailing is one of the most important advertising instruments for small and medium-sized companies. In larger enterprises, direct mail is also used for internal communication.

4. 10. 2. DIRECT MAIL DESIGN: DO'S AND DON'TS

Every day, direct mail letters are sent out that are not worth the money that has been spent on them. "**Less is more**" is one of the most important rules that is frequently disregarded.

► *Direct mail design*

Professionally designed direct mail letters

- are concise
- are easily legible because of a pleasant font, a good structure and short sentences
- may use graphics or photos as eye catchers or
- may include a sample or a small present like miniature cosmetics, pens, etc.

As mentioned above, it is highly advantageous if the recipient can be addressed personally. "Dear Mr Jones" is simply more flattering than "Dear Sir or Madam".

If a more affluent target group is addressed, it is important to select the right type and colour of paper, folder or envelope so as to create a good first impression and signal style.

4. 10. 3. THE AIDA FORMULA

When you structure a direct mailing letter, you may resort to the popular AIDA formula which says that in order to be effective, a message should

➤ AIDA formula

- ➔ get **a**ttention
- ➔ hold **i**nterest
- ➔ arouse **d**esire and
- ➔ induce **a**ction.

1. Get attention

It is safe to assume that it takes the recipient of a mailing letter only a few seconds to decide whether to read the message or throw it out instantly. Attracting the recipient's immediate attention is therefore crucial.

It is the reference line and the opening sentence that carry all the weight. They determine whether the recipient perceives the letter as interesting and exciting enough to read on. It takes certain skills and some creativity, however, to ignite instant attention.

At this point it may be worth remembering how the human brain works and that a message must first win the right cerebral side (responsible for emotions). This can be done by addressing the customers' needs and emotions in a very vivid manner.

Product	Attention
New form of loan financing	Did you sleep well last night? If you did not, can it be that you are worried about your upcoming instalment payment?
Children's theatre	Is there anything better in the world than watching your child laughing and squeeling with delight? The play XYZ guarantees two hours of entertainment and children's laughter.
Private dental clinic	How long did you have to wait at the dentist's last time? Couldn't you have done something useful during that hour?

2. Hold interest

Once the first hurdle has been overcome, interest needs to be created and held. This is best done in a few short sentences which inform the reader about the outstanding features and, more importantly, the benefits of the product.

Product	Interest
New form of loan financing	Our new FFT financing tool is so flexible that you can personally decide what your monthly instalment payment will be.
Children's theatre	Our performance has been attended by more than 3,000 children who had the time of their lives – and took home a moral message as well: Happiness is something to share.
Private dental clinic	There is no waiting time at our clinic. Our new reservation service guarantees prompt and excellent service. In case you do need to wait, we will recompense you one euro for every minute of idleness.

3. Arouse desire

Nun muss der Wunsch geweckt werden, das Produkt auch zu haben bzw. zu erwerben.

Product	Desire
New form of loan financing	If you want to sleep well in the future, you should inquire about our new loan financing tool as fast as possible.
Children's theatre	We are sure that your child will remember this entertaining show for weeks and reward you with a big hug.
Private dental clinic	If you want to spend your time with family and friends rather than in a dentist's waiting room, come to us.

4. Induce action

Finally an instant reaction (to the message) must be prompted. If this does not happen, there is the risk that the reader who did actually show interest will have forgotten all about the offer after a day. In order to prompt spontaneous action, the message may invite the recipient to

Example



- *make a telephone call immediately*
- *fill in the enclosed order or registration form*
- *visit the enterprise's home page and register as a guest, or*
- *ask that a free sample be sent to him.*

Product	Action
New form of loan financing	Until 30 June you can talk to one of our customer advisors free of charge. Please call # 007 for an appointment.
Children's theatre	Until 30 June two children can attend the performance at the price of one. Tickets are limited.
Private dental clinic	We offer free dental checks until 30 June. Visit or homepage www.toughteeth.com to schedule your own appointment.

4. 10. 4. TELEPHONE MARKETING

► Telephone marketing

Those who use direct mail should have no illusions: Even the most professionally-designed mail will prompt the desired, instant response of only a very small group of people. All the daily duties and appointments make even interested people forget direct mail letters quickly.

The success rate may be raised, however, if the letter is followed by an immediate telephone call in the course of which the recipient is asked cunningly whether

- he has received the mail
- he has read it
- the product is of interest for him, and
- he would like to have a free sample.

The goal of **telemarketing**, which is the second most common form of direct

marketing, is not necessarily an instant order but rather an appointment with a potential customer, during which a product or service will be presented.

4. 10. 5. CALL CENTRE

Telemarketing activities are frequently outsourced to firms – referred to as **call centres** – which specialize in this kind of selling practice. The call centre staff may know less about the products but have the talent and skills and have been trained in applying methods that are necessary to make people talk and listen on the telephone.

➤ *Call centre*

4. 10. 6. SALES PROMOTION

Sales promotion consists of a wide variety of promotional tools that supplement a firm's advertising activities in order to stimulate stronger market response. The most popular examples are free samples of snacks, coffees or fruit juices, cosmetics, etc which are offered to customers at special stands set up in supermarkets.

➤ *Sales promotion*

Other tools of sales promotion that target customers include offering products for testing purposes (for a short time at greatly reduced prices) and ad-ons to newspapers, such as lotions, perfumes, food in small packages and DVDs that show excerpts of videos or movies.

Sales promotion may also come in the form of direct or indirect sales force promotion, which comprises sales force training, salesmen contests and presentations or demonstrations to marketing intermediaries.

4. 10. 7. EVENT MARKETING

In the past, firms organised corporate anniversaries, had Christmas parties or held product presentations. They still do all that, but today all these activities are part of event marketing. The goal of this instrument is to impress

➤ *Event marketing*

- ➔ customers
- ➔ employees
- ➔ the media, or
- ➔ public figures and celebrities

by means of a spectacular event and to win their loyalty or support. Frequently these events are also meant as a "thank you" to particularly loyal customers or employees.

As concerns event marketing, there are hardly any limits to corporate imagination. When enterprises launch new products, they may invest hundreds of thousands of euros in a single event. They have their guests flown in by helicopter, select an imperial castle as location, set up a fifty-metre buffet with delicacies from all over the world, hire a television star as event moderator and invite international pop stars for entertainment.

Even if a corporate event is of a smaller dimension, it still requires some skills and know-how to organise it. It takes some experience to find a suitable location that provides a first-class buffet and has sound equipment that guarantees acoustically flawless speeches and music.

Small wonder that recently an increasing number of enterprises have been founded that specialize in organizing and running such corporate events (= event marketing agencies) and that more and more business schools offer courses in "event management".

4. 10. 8. PUBLIC RELATIONS

► *Public relations*

Advertisements in newspapers and magazines as well as radio and television commercials are expensive and have low credibility, because it is apparent that a firm wouldn't say anything negative about itself.

Credibility is much higher if it is not the firm that draws attention to itself but a journalist who does so by writing an article about the enterprise in a popular newspaper. The art of securing editorial space (in contrast to paid space = advertising) in all media which is read, viewed or listened to by a company's customers is known as public relations, or PR.

As journalists will only write about an enterprise if they are sure it is of sufficient interest for their readers, the story or event to be reported on must be new, important, unique or exciting.

Spending time and money on a PR campaign will therefore make sense only if companies can actually offer interesting news.

There are several methods a company may use in order to make it into the media:

- ➔ **Press or news release:** This is new, written or recorded information

about an enterprise sent to members of the news media. As the latter are often under time pressure, they appreciate such information – particularly if they can use it verbatim or need to make only minor changes, for which one or two telephone calls or interviews will suffice. Ideally, a press release is professionally designed and well adapted (like an e-mail press folder supplemented with high-quality photos).

- ➔ **Press conference:** Media reporters are invited to attend an informative meeting that is called especially for them. They are offered the opportunity to be the first to be informed about a certain subject matter. After the information has been released, they may ask questions and conduct interviews with individual company members. Still, many journalists lack the time to attend such events, and even incentives such as unique buffets and unusual locations fail to attract attention.
- ➔ **PR agency:** Professionals working for PR agencies know how to attract the attention of journalists. What is even more important, they often know them personally and have friends among them. Thus a firm has a better chance of finding its way into the media if it uses the services of a PR agency.
- ➔ **Bought news space:** If you go through a newspaper carefully, you may be surprised to come across a very positive article about an enterprise on one of its first pages. It may even be a full-page interview with its C.E.O. Later, on page 25 or so, you will find a one-page advertisement of the same company. This practice of offering news space to firms which place ads in the paper may be against the journalistic code of honour, but there are not many newspapers which can afford to do without the money such advertisements generate. By the way, these positive corporate news reports usually come with the thinly printed word "promotion" on one of the margins.

4. 10. 9. SPONSORING

You find them on soccer uniforms, on façades of opera houses, museums and church steeples, on the collars of show hosts and news commentators and on the home pages of charity organisations – there hardly any public space that is not laced with a company logo. Companies and organisations which support a sports club, a project or an event financially or in kind are known as sponsors.

In most cases they do it for business and not for charity reasons, and frequently it is a more attractive method of presenting themselves to the general public than placing an advertisement in a newspaper or running a commercial on television.

➤ Sponsoring

First, there is a higher recognition effect. If you watch a sports event on television, you may be exposed to the same company logo again and again, and sometimes it occupies even your entire screen.

Secondly, sponsoring almost always contributes to a positive image. After all, it supports a team, helps renovate a church or build an orphanage, or makes a theatre performance possible.

So-called sponsoring packages inform the potential sponsor about the promotional or advertising value his sponsor money would buy.

Example



For 15,000 euros you could become the main sponsor of the national school contest. In exchange,

- ➔ *your banner will appear on the contest home page*
 - ➔ *number of visitors expected per day: 1,000*
 - ➔ *advertising value: 5,000 euros*
- ➔ *you can place your logo on the contest folder*
 - ➔ *number of copies: 5,000*
 - ➔ *advertising value: 10,000 euros*
- ➔ *you will be able to give a speech at the contest and hand out the certificates and trophies in the presence of the media*
 - ➔ *advertising value: 20,000, and*
- ➔ *your name will be mentioned in all press releases*
 - ➔ *advertising value: 10,000.*

In total, the advertising value of this sponsoring package is 45,000 euros.

4. 10. 10. INTERNET OR ON-LINE ADVERTISING

➤ Internet advertising

Example



Within a few years, the Internet has revolutionized the advertising industry. There is hardly any consumer who has not yet informed himself through the Internet before a purchase.

- ➔ *Before a journey, prospective travellers retrieve information about the country they will visit, its sights and customs as well as the itinerary. The only reason why a travel agency may be contacted is to book the trip.*
- ➔ *People who have health problems may search the Internet to inform themselves about their possible illness and its treatment even before they consult their doctor.*

As professionally managed websites often also allow the users to compare the products and prices of the various suppliers at one glance, the Internet is probably the source of information with the highest level of sophistication.

For enterprises this may mean that sometimes their customers are even better informed than their sales force. As many potential buyers know about the basics of a product or service, they become more demanding and request more detailed answers to their special questions.

What is more, the Internet no longer serves as an information platform only. Customers more and more often use it as a direct sales outlet and buy books, flights, cars and many more products in **web shops**. This development is not likely to stop and will pose a challenge to trade.

In conclusion, there are plenty of reasons why companies need to be represented on the Internet today – regardless of their size and the industry they operate in.

If an enterprise has its own website it can offer visitors a quick initial overview of its product range and allow subsequent browsing through details. In addition, the website lets customers know how to contact the firm's management or sales people either personally or via e-mail. As mentioned above, orders can be placed with the web shops directly, and payment can be effected provided the firm has installed the necessary safety mechanisms. In order for a website to be installed, an enterprise needs to be given a domain (such as www.ebcl.eu), which are sometimes colloquially (and incorrectly) referred to by marketers as "web addresses".

Having your own website is only the first step, however. It takes some skills to make sure that this homepage does not go under in the endless depths of the Internet but is discovered and visited. Remember that there are tens of thousands of competing homepages out there in virtual space to which **search engines** link visitors when they enter an appropriate keyword.

If your company is not listed in the first few pages, chances of being discovered by customers are small. Still, specialists know what needs to be done for your website to come out ahead.

Another option is to advertise via search engine operators who refer to your company, its products or a special offer whenever the appropriate search item is entered.

Furthermore, a firm may opt for placing a banner advertisement on a frequently visited homepage (like that of a newspaper). **Banner ads** simultaneously appear with the web page into which they are embedded. The price of

such a banner ad depends on how often the homepage is visited or on the so-called click rate, which is the number of clicks on an ad on a web page as a percentage of the number of times that the ad was downloaded with the page. Another determinant is the length of the visit to the web page.

An all-comprising advertising strategy would seek to **combine traditional advertising with advertising via the new media** (Internet advertising). A company could, for instance, place a short ad in a newspaper, inviting the readers to visit its more informative homepage.

4. 10. 11. MERCHANDISING

► Merchandising

Merchandising refers to the practice of distributing (or selling) products which carry the logo of an enterprise, institution, sports club or event directly to the target groups or to people who are likely to come into contact with the target groups.

These products include balloons, pens, caps and T-shirts and are offered at fairs or other major events.



Bossi's Pink Sauce: The advertising strategy

After the market research results have been analysed, Mrs Bossi is convinced that the success of the Pink Sauces fully depends on their advertising activities. To start with, a new demand for still-unfamiliar pink pizzas must be created. Secondly, given the negative reactions prompted by the colour pink, efforts must be made to raise the acceptance level of this colour in general and not just among those people the Bossis know and can therefore influence personally.

Thus the advertising goals for the first phase are defined as follows:

- ➔ *Increase the pink sauce's degree of popularity with the target group 'early adopters between 20 and 40 years old'. At least 30% of this target group should become fully aware of the existence of Bossi's Pink Pizzas.*
- ➔ *By means of word of mouth, this important target group should make Pink Pizzas popular with other target groups as well. It is the Bossi's intention that within the next two years, 20 % of the district's population aged between 15 and 60 should know their Pink Pizzas.*
- ➔ *The intended image for Pink Pizzas is that they are an exceptional culinary delight. The advertising message must be: you are not 'in'*

unless you have tasted the Pink Pizza.

Mr Bossi agrees to the advertising goals, but there is no unanimous decision on what the budget for the advertising campaign is supposed to be. As concerns advertising expense, Mr Bossi, who has never spent more than 1,500 euros on advertising, is thinking in traditional terms. Mrs Bossi, however, has ten times this amount in mind. Although a lengthy discussion does not lead to any results and although she does not receive her husband's permission, she intends to spend 15,000 euros on advertising.

As much as 4,000 euros have to be set aside for their corporate design concept, including logo, graphics, creating their folders and bottle labels, and designing an advertisement. In fact, even this amount would not be enough if it weren't for a friend of Mrs Bossi's who is a graphic designer.

An additional 2,000 euros will flow into their new homepage, which is simple but attractively designed. Internet advertising plays a vital role for Mrs Bossi, because it allows her to place short, effective, and thus affordable ads which refer to their homepage.

For the moment, their print ads will be placed in the local newspaper only. They will be on the front page, however, and will appear on three consecutive days. The cost is a hefty 1,000 euros, but when Mrs Bossi attempts to bargain, the newspaper's ad salesperson explains to her that assuming a readership of 20,000, the advertising expense per (potential) customer is only 16 euros. He cannot go lower than that. What he can offer her, though, is to write an additional short article on Bossi's Pink Pizzas.

Mrs Bossi likes this suggestion and knows that she will come back to it later. "In order to be 'in' we simply have to be present in the media," she is thinking to herself, and she intends to invite the entire editorial team to taste their new dish – precisely one day before they officially launch their Pink Pizza.

The ad with its logo showing Mr Bossi as its central feature and the signaling colour pink will most certainly attract broad attention. "A colourful picture is worth a thousand words," Mrs Bossi is sure. The logo will therefore be complemented by nothing else but the advertising slogan and the Internet address: "Bossi's Pink Pizza – It's addictive." www.PinkPizza.com.

In addition, the target group will be addressed directly through advertising letters even though it has turned out that the cost of the needed addresses is more than previously assumed. The purchase of 8,000 sets of data costs as much as 500 euros. Still, they are pre-selected, which means that there will be no losses from non-selective advertising – according to the sales

person of the databank firm.

This is also important for Mrs Bossi because it helps her reduce printing costs. Very soon she finds out, though, that it makes little difference whether she has 7,000 or 10,000 folders printed. The first 1,000 copies are quite expensive but after that the unit cost decreases significantly.

Mrs Bossi believes that the mailing letter should also include some funny and cheeky element and she has a great idea. She intends to seek the mayor's permission to have him photographed while devouring one of their Pink Pizzas- with his mouth being pink all over. This picture would go perfectly with their advertising slogan "Bossi's Pink Pizza – It's addictive."

As local elections are scheduled to be held soon, the mayor actually gives his consent. After all, he can count on his photograph being distributed to 8,000 potential voters.

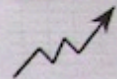
For the launch of the Pink Pizza Mrs Bossi is planning to stage a major event for which she wants to invite the neighbourhood's 100 most important people. A popular local comedian, who will run a special show on 'Pink, Pizza and Addiction', is intended to be an additional crowd puller.

Finally, after an entire month Mrs Bossi has put together the advertising concept. Now a last, known hurdle needs to be overcome: will Mr Bossi agree?

EASY BUSINESS IN TELEGRAM STYLE

MARKETING – Part 3: Communications policy / Advertising / Specific methods and instruments of communications policy

Learning targets



The following keywords and concise descriptions give an overview of the EBC*L Level B learning objectives. They do not, however, offer detailed explanations of the business terms and contexts (which are required for Level B exams). For those, please see the business texts and examples in this book. In addition, we advise you to identify practical examples from the real business world – for further progress.

➤ Explain the term "communications policy".

An enterprise's communications policy comprises all measures that are applied to inform relevant internal and external target groups (employees and customers) about the company itself and its products.

Instruments of the so-called communications or promotional mix:

- advertising
- sales promotion
- public relations (PR)
- personal selling (See Chapter Sales)

➤ Explain the term "corporate image".

'Corporate image' refers to a firm's reputation it enjoys both with the general public and within the company. In order to create and cultivate a certain image, clear ideas and an image strategy that is supported by everyone in the firm are required.

An enterprise may want to be associated with quality reliability innovation, etc.

➤ Explain the terms "brand", "logo" and "slogan" and their role in a company's communications policy.

Any known company has its brand(name), a memorable logo and a catchy slogan by which it is easily identified. These three elements are at the heart a company's communications policy. Brands, logos and slogans are also created for individual products so as to differentiate them from those of the firm's competitors.

➤ Explain the term "corporate design".

The term 'corporate design' refers to the official graphical design of the logo and name of a company which is used on letterheads, envelopes, forms, etc. In its wider meaning, corporate design also encompasses elements of product design and corporate architecture.

Elements of corporate design (that support corporate uniformity):

- stationery, envelopes and business cards
- brochures, image and presentation folders and display material
- advertisements in print media and on television
- advertising campaigns
- PowerPoint presentations
- company uniforms, and
- architecture and interior design of company buildings

➤ Explain the term "advertising" and its tools

The purpose of advertising is to motivate customers to buy a new product, to buy more of a certain product or simply to remain loyal to a product. Advertising instruments include radio and TV commercials, billboards, Internet advertising, etc.

➤ Name and explain the different steps in planning an advertising campaign.

- When a company plans an advertising campaign it has to
- make an actual analysis (popularity of a product, market data)
- define its advertising goals
- set up an advertising budget, and
- select suitable advertising tools and an advertising medium.

➤ Name and explain advertising goals.

- Ultimate goal: increase in sales and revenues. This can be achieved by creating demand for a new product, stimulating the demand for an existing product, encouraging a target group to buy more or attracting new target groups.
- Additional goals: entering a new target region or producing certain results within a particular time period.

➤ Explain the terms "advertising budget" and "cost factors of advertising".

The term "advertising budget" denotes total anticipated / planned advertising expenses per time period, which can be a year, a quarter, etc. or total advertising expenses for an advertising campaign.

Cost items:

- payments to advertising agencies, graphic artists, copywriters, photographers, etc.
- payment for placing the advertisement in a newspaper or magazine, etc.

➤ Explain the terms "advertising tool or vehicle" and "advertising medium".

The term advertising tool or vehicle refers to the form in which the advertising message is communicated (classified advertisements, fliers, brochures, radio spots, infomercials, etc.)

Advertising media are the institutions and communication channels which carry the messages, including television, radio, magazines, newspapers, the Internet, the sides of buses and taxis or the walls and roofs of buildings.

➤ Explain the significance of advertising expense per customer.

The so-called advertising expense per (potential) customer is calculated by dividing the cost of a particular advertising activity by the number of people reached by the advertising message.

➤ Explain the term "losses from non-selective advertising".

Losses from non-selective advertising arise because spending money on contacting people who are not target group members is inevitable.

➤ Explain the significance of measuring promotional success.

Explain the terms "advertising effectiveness" and "reminder advertising".

To find out whether an advertising campaign has been successful, the answers to the following questions need to be analysed:

- Has the campaign really reached the desired number of people?
- Were these people aware of the campaign? (advertising impact or effectiveness)
- If so, do they still remember the advertisements after a month? (advertising retention)
- Has the company's image improved among the people who were aware of its campaign? (image enhancement)
- Has the advertising campaign raised sales figures?

It takes specialists of market research institutions to measure advertising impact, advertising retention and image enhancement.

► Explain the basic elements of advertising psychology.

Advertising is successful if it properly addresses the different cerebral hemispheres.

1. Conquer the right side of the brain with beautiful pictures, music and anything else that arouses positive emotions.
2. Conquer the left side of the brain, where the emotions from the right hemisphere can become associated with practical information.
3. Repeat the messages frequently.

► Name and explain strategies of advertising design.

Celebrity endorsement: Movie or sports stars endorse a product.

- Expert testimonial: (Actors who appear as) professionals guarantee the quality of a product.
- Quality or technical certification: A product that has been tested and received a quality certificate.
- Pretended shortage: Messages such as 'Short time only' attempt to talk customers into buying quickly.
- Pleasant setting: The product is presented by an attractive model or shown in a luxury home.
- Personality symbol: It is always the same memorable character (animated or real) that presents the product and communicates the advertising message.

► Explain points of advertising criticism.

- The points brought forward are that advertising
- creates a desire for things nobody actually needs
- uses unfair tricks in that it targets people's subconscious
- seduces and manipulates people
- turns defenceless children into mindless consumers
- is a daily nuisance which one cannot escape
- distracts people and takes away valuable time.

Furthermore, the level of aggressiveness in advertising has been rising. Often advertising messages appeal to people's low instincts, and negative characteristics such as greed, selfishness, etc. are made more socially acceptable as they are linked with positive advertising messages.

► Explain the term "direct mail marketing".

Direct mail, also known as junk mail is unsolicited advertising material that is sent in bulk to both households and businesses through the postal service or electronically as e-mail.

► Name and explain the basic rules for and the most frequent mistakes made in direct mail design.

Professionally designed direct mail letters

- are concise
- are easily legible because of a pleasant font, a good structure and short sentences
- may use graphics or photos as eye catchers
- may include a sample or a small present

Mistakes: long messages, poor design, etc

► Explain the AIDA formula.

The popular AIDA formula says that in order to be effective, a message should

- get attention
- hold interest
- arouse desire and
- induce action.

➤ Explain the term "telephone marketing".

It is advisable to let the ad mail be followed by a telephone call. The recipient is asked cunningly whether

- he has received the mail
- he has read it
- the product is of interest for him, and
- he would like to have a free sample.

The goal of telemarketing is not necessarily an instant order but an appointment with a customer, during which a product will be presented.

➤ Explain the term "call centre".

Telemarketing activities are often outsourced to firms (= call centres) which specialize in this kind of selling practice. Call centers may also take telephone calls from customers to offer them some help or to respond to complaints.

➤ Explain the term "sales promotion".

Sales promotion consists of a wide variety of promotional tools that are intended to stimulate stronger market response. Examples include free samples, ad-ons to newspapers, etc. Sales promotion may also come in the form of sales force promotion, which comprises sales force training, salesmen contests etc.

➤ Explain the term "event marketing".

Corporate parties or product presentations organized as spectacular events to impress

- customers
- employees
- the media, or
- public figures and celebrities.

➤ Explain the term "public relations".

The art of securing editorial space (in contrast to paid space = advertising) in all media which is read, viewed or listened to by a company's customers is known as public relations, or PR. PR instruments: press or news release, press conference, services offered by PR agency, bought news space.

➤ Explain the term "sponsoring".

Companies and organisations which support a sports club, a project or an event financially or in kind are known as sponsors.

Sponsoring creates a higher recognition effect and almost always contributes to a positive image.

➤ Explain the term "Internet or on-line advertising".

Within a few years, the Internet has revolutionized the advertising industry and a large number of enterprises have professionally managed websites.

Customers inform themselves through the Internet before purchases and compare the products and prices of the various suppliers.

SALES



Overall Learning Objectives:

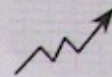
- ▶ Being able to explain the most significant basic rules for success in selling projects, products and services.

5. 1. Basics of Sales Success

Learning targets:

- Being able to explain sales activity as an everyday business process that concerns every individual
- Being able to explain the term "sales ethics"
- Being able to explain the term "win-win situation"
- Being able to name and explain requirements and competencies that are needed for selling
- Being able to name and explain the different phases of the sales communication process
- Being able to name and explain important steps in preparing the sales communication process
- Being able to explain significant aspects pertaining to opening the sales communication
- Being able to explain the difference between communication on a personal level and on a business level
- Being able to name and explain significant aspects of a customer needs survey
- Being able to explain the difference between "need" and "demand"
- Being able to name and explain significant aspects pertaining to questioning or interview techniques
- Being able to explain the terms "open" and "closed questions"
- Being able to explain the term "leading question"
- Being able to explain the term "active listening"
- Being able to explain significant aspects of sales argumentation
- Being able to explain the difference between product features or characteristics and product benefits
- Being able to explain the term "visualization"
- Being able to explain the difference between objection and pretext and describe how to react properly to each one
- Being able to explain significant aspects of price argumentation
- Being able to name and explain significant aspects pertaining to closing the sale
- Being able to name and explain buying signals

Learning targets



- *Being able to explain specific criteria pertaining to sales to corporate customers*
- *Being able to explain the term "key account management"*

5. 1. 1. SALES ACTIVITY AS AN EVERYDAY BUSINESS PROCESS

"Selling something? I? Never in my life. I am not a roper who talks people into buying things they don't need."

Quite a number of people think in these terms and associate the word "selling" with pushy insurance agents and unscrupulous car salesmen. Because of a few black sheep, the image of these two business sectors has been tarnished, even though the wide majority of sales team members are actually honest and respectable.

It is generally overlooked that selling is not exclusively practiced by those whose business cards identify them as salespeople but rather by everyone every day. The only difference is that some of us are more and others are less successful.

- *Sales activity as an everyday business process*

The general attitude towards sales activity may change, however, if 'selling' is given a different name or looked upon from a different viewpoint. It could be regarded as

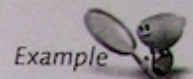
- ➔ a process of persuasion, whose goal is to convince people of a product, an idea or a person, lead to acceptance or agreement and ultimately trigger a purchase or
- ➔ a solution to a problem
 - that is either known to the other party (for example, Mr Salt needs a new car because his old one does not run any more) or
 - which the other party is not necessarily aware of (for example, Mr Bossi's house is insured insufficiently; if it burns down he will be reimbursed for only half of its current value).

In contrast to advisory or consulting activities, selling ultimately aims at the customer's purchasing a product or service, placing an order or giving his consent to a project and paying for it. If this cannot be achieved, time and therefore money have been wasted.

Selling is practiced by anyone who establishes contact with the customer in any form. The hotel receptionist, the waiter in the restaurant and the secretary on the telephone – all of them consciously or subconsciously apply sales techniques to induce a first-time purchase by the customer or to convince the customer to come and buy again.

Within enterprises too, 'selling' is practiced every day. Consider the following examples:

- ➔ *The head of the firm would like all employees to take vacation at the same time (vacation close-down).*
- ➔ *The marketing department must first 'sell' a new product to its own sales team members so that the latter are sufficiently motivated to represent the product.*
- ➔ *As her back is causing problems, an assistant wants her boss to agree to the purchase of a new ergonomic chair.*
- ➔ *The head of the IT department wants to make sure nobody violates the security regulations.*
- ➔ *The project manager wants the project team members to complete their future tasks in time.*
- ➔ *The new department head wants to be accepted by all employees*



Also the designers of a business plan must sell their idea to superiors and creditors (banks and funding authorities) in order to receive permission to carry out a project.

This is precisely what Mrs Bossi will have to do now. She wants to convince her husband that the production of their Pink Sauces has great potential, and in doing so she will apply all the basic rules pertaining to successful selling.

Bossi Pizzeria: Mrs Bossi 'sells' her husband the idea of producing Pink Sauces

Mrs Bossi knows that her husband has finally caught on to their new product and is dead keen to use the Pink Sauce – but only in their own pizzeria for their own pizzas and pastas. The thought of producing the Pink Sauce in large volume and selling it to private customers and even to other pizzerias is as remote to him as it could possibly be. For that reason, Mrs Bossi is aware of how difficult it will be to make her husband and business partner buy this business idea.



It is true that she is can twist him around her little finger if she wants to have something from him. In this case however, she wants her husband to be thoroughly convinced of the benefits of expanding the Pink Sauce strategy even further. Only if he fully supports this project will they be successful and able to solve this or that problem together. (Sales ethics, building credibility)

She asks her husband whether they could have a lengthy talk about the project. Her intention is to make Mr Bossi study in detail the business plan, which has grown to quite some size in the meantime. Afterwards she hopes they will go together to their bank to ask for a loan.

Before this talk, however, she would like to prepare herself thoroughly and therefore asks herself the following questions about her husband and business partner:

- ➔ *What wishes and problems does my husband have as a private individual? What does he still want to accomplish privately?*
- ➔ *What wishes and problems does my husband have as a businessman? What does he still want to accomplish professionally?*

She comes to the following conclusion: Mr Bossi is 45 years old and has been an independent businessman for 15 years. Their two children are very important to him, and he very much regrets that he has not been able to spend enough time with them because of all his business stress. They should have the best education possible, which means another ten years of high expenses. He has all but abandoned his dream that their children will take over the pizzeria at some point. They have experienced too closely what effort it takes to run a restaurant well.

What he loves most about being a businessman is his independence. Although he could probably earn much more as a branch manager of a restaurant chain, he would never want to be an employee and report to a boss. During his early business years he was bursting with creativity and energy, but this enthusiasm has clearly waned over the past few years. The dream of becoming rich quickly has been replaced by the desire for security, and his business attitude has changed accordingly. He is more cautious now, and debt redemption and financial liquidity are given top priority. (Preparation for conversation, analysis of needs and motives)

These are the results of Mrs Bossi's analysis. As she is not hundred percent certain, though, what her husband still wants to accomplish in life, she decides to ask him. Since this cannot be done just in passing, Mrs Bossi is waiting for the appropriate moment. The opportunity fortunately presents itself soon when both of them have time for a glass of wine after an unusually quiet business day. (Opening the conversation, conversation environment)

One single question is enough to trigger off a torrent of words from Mr Bossi:

- ➔ "Tell me, what do you still want to accomplish in life?"

All Mrs Bossi needs to do now is to listen and keep the positive conversation going by asking follow-up questions. (Questioning or interview techniques, active listening, needs survey)

It turns out that many of Mrs Bossi's assumptions were right. What particularly worries Mr Bossi is the competition, whose financial means are seemingly inexhaustible. In addition, his regular customers show up less and less often, and he is especially annoyed at some guests whose attitude has become impossible. Whereas they have become real penny pinchers when they have a pizza at his place, he knows that they don't hesitate to spend hundreds of euros when they dine at a star-rated restaurant. This makes him fear the future and has caused quite a few sleepless nights. His discomfort has been additionally aggravated over the past few weeks by the sobering appointment he had with his tax consultant.

What Mrs Bossi has underestimated, however, is Mr Bossi's pride and ambition. They still exist, and more than anything else Mr Bossi would love to attract public attention and become the talk of the town. He managed to accomplish just that several times during his early days in business.

Now the time has come for Mrs Bossi to ask the following question:

- ➔ "Should the opportunity present itself to cause a sensation by selling our Pink Sauce not only in our town but all over the country, which would make us less dependent on the moods and attitudes of our guests, would you want to seize it?" (Arousing needs)

Mr Bossi's answer to this (closed) question is "Yes, of course." He instantly counters with his own question, though, and wants to know how all that could be possible.

Now the moment has come when Mrs Bossi pulls out her business plan and presents it to her husband. The tactic of surprise works, and Mr Bossi is highly impressed by the extent of the business plan. Mrs Bossi does not want to go into details yet and would first like to point out the advantages of the project. (Argumentation, characteristics and benefits)

Her arguments are as follows: If they sell their delicious pizza sauce (through the retail trade) to the end consumer and also to corporate customers such as other pizzerias and restaurants, they

- ➔ *open a new market niche, as the market research results have shown, and create enormous profit and growth potential*
- ➔ *become less dependent on the restaurant business and can spread their risk*
- ➔ *will most certainly attract the attention of the entire industry and may even become a sensation for the press*
- ➔ *may be able to delegate important tasks after a two-to-three-year start-up phase, restrict their activities almost exclusively to managing the business and thus have more time for their family and their hobbies, and*
- ➔ *might arouse their children's interest in taking over their business after all.*

These arguments impress Mr Bossi but he also has serious objections:

- ➔ *What if the customers don't like the colour pink at all?*
- ➔ *What if a major competitor enters the scene and simply steals our idea?*
- ➔ *etc.*

As Mrs Bossi has been thinking about these risks as well, she knows precisely how to react to her husband's concerns. In various scenario and portfolio analyses, she has dealt with these issues thoroughly and has a well-justified response to each of Mr Bossi's objections. (Objections and treating objections)

Of course she has also expected to face the 'mother of all objections':

- ➔ *It all sounds great but this project will certainly devour hundreds of thousands of euros. We can definitely not afford that. We are lucky if we can meet our current daily expenses.*

Mrs Bossi is not unprepared for this objection either, and she pulls out a piece of paper on which she has done a first rough calculation. Admittedly, the amount to be invested is huge – she won't deny it – but each of the expense items creates an opportunity as well.

EXPENSE	PURPOSE	OPPORTUNITY
45,000	Bottling facility and other capital goods	High return as early as in third year
5,000	Brand registration	Spreading of risks
10,000	Advertising, public relations	Image, reputation
30,000	Personnel	More leisure time
10,000	Additional items	
100,000	TOTAL INITIAL INVESTMENT	

(Price argumentation and visualization of expenses)

It seems as if Mr Bossi is already convinced, but he manages to conjure up a final counter argument: "To be honest, I have actually never liked the colour pink. Come to think of it, you have also eliminated all your pink dresses from your cabinet. Yet now you think we will strike gold with pink sauces?"

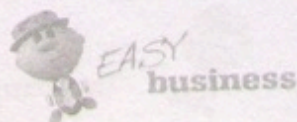
This is, however, only a pretext which cannot be taken seriously, and Mr Bossi's facial expression shows it. Mrs Bossi easily refutes his argument with a bit of a smile and a witty response. (Pretext)

In spite of her successful campaign, Mrs Bossi knows that the race is not over yet. Now the time has come to finish things and receive a binding promise from Mr Bossi so that concrete measures can be taken. If Mr Bossi does not make a commitment now, she will have to start all over again tomorrow.

She remains firm: "You will read through the business plan tomorrow so that we can talk about it in detail the day after. We will take your suggestions into consideration and then contact our bank."

Now things are moving a bit too fast for Mr Bossi, and he wants at least one month to think things over. Mrs Bossi, however, has already made an appointment with one of the bankers for next week. They therefore agree to discuss the business plan thoroughly in four days from now. Furthermore, Mrs Bossi assures her husband that they will go to this appointment only after his questions and concerns arising from the business plan have been dealt with in depth and when he is completely convinced that taking the risk will pay off. (Closing phase)

Mrs Bossi's successful sales presentation described above can now serve as a guideline that helps you understand the basics of sales activities and distinguish between the different phases of the sales negotiation process.



5. 1. 2. SALES ETHICS. BUILDING CREDIBILITY

► *Sales ethics*

'To palm something off to someone', 'to take somebody to the cleaners' and 'to corner a customer' are expressions that imply that you manipulate your customer with psychological tricks, withhold important information from him, put him under pressure or talk him into a purchase decision that causes financial difficulties. These are improper and dishonest selling practices which won't lead to success in the long run. Customers that have been won in such a manner will most probably turn their backs on you as soon as you want to sell something to them again. After all, they have plenty of alternatives.

5. 1. 3. WIN-WIN-SITUATION

► *Win-win situation*

All respectable sales training programs and books will emphasise the necessity of building credibility and trust through proper and honest sales practices, which create a win-win situation for seller and buyer.

- The customer is provided with a solution to a problem.
- In return, the salesperson receives instant payment, the promise that an order will be placed or another appropriate reward.

Both parties win.

5. 1. 4. THE SUCCESSFUL SALESPERSON

Whoever wants to sell something should possess certain competencies:

► *Competencies for sales success*

- Social competence encompasses the ability to deal with people, an interest in listening to others and the willingness and ability to accept a secondary role.
- Business competence implies that you know the basic features, the advantages and the drawbacks of your product(s) very well and are also familiar with your competitors' products.
- Sales competence includes purpose-oriented thinking and the ability to focus on and apply the most important selling arguments. Furthermore, you need to have certain psychological skills to understand what drives people, i.e. what their needs and motives are. In addition, you must know the most essential factors for sales success.

5. 2. Phases of the Sales Communication Process

Sales negotiators are likely to be successful if they follow the certain procedure:

1. Preparing the sales communication process
2. Opening sales communication
3. Customer needs survey
4. Presentation and argumentation
5. Closing the sale

► *Phases of the sales communication process*

5. 2. 1. PREPARING THE SALES COMMUNICATION PROCESS

Thorough preparation for the sales communication process is one of the major determinants of concluding a contract of sale and includes the following elements:

- ➔ Define a concrete aim: What is the actual purpose of the sales conversation?
- ➔ Analyse the other party: What are his needs? What are his desires and fears in the present situation? What are his financial means? Is he subject to anyone else's influence? Is he in the position to make decisions?
- ➔ Prepare information material. It may offer crucial help in the sales communication process. Well-documented information offers technical support to the seller and helps the buyer visualize what he has been told.
- ➔ Establish a negotiation guideline. It includes options of how to start the negotiation process, questions pertaining to a customer needs analysis, tailor-made arguments as well as answers to objections which the customer might possibly present.
- ➔ Choose the right moment or seize the perfect opportunity. Many sales negotiation processes fail because the wrong moment was selected. The customer must have the time and the willingness to apply himself to solving a problem and making a buying decision.

► *Preparing the sales communication process*

5. 2. 2. OPENING THE SALES COMMUNICATION

► *Opening the sales communication*

Sales negotiations start even before the first words are exchanged. The first impression you create when you enter a room, establish eye contact, or shake hands is perhaps reinforced by the way you are dressed and look at the other person and is crucial for the success of the upcoming sales talk. The saying that 'there is no second chance to make a first impression' should therefore be taken seriously.

From here on, one should attempt to create a **positive negotiation environment**. The customer should not be rushed into business instantly but be allowed to loosen up during a short warm-up phase. Some small talk about the weather, the traffic conditions, and perhaps business and sports news will serve this purpose.

Particularly in this phase, tact and sensitivity (social competence) are needed to figure out how much time the sales meeting is likely to occupy. It makes a difference whether you want to sell an insurance product to a pensioner who has plenty of time or wrest an executive's consent who must rush to another one of his appointments in twenty minutes at the latest. Furthermore, cultural background and customs of the other party play a significant role in international sales. A German customer is as different from a Greek one as an Arabic customer is different from a business partner from China. They all require special, individualized treatment.

► *Communication on a personal level and on a business level*

In any case, during the first few minutes the foundations for a relationship of trust must be laid. Customers will buy only if they feel that they are properly taken care of by the seller. **Communication on a personal level** may play an even more important role than **communication on a business level** (= presentation of the product). Frequently customers accept a product's drawbacks as long as they can count on proper and reliable treatment by the seller.

Proper body posture, a deliberately friendly facial expression, well-timed eye contact, a pleasant voice and similar features are often heralded as indispensable success factors. Accordingly, hundreds of seminars that train such behaviour are offered. Learned patterns of behaviour, however, may come across as artificial and are better applied on a stage than at a sales meeting, in which unnatural play-acting is likely to alienate the customer.

Natural and **authentic behaviour** is far more advisable. Don't disguise and hide your weaknesses, but be aware of your strengths, and rely on the advantages you can offer. Honesty towards yourself and others is more likely to be accepted and appreciated by customers than a rehearsed sales show.

5. 2. 3. CUSTOMER NEEDS SURVEY

In this phase the salesperson must determine whether the customer actually has a need for the product that is offered (= buying motive). A need may be a certain wish the customer seeks to fulfil or a problem that has to be solved.

➤ *Customer needs survey*

Customer needs are plentiful and complex. They include physiological needs for food, health and safety, social needs for influence and wealth, and more. (See also Chapter "Maslow's hierarchy of needs")

As pointed out in the chapter on 'Marketing', needs must be distinguished from demands. Not all needs can actually be filled: they are not affordable or cannot be achieved for another reason.

➤ *Need / demand*

Some salespeople are absolutely convinced that they know best what their customer needs the most or what he most definitely should spend his money on. In reality, however, there is only one legitimate method of finding out about customer needs: simply ask your customers what their needs are.

As regards questioning techniques, we can distinguish between different kinds of questions:

➤ *Questioning techniques*

➔ **Open or open-end questions** such as 'How are you?' start with interrogative pronouns (who, what, how, where, when, which, why). They trigger off a thinking process and force the customer to formulate his own answer. It is the customer himself who ultimately identifies the need that has to be satisfied.

- *What colour do you like best on cars?*
- *Why did you decide to buy a blue car?*

➔ **Closed or closed-end questions** like 'Do you feel fine?' invites a greatly limited range of answers: yes, no, not really, etc.

- *Do you like the colour yellow on this car?*

➔ **Alternative questions** such as 'Do you feel good or bad?' present two or more possible answers for the respondent to choose from.

- *Which colour do you like better on this car: yellow or red?*

➔ **Reflective questions** like 'Do I remember correctly that you feel absolutely fine?' signal that you were listening to what the customer said and help you check whether you understood things correctly.

- *You said that yellow is an inappropriate colour for this car and that red would be the only choice. Is that correct?*



Examples



At the beginning of a customer needs survey, open questions make more sense because they get a person to speak. When later more specific answers are desired to check facts and clarify things, closed-end and alternative questions are more suitable.

► *Leading questions*

Example



Leading questions should be avoided at any point. The person asking this type of question seeks to gain acceptance of his view only and doesn't give the respondent any options.

- ➔ *You look absolutely great and I am sure you feel great too. I cannot possibly be wrong about that, can I?*
- ➔ *Anyone who wants to be 'In' today must have a yellow car. Don't you think so?*

The person asked will in most cases give the desired response, but the view or opinion he provides may not be 'honest'. He feels cornered and uncomfortable because he feels forced not to disagree. He will most probably seize the first opportunity to escape this situation and discontinue the conversation.

► *Active listening*

Asking the right questions at the right time and in the right manner is indeed the high art of selling. The ability to listen, however, is at least equally important. **Active listening** signals to the customer that you focus on him, have time for him and respect him. Besides, active listening keeps the conversation going. It includes everything that is typical of good communication between friends: eye contact, an occasional confirmation, a smile at the appropriate time and interim and follow-up questions.

In many cases it also makes sense to take notes of what the customer is saying, which may become useful later on in the conversation.

A salesperson who applies the right questioning technique and has active-listening skills will find it easy to detect the customer's needs, which takes him a lot closer towards closing the sales negotiations successfully.

5. 2. 4. PRESENTATION AND ARGUMENTATION

In this phase of the sales communication process the salesperson attempts to show why his product is best suited to satisfy the customer's needs.

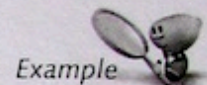
Product features or characteristics versus product benefits

When a product is presented, it is important to distinguish between its features or characteristics and the actual benefits they provide. Product characteristics are just a means to create particular benefits.

► Features / benefits

Nobody spends 2,000 euros on hi-fi equipment with 400 watts (= characteristic) because he 'wants to buy 400 watts' but because 400 watts

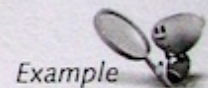
- give him the ultimate listening pleasure
- raise his reputation among his friends, or
- allow his equipment to overpower his neighbour's violin.
(= Benefits)



The perfect strategy for a salesperson is therefore to explain a product's features and the benefits that can be derived from them at the same time. The less technical knowledge a customer has, the more important the reference to a product's benefits is. Information on pixel, shutter speed and focal length / zoom may be confusing to a hobby photographer if he is not told what these features do for him.

Purchase of a Camera

FEATURES/CHARACTERISTICS	BENEFITS
The camera has twelve mega pixels.	This enables you to enlarge your vacation pictures to wallpaper size.
The shutter speed is one tenth of a second.	This feature allows you to take a series of quick successive snapshots of the most active children and to document moments that are otherwise irretrievably lost.
The camera has a zoom factor 5.	You will be able to follow even the shyest birds.



The above-mentioned examples of benefits show one thing quite clearly, though: in order to base your arguments on a product's benefits, a previous needs analysis is an absolute necessity. People who hate photo wallpapers, have no children and couldn't care less about our feathered friends will most probably remain unimpressed by these arguments.

➤ Visualization

Visualization

Many customers are incapable of taking in information by only listening to it. Visual presentation of the product you intend to sell is therefore a must (product visualization). This can be done easily with a tangible product such as a camera, which can be shown to a customer and whose functions can be demonstrated. If the product is intangible like a service or a business idea, you definitely need written information for your sales presentation.

- ➔ The salesperson may resort to a professionally designed folder, mathematical calculations, diagrams or an entire business plan, or do a computer or notebook presentation that enables particularly effective visualization. Caution is advised, though, because the use of technical equipment may weaken – or lead to a loss of – the personal relationship between the seller and the customer.

Product endorsement

Customers want to be sure that they spend their money on something that is worth the expense. Reference to the following may help to convince them:

- ➔ a list of other (well-known) customers who already bought the product and are highly satisfied with it
- ➔ a performance and quality report of a product test showing that the product has done exceptionally well
- ➔ a press article in a special magazine in which the product has received a very positive write-up

How to react to objections and pretexts

There is hardly any sales presentation in which the customer unconditionally accepts everything that is said about a product. He is likely to question the salesperson's arguments and wants to compare the product with others. If a customer is serious and if his counter argument is justified, it is referred to as an **objection**.

Example



➔ *How is it possible that another store sells a camera with 13 mega pixels at 300 euros only?*

➔ *As a hobby photographer, do I really need a camera with 12 mega pixels? Don't you think one with 6 mega pixels that costs 200 euros less will also do?*

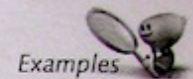
Of course objections must be treated accordingly, which means that you should present justified counter arguments. This can be done most easily if you anticipated all possible objections prior to the sales conversation and prepared answers to each of them.

► Objection

A rather vague argument which doesn't really refer to the presented product or the sales conversation is called **pretext**.

► Pretext

→ *Isn't it crazy to buy a camera today that is sold at half the price six months from now?*



It is up to the seller simply to ignore the argument and to continue his sales presentation or briefly comment on it with a very general response:

→ *That is true and the same thought crossed my mind when I bought a new computer the other day. Still, you cannot wait forever, can you?*

Price argumentation

The most important rule concerning the crucial price issue is that ideally the price should be the last element in the chain of sales arguments – independent of whether the product is exceptionally affordable or highly expensive. Before he is informed about the amount he will have to spend, the customer needs to be told what he will get for his money.

► Price argumentation

For price argumentation, visualization may be of importance again, i.e. the price to be paid (= the investment) is presented together with the product's benefits.

Purchase of a Camera

FEATURES/CHARACTERISTICS	BENEFITS	PRICE (INVESTMENT)
The camera has twelve mega pixels.	This enables you to enlarge your vacation pictures to wallpaper size.	400 euros
The shutter speed is one tenth of a second.	This feature allows you to take a series of quick successive snapshots of the most active children and to document moments that are otherwise irretrievably lost.	
The camera has a zoom factor 5.	You will be able to follow even the shyest birds.	

Visualization also helps to offset the typical objection to a product's price, once it has been revealed. When a customer says, "That's really expensive"

or "The costs are quite high," the salesperson can once again summarize what the customer gets in exchange for his money.

In sales training courses price argumentation and defending are practiced intensively. The goal is to teach salespeople how to motivate customers to buy a product without offering a discount or making any other concession. Some customers, however, absolutely need to enjoy the triumphant feeling that comes along with bringing down the price – even by just a few euros. If the salesperson believes that a customer falls into the category of people who need this form of self-esteem, he may be advised to give in. After all, the alternatives to an insignificant discount are that the customer does not buy at all or leaves in a huff and buys from the competition.

5. 2. 5. CLOSING THE SALE

► Closing the sale

If the salesperson has taken his customer successfully through all the above-mentioned phases of the sales negotiation process, closing the sale should be the next and final logical step. Still, in reality things are often different for a simple reason: the seller doesn't recognize that the customer is signalling buying intent.

► Buying signals

A customer clearly signals his intent to buy when he

- ➔ wants to know every detail about a product
- ➔ asks what the next step could be
- ➔ would like to test the product, or
- ➔ makes suggestions and brings in his own ideas.

The salesperson who reads such signals should not hesitate to clinch the deal with such questions as:

- ➔ "May I ask you to sign the contract now?"
- ➔ "Can I wrap it for you?" or
- ➔ "Does this mean you have accepted the business plan and I can take further steps now?"

Very often, however, this final question is not asked, and the reason may simply be the salesperson's human fear of being rejected. Nobody likes to hear a "No" and instead rather waits for a new opportunity. Whether another opportunity will actually present itself is more than questionable, though, because

- ➔ the customer is not likely to have the time for yet another lengthy meeting, or
- ➔ it may be that the competition has just been waiting for its chance to wrap things up, which is easy now that you have been so nice as to do all the preparatory work for them.

This concludes our analysis of the basic points of sales negotiations and their different phases. You may now want to return to Mrs Bossi's sales conversation at the beginning of this chapter. Note that Mrs Bossi is most definitely a salesperson of great talent. She did everything right.

5. 3. Sales to Corporate Customers

Mrs Bossi was looking at her husband from two viewpoints: she saw him as a private individual and a business person. The same needs to be done when you sell to corporate customers. On the one hand, you must remember that you are dealing with people who have special needs for safety, social contact and recognition. On the other hand, your sales presentation needs to address the business organisation and take its particular circumstances into consideration. At this point it may help to remember the specific features of corporate customers that were outlined in the chapter on "Customer segmentation".

► Sales to corporate customers

1. Several people are involved in the decision-making process.
2. Decision-making processes take longer.
3. Enterprises are more demanding. They want quality and reliability because poor quality and delays in delivery may cost them their own customers.
4. Decisions made by companies also have to meet business criteria such as profitability and liquidity.
5. In general, corporate customers make more rational decisions.

As they have been in contact with their customers for many years, special **key account managers** know

► Key account management

- the business requirements of these enterprises and
- the people who have the ultimate say in the decision-making process and their desires and preferences.

Sales argumentation based on business reasons

Today business know-how is indispensable if you want to be successful in selling to corporate customers. Only a person who

- is aware of the overall corporate objectives of an enterprise
- knows the specific business goals of the individual he communicates with, and
- understands and speaks the language of the entrepreneur, the managing director or the department head

will have the necessary communicative background to be able to present a suitable offer and the arguments to support it.

If you understand the technical terms and business contexts presented to you in the catalogues of learning objectives of EBC*L Levels A and B, you will be properly equipped to succeed in sales to corporate customers.

At this point, two additional aspects need to be dealt with in greater detail: corporate objectives and business goals of the decision makers.

1. Corporate objectives

Before a product is sold to an enterprise, its possible contribution to the firm's overall business objectives must be analysed. These may be

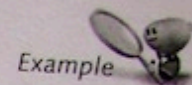
- ➔ higher profitability
- ➔ maintenance and improvement of liquidity, and
- ➔ higher productivity.

These objectives can be achieved in a number of ways and may arise out of the effect which a (new) product or service brings with it, such as

- ➔ acquisition of new customers
- ➔ increase in quality
- ➔ better prices
- ➔ cut in variable or fixed costs
- ➔ lower processing time
- ➔ greater employee motivation and satisfaction
- ➔ tax benefit
- ➔ optimal (profit) contribution margins

The above-listed effects are at the same time the benefits a product brings to the enterprise, and the salesperson will want to elaborate on them in his presentation to the corporate customer.

Selling a sales training seminar



CHARACTERISTICS	BENEFITS
Your sales staff will be excited by our experienced sales trainer.	The sales trainer's experience greatly reduces the risk that the time your sales staff spend at the seminar will be wasted.
The seminar is scheduled for two days only and will be held in a central location.	Because of the short travel distance and the compact nature of the seminar, travel expenses and time loss for the participants are reduced to a minimum.
Particular attention is paid to the crucial issue of "Defence strategies against customer requests for price cuts".	Experience has shown that discounts and other concessions significantly lower profit contribution. This seminar will help you lower the necessity of such sales practices.
The cost is 500 euros per participant.	The relatively low investment of 500 euros per person is more than offset by the benefits for your company. As you can expect to close additional sales very soon, the seminar will pay off almost instantly.
Payment can be effected in three instalments.	Instalment payment offers you an attractive, liquidity-friendly alternative.
Seminar expenses are tax-deductible, and for some of the participants you may apply for public funding.	For an enterprise like yours, tax deductibility is of utmost importance. In addition, if you are eligible for public funding – applying for it is fairly easy – half of the seminar expenses are paid for by the Ministry of Finance.

Selling office chairs

CHARACTERISTICS	BENEFITS
The swivel chairs are ergonomically shaped, have a high backrest and rubber-coated wheels.	<p>The chairs' ergonomic shape and high backrest lower the risk of shoulder and back pain significantly. Thus your employees can fully concentrate on their demanding work and the loss of working time due to sick leaves will be reduced.</p> <p>Because of the rubber-coated wheels the chairs will make less unpleasant noise which would otherwise break the employees' concentration and lower productivity. Furthermore, costs arising from office floor repair work will be reduced.</p>

► *Sound sales argumentation*

2. Business goals of the decision makers

Business decisions are not made exclusively at top-management level. Department heads and project managers, too, have their own budgets and make purchasing decisions. As they are frequently responsible for separate profit centres, they must be familiar with cost centre accounting, financial ratio analyses, and economic efficiency assessments and must be able to think economically. These skills are no longer reserved for entrepreneurs and managing directors.

Any salesperson who addresses department heads and project managers must be aware of that and use sound business arguments when addressing them. He must know precisely what contribution his product can make so as to meet their specific targets. They may have to

- lower costs
- achieve or improve certain (profit) contribution margins
- reach financial ratios (by which the performance of the department head or branch manager may be measured), or
- follow strict time schedules.

Additional information

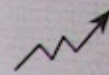
The dramatic rise in the number of books on the market best demonstrates how crucial this issue is for enterprises. We recommend books which focus in particular on sales ethics and building corporate credibility, including publications by Heinz Feldmann and Niklas Tripolt, from whom the author of this book has received a number of valuable suggestions.

EASY BUSINESS IN TELEGRAM STYLE

SALES

The following keywords and concise descriptions give an overview of the EBC*L Level B learning objectives. They do not, however, offer detailed explanations of the business terms and contexts (which are required for Level B exams). For those, please see the business texts and examples in this book. In addition, we advise you to identify practical examples from the real business world – for further progress.

Learning targets



- Explain sales activity as an everyday business process that concerns every individual.

Every person sells himself, products or ideas several times every day.

Selling can be seen as

- a process of persuasion, whose goal is to convince people of a product or an idea and ultimately trigger a purchase, or
- a solution to a problem that is either known to the other party or which the other party is not aware of.

- Explain the term "sales ethics".
Explain the term "win-win situation".

Manipulating customers with psychological tricks, withholding information from them, or putting them under pressure are practices which violate sales ethics and won't lead to success in the long run.

Building credibility and trust through proper and honest sales practices creates a win-win situation for seller and buyer.

- The customer is provided with a solution to a problem.
- In return, the salesperson receives an appropriate reward (instant payment, order is placed).

- Explain requirements and competencies that are needed for selling.

- Social competence: ability to deal with people, interest in listening to others.
- Business competence: knowledge of the basic features, the advantages and the drawbacks of your product(s).
- Sales competence: purpose-oriented thinking, ability to present sales arguments, psychological skills to understand what customers' needs and motives are.

- Name and explain the different phases of the sales communication process.

- Preparing the sales negotiation process
- Opening sales negotiations
- Customer needs survey
- Presentation and argumentation
- Closing the sale

- Name and explain important steps in preparing the sales communication process.

- Define a concrete aim: What is the actual purpose of the sales negotiations?
- Analyse the other party: What are his needs, desires and fears? What are his financial means? Is he in the position to make decisions?
- Prepare information material: Well-documented information offers support to the seller and helps the buyer visualize what he has been told.
- Establish a negotiation guideline: Know how to start the negotiation process. / Prepare arguments that speak for the product. / Have answers to possible customer objections.
- Choose the right moment: The customer must be willing to make a buying decision.

- Explain significant aspects pertaining to opening the sales communication.
Explain the difference between communication on a personal level and on a business level.

- The first impression you create is crucial for the success of the upcoming sales talk. There is no second chance to make a first impression (appearance, greeting).
- Create a positive negotiation environment. Build credibility.
- Communication on a personal level may play an even more important role than communication on a business level (= presentation of the product).

- Name and explain significant aspects of a customer needs survey.
Explain the difference between "need" and "demand".

The salesperson must determine whether the customer has a need for the product (= buying motive). A need may be a certain wish the customer seeks to fulfil or a problem that has to be solved.

Needs must be distinguished from demands. Not all needs can actually be filled: they are not affordable or cannot be achieved for another reason.

- Name and explain significant aspects pertaining to questioning or interview techniques.
Explain the terms "open" and "closed questions".
Explain the term "leading question".

During the different phases of the sales communications process different questioning techniques are applied.

At the beginning of a customer needs survey, open questions are asked to analyse demand. In the course of and at the end of sales negotiations, closed-end and alternative questions are more suitable (to confirm previously made agreements).

- Open or open-end questions most often start with interrogative pronouns (who, what, how, where, when, which, why). They force the customer to identify the need that has to be satisfied.
- Closed or closed-end questions invite a greatly limited range of answers: yes, no, not really, etc.
- Alternative questions present two or more possible answers for the respondent to choose from.
- Leading questions seek to gain acceptance and don't give the respondent any options. He feels cornered and uncomfortable because he is practically forced not to disagree.

- Explain the term "active listening".

Active listening signals to the customer that you focus on him, have time for him and respect him. Active listening includes eye contact, an occasional confirmation, a smile at the appropriate time and interim and follow-up questions.

- Explain significant aspects of sales argumentation.
Explain the difference between product features or characteristics and product benefits.
Explain the term "product visualization"

- When a product is presented, it is important to distinguish between its features or characteristics and the actual benefits they provide. The perfect strategy for a salesperson is to explain a product's features and the benefits that can be derived from them at the same time.
- Product visualization: A professionally designed folder, photos, mathematical calculations, diagrams, an entire business plan, or a notebook presentation offer valuable support during sales negotiations.
- Product endorsement: A list of other (well-known) customers who already bought the product, a positive performance and quality report of a product test or a very positive write-up in a press article may contribute to sales success

- ▶ Explain the difference between objection and pretext and describe how to react properly to each one.
 - Objection: The customer presents a serious and justified counter-argument that must be responded to.
 - Pretext: The customer's argument is of general nature and may be ignored.
- ▶ Explain significant aspects of price argumentation.
 - Ideally, the price should be the last element in the chain of sales arguments and should be communicated at a time when the customer already knows what he will get for his money.
 - Visualization may be of importance again, i.e. the price to be paid (= the investment) is presented together with the product's benefits.

- ▶ Name and explain significant aspects pertaining to closing the sale.
Name and explain buying signals.

At the end of sales negotiations, the seller must recognize the

- customer's buying signals
- and react instantly by asking the customer to sign the contract / whether he has accepted the conditions of sale, etc.

A customer clearly signals his intent to buy when he

- wants to know every detail about a product
- asks what the next step could be
- would like to test the product, or
- makes suggestions and brings in his own ideas.

- ▶ Explain specific criteria pertaining to sales to corporate customers.
 - Several people are involved in the decision-making process.
 - In general, corporate customers make more rational decisions.
 - Decision-making processes take longer.
 - Enterprises are more demanding because poor quality and delays in delivery may cost them their own customers.
 - Decisions made by companies also have to meet business criteria such as profitability and liquidity.

- ▶ Explain the term "key account management".

Key account managers have been in contact with their corporate customers for many years and know

- the special the business requirements of these enterprises and
- the people who have the ultimate say in the decision-making process.

Preview

In performing an **actual analysis** (company analysis and analysis of the external business environment), drawing up a **marketing plan** and a **project plan**, and **'selling'** her business idea to Mr Bossi, Mrs Bossi has cleared the most critical hurdles of her **business plan**.

Some questions still need to be answered, though:

- ➔ Can Bossi Pizzeria actually afford to realize the 'Pink Sauces' project? Does the enterprise have sufficient funds? Will a bank or other investors provide additional capital? (To answer these questions, corporate financial planning is necessary.)
- ➔ Will the 'Pink Sauces' project pay off? Will it be profitable enough so that it is worth the effort and risk? (Here, an investment analysis has to be performed.)

Financial planning and **investment analysis** – for which knowledge of EBC*L Level A material and a pocket calculator are necessary – will be the topics of EBC*L Level B, Part 2.

The English version of EBC*L Level B, Part 1 was designed by Mag Diana Raab and Mag Michael Raab, lecturers at the Vienna University of Economics and Business Administration. Should you or your company require proofreading of English business texts, preparation for an English business presentation or a tailor-made course in English business communication, please contact: mraab@wu-wien.ac.at.



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Study Manual



**European Business
Competence* Licence**

EBC*L Level B – Part 2

**Investment Analysis
Financial Planning (Budgeting)
Financing**



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Introduction

This book deals with the subjects of "investment analysis", "financial planning / budgeting" and "financing", which make up the syllabus of EBC*L Level B – Part 2 of the European Business Competence Licence. It hooks up to "EBC*L Level B – Part 1", which comprises the subject areas "business plan (basics)", "marketing and sales" as well as "project planning".

Investment analysis and financial planning are business planning techniques that focus on what you would call the "hard facts" of a business plan. Starting out from projected facts and figures, these tools serve to develop a rational basis for decision making. Examples for decisions to be taken are:

- ➔ Should we invest in a new product?
- ➔ Should we invest in a new plant?
- ➔ Should we replace an old plant by a new one?
- ➔ Would it pay to employ additional personnel?
- ➔ Are we able to afford the investments out of our own resources? Is there sufficient liquidity available?
- ➔ If no, how else could the investment be financed?

To answer these questions, the following instruments have been developed in the field of business administration and management:

- ➔ investment analyses
- ➔ financial planning: budgeted profit and loss account, budgeted balance sheet, liquidity plan
- ➔ ratios
- ➔ financing instruments

In this workbook you will find out that these instruments are a means of making the future more predictable and that neither businesses nor, indeed, private individuals can actually afford not to use them.

The **target group** of this knowledge – and hence of this workbook – is practically anyone planning an undertaking with implications of an economic nature, be it the foundation of a company or the organisation of a club event. All these undertakings require careful planning.

This workbook also addresses anyone who has to prepare a budget. Having worked through this book they will have a much better understanding of the budgeting process and the terminology used in this context.

The target groups specifically include:

- entrepreneurs and business managers
- company founders
- managers with budgeting competence (heads of divisions, departments, cost centres and profit centres)
- all other key employees with planning competences
- private individuals wishing to make a success of their projects (building a house, a vacation, a new car, ...)

Targeted preparation for the EBC*L Level B exam

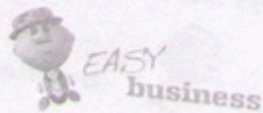
The target group naturally also includes all those people who are preparing for the EBC*L Level B exam. This workbook will certainly be a great help in tackling this challenge.

The centrepiece of Level B is the business plan and its wide variety of planning and appraisal tools. This workbook is structured in line with the Catalogue of Learning Targets of EBC*L Level B – Part 2. Having worked through this manual you will be able to carry out an investment analysis and draw up a financial plan or budget.

Didactical structure

The red thread leading you through this workbook is the story of Mr. Herzog who decides to start a career as a football referee. Mr. Herzog looks at his project from all the different angles and perspectives to find out whether the high training costs he will have to incur to indulge in his new hobby will pay off in the end and whether he can actually afford this undertaking.

Explained on the basis of this very simple example, financial planning, although usually considered a rather knotty topic, becomes easy to understand even for non-professionals. You will benefit greatly if you have a basic knowledge of EBC*L Level A.



Below is a summary overview of the basics of Level A, on which this workbook is based (these items are not explained separately in the text).

Chapter on **accounting**:

- balance sheet
- profit & loss account
- as well as all related concepts and terms such as depreciation and amortisation, receivables, liabilities, sales, profit, loss, result from ordinary activities, etc.

Chapter on **business objectives and ratios**:

- profitability
- return on equity and return on investment (ROI)
- liquidity and liquidity ratios
- productivity, return on sales

Chapter on **costing and pricing**:

- terms related to cost (cost elements, cost units, cost centres)
- fixed / variable costs
- contribution margin
- profit centres

Notes on the layout:

- *The case study of Mr. Herzog, a former football player, has been accentuated by setting it in italics.*
- On the page margin you will find marginalia indicating the learning target discussed, references to examples and other notes.

To ensure easy reading:

- Companies produce and trade products, goods, services. In this manual we always speak of products; this term is thus used as a synonym for anything else a company may have on offer.

Note



Tips on how to use this workbook

Please use this manual as it is intended, namely as your personal learning guide in which you can highlight and underscore text as you please.

People with a basic knowledge of business administration will find that this manual provides sufficient information to prepare for the EBC*L exam. For everybody else we recommend attending a preparatory course at an accredited EBC*L educational institute.

For further information please refer to

www.ebcl.eu

www.easybusiness.at

We wish you pleasurable reading and all the best for your preparation for your EBC*L exam and your professional career.

INVESTMENT ANALYSIS



General Learning Objectives

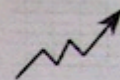
- ▶ *Being able to explain the objectives of investment analysis and draw up concrete analyses*
- ▶ *Being able to explain the limitations of investment analysis*

1. 1. Basics of investment analysis

Learning targets:

- *Being able to explain the purpose of investment analysis*
- *Being able to explain the principal methods of investment analysis (overview)*

Learning targets



Investment analysis provides companies with a valuable instrument to plan and calculate future developments and the success of investments. Investment analysis provides answers to the following questions:

- ➔ How many units (= volume) must be sold for the investment to reach profit level? (= break-even point)
- ➔ Which is the minimum sales volume for the investment to reach profit level? (= break-even sales)
- ➔ How long will it take to earn back the investment? (= pay-back period)
- ➔ Will it pay off to replace old machinery by new equipment? (cost comparison calculation)
- ➔ Which of several investment options promises the highest profit? (profit comparison calculation)
- ➔ How profitable is this investment? (= profitability analysis)

- *Purpose of investment analysis*

Below, these issues will be analysed step by step using the concrete example of referee Herzog.

First a hint to help you learn: Time and again you will be asked to calculate the examples yourself. Actually doing these calculations will greatly improve the success of your studies.

We would recommend you to stick to the following rule: Please keep your attention focused on the facts and data given in the examples – and for the time being ignore anything else you might think should be taken into account.

Example



Mr. Herzog trains to become a referee

Mr. Herzog, a former football player, is invited to take a referee training course by his football association. The costs of this comprehensive course amount to 5,000 euros. The referee licence remains valid for two years, then Mr. Herzog would have to take a refresher or further training course.

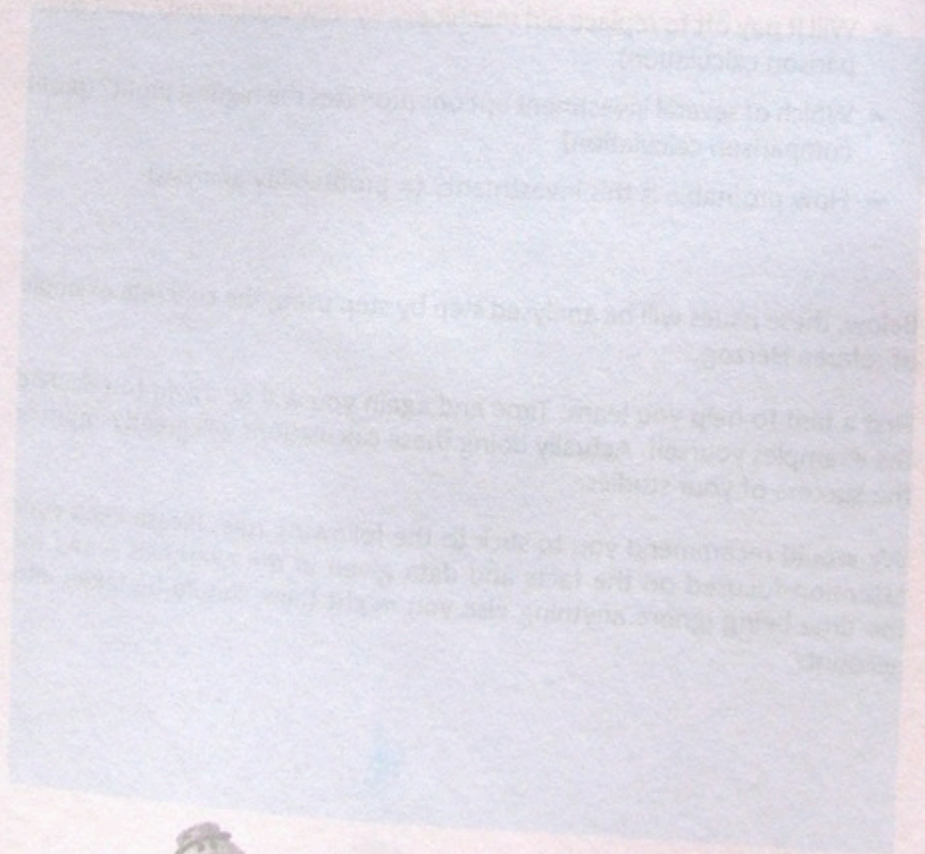
Having completed this course he would be employed to act as referee at football matches. Per match he would get 140 euros plus meals. Travelling costs amounting to about 40 euros on average would be the only costs Mr. Herzog would have to pay out of his own pocket.

For Mr. Herzog, acting as a referee would mean that he could remain in close contact with his favourite hobby, football. But Mr. Herzog is not what you call a rich man, and on top of this, he is a calculating person: He does not want his hobby to cost him more than it earns him.

He therefore wants to know how many referee assignments he would need to earn back at least the cost of his initial investment of 5,000 euros in the training course.

Could you help him with his calculation?

Your solution



Solution:

Your calculation could be as follows: You divided

- the training costs of 5,000 euros by*
- the 140 euros income less 40 euros travelling expenses per match*

$$\frac{5,000}{(140 - 40)} = 50 \text{ assignments}$$

Solution



If the result of your calculation is 50 matches, you have accomplished something great, you have actually done a break-even calculation!

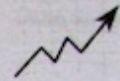
This is one of the very central concepts in business management. And it wasn't difficult, was it?

1. 2. Investment analysis methods

Learning targets:

- Being able to perform a break-even calculation and explain it
- Being able to work out a pay-back calculation and explain it
- Being able to calculate break-even sales and explain the calculation method
- Being able to explain the terms "contribution margin" and "contribution margin percentage" and calculate them
- Being able to perform and explain a cost comparison calculation for new investments and replacement investments
- Being able to perform and explain a profit comparison calculation
- Being able to calculate the return on investment (ROI) and explain the calculation method
- Being able to perform a profitability analysis and explain it
- Being able to explain the term "input variables of an investment analysis" and explain the effects of modifications of the variables
- Being able to explain the difference between static and dynamic investment analysis methods

Learning targets



1. 3. Break-even point

The break-even point provides an answer to the following question:

► Break-even point

What is the quantity or number of units (unit sales) at which all costs have been earned and the profit level has been reached?

The formula for calculating the break-even point is:

$$\text{break-even point} = \frac{\text{investment costs}}{(\text{price} - \text{variable costs})}$$

Necessary information for calculating the break-even point includes:
(example of Mr. Herzog)

investment costs:	€	5,000
price (sales revenues) per unit:	€	140
variable costs per unit:	€	40

EBC*L Level A trainees will remember using the following method for calculating the contribution margin:

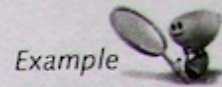
price (sales revenues) per unit:	€	140
- variable costs per unit:	€	40
= contribution margin per unit	€	100

Hence, the equation for calculating the break-even point may also read:

$$\text{break-even point} = \frac{\text{investment costs}}{\text{contribution margin per unit}}$$

Example of referee Herzog:

$$\frac{5,000}{(140 - 40)} = 50 \text{ assignments}$$



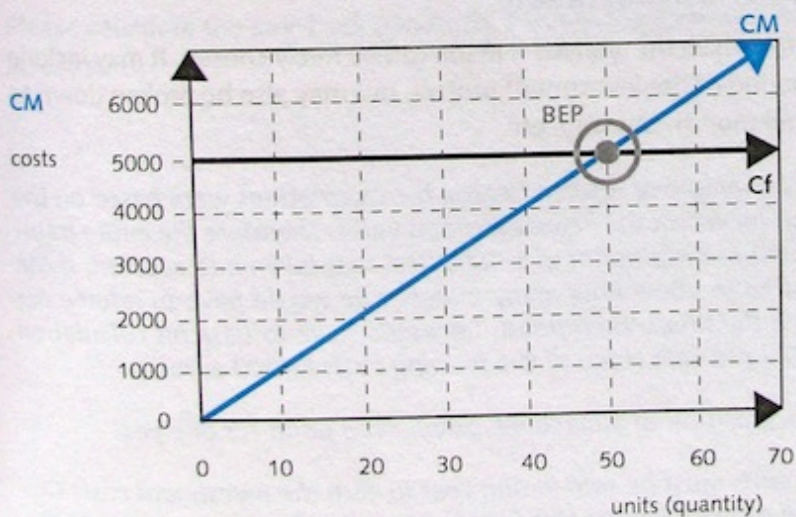
Let us now analyse what the break-even point means with regard to Mr. Herzog's project. Reaching the break-even point after 50 matches means that:

- up to the 49th match Mr. Herzog remains in the loss zone;
- with match 50 he is on par, i.e. he has reached the break-even point;
- with match 51 he enters the profit zone; with every further match his profit increases by 100 euros.

For his investment decision (the referee training) he now only needs to assess whether he will actually be called as referee for at least 50 matches.

To be on the safe side, he could conclude a contractual agreement with the football association in which the latter guarantees him a minimum of 55 assignments.

The break-even point can easily be illustrated using a very simple chart:



Cf.....fixed costs (investment costs)

CM...contribution margin

BEP...break-even point

Investment costs, fixed costs

For didactic reasons we consciously left aside a number of cost items in our referee example. The numerator in the equation for calculating the break-even point therefore comprises only the investment costs.

$$\text{break-even point} = \frac{\text{investment costs}}{\text{contribution margin per unit}}$$

In practice, however, there will be rental costs, depreciation and amortisation, interest payments and, above all, payroll expenses that need to be taken into account as well. In order to calculate the break-even point, all fixed costs incurred in a given period are offset against the attainable contribution margin per unit.

$$\text{break-even point} = \frac{\text{fixed costs per period}}{\text{contribution margin per unit}}$$

Period under consideration

The period for which the analysis is made can be freely chosen. It may include the entire period of the investment project, but may also be broken down to one year, one month, one day, etc.

In the above example of referee Herzog the calculations were based on the entire period for which the licence remains valid. Therefore the entire training investment in the amount of 5,000 euros was taken into account. If Mr. Herzog wanted to know how many matches he would have to referee per year to reach the break-even point, he would have to base his calculation on the annual pro-rata share of the training costs (2,500 euros).

Example - acquisition of a machine: break-even point for one year

How many units must be sold in one year to earn the investment costs (= depreciation rate) plus other fixed costs (payroll, interest expenses, etc.)?

1. 4. Pay-back calculation

The pay-back method is used to calculate the period (days, months, years) required to earn back the costs of an investment and reach the break-even point. This period is called the pay-back period.

Referee Herzog

Having calculated the break-even point (50 assignments), Mr. Herzog now wants to know how many months it takes for the investment to reach the profit zone (= the break-even point). In order to calculate this period, he needs one more piece of information, namely the envisaged number of assignments per month.

The football association expects to call him in about five times per month.

Let's recap the key data of Mr. Herzog's referee job:

investment costs (and/or fixed costs):	€	5,000
price per unit:	€	140
variable costs per unit:	€	40
assignments per month:		5

Please calculate the pay-back period for Mr. Herzog's referee training investment.

► Pay-back calculation

Example



Your solution



Solution



Solution:

It takes ten months for Mr. Herzog's referee training investment to repay. After a period of ten months his investment enters the profit zone (= break-even point).

The formula for calculating the pay-back period is:

$$\text{pay-back period} = \frac{\text{investment costs}}{(\text{CM per unit} \times \text{expected number of units sold per period})}$$

Referee Herzog

$$\text{pay-back period} = \frac{5,000}{(100 \times 5)} = 10 \text{ months}$$

For Mr. Herzog the calculated pay-back period of ten months implies the following:

- Up to and including the ninth month Mr. Herzog remains in the loss zone.*
- At the end of the tenth month he is on par. He has reached the break-even point.*
- With the eleventh month he enters the profit zone. With each further month he nets a profit (a contribution margin, to use the precise term) of 500 euros per month.*

The earlier the investment reaches the break-even point, the safer the investment is. If Mr. Herzog had the option of choosing a different investment variant with a pay-back period of only seven months, that variant would be preferable.

Businesses are increasingly attaching importance to short pay-back periods, which is due to the fact that product life cycles are getting shorter and shorter. A mobile phone just introduced on the market, for instance, is ready to be thrown on the scrap heap a mere six months later.

Management talk: "How long will it take for the investment to pay for itself?"

1. 5. Break-even sales

A further decision-making factor to be calculated besides the required unit number is break-even sales, i.e. the volume of sales revenues at which the investment reaches break even and starts yielding a profit.

► Break-even sales

Referee Herzog

Try to calculate the break-even sales volume Mr. Herzog has to attain for his training investment to reach break even. We again use the raw data we have already established:

Example



investment costs (and/or fixed costs):	€	5,000
price per unit:	€	140
variable costs per unit:	€	40

The break-even point was calculated to be 50 assignments.

Your solution



Solution

**Solution:**

There are two possible variants for calculating break-even sales:

Variant 1:

$$\text{break-even sales} = \text{break-even unit sales} \times \text{price per unit}$$

Referee Herzog:

$$\text{break-even sales} = 50 \text{ assignments} \times 140 \text{ euros} = 7,000 \text{ euros}$$

Variant 2: This variant is calculated in three steps.**Step 1:** Calculation of the contribution margin per unit

<i>price per unit</i>	€ 140
- <i>variable costs per unit</i>	€ 40
= <i>contribution margin per unit</i>	€ 100

► Contribution margin percentage

Step 2: Calculation of the contribution margin percentage

This percentage rate is determined by establishing the percentage relationship of the contribution margin per unit (CM) to sales revenues (price) per unit and multiplying the result by 100.

$$\text{contribution margin percentage} = \frac{\text{CM}}{\text{sales revenues}} \times 100$$

$$\text{CM in \%} = \frac{100}{140} \times 100 = 71.40 \%$$

This means that a contribution margin of 71.40 euros remains per 100 euros of sales revenues. Variable costs thus amount to 28.60 euros.

Step 3: Calculation of break-even sales based on the following equation:

$$\text{break-even sales} = \frac{\text{investment costs}}{\text{CM in \%}}$$

$$\text{break-even sales} = \frac{5,000}{71.40\%} = 7,000 \text{ euros}$$

Both calculation variants show that break-even sales that have to be attained amount to 7,000 euros. This amount exceeds total investment costs by 2,000 euros. Why?

Revenue does not equal profit

Again, the principle that "revenue does not equal profit" applies. After all, the travelling costs (= variable costs) must be deducted from the 140 euros of sales revenue Mr. Herzog earns per match.

The lower the contribution margin percentage (i.e. the higher the share variable costs "eat away" from revenues), the higher the revenues must be.

Referee Herzog

How much would Mr. Herzog have to earn in terms of break-even sales if (due to larger distances he has to travel per match and higher fuel costs) travelling costs per assignment surged to 120 euros?

Example



Your solution



Solution



Solution:

Step 1: Calculation of the new contribution margin per unit

price per unit	€	140
- variable costs per unit	€	120
= contribution margin per unit	€	<u>20</u>

Step 2: Calculation of the contribution margin percentage

$$CM \text{ in } \% = \frac{20}{140} \times 100 = 14.30\%$$

Step 3: Calculation of break-even sales

$$\text{break-even sales} = \frac{5,000}{14.30\%} = 35,000 \text{ euros}$$

The result is dramatic! Mr. Herzog would have to earn 35,000 euros in sales revenues to earn back the investment costs of 5,000 euros.

Such dramatic results are much more frequently encountered in everyday business life than you might have thought. The principle that "revenue does not equal profit" is such a simple and fundamentally logical one, but people all too frequently forget it.

Here is a further example you might easily encounter in practical business life:

Bookseller "**Books**" attains a contribution margin percentage of 25% (= discount on the purchase price granted by the publishing houses):

Based on this rate, break-even sales are calculated for a number of expense items.

a) The company invests in a new computer system; investment costs amount to 10,000 euros.

➔ The break-even sales volume required to cover this investment is 40,000 euros.

b) "Books" invests in a new employee. Payroll costs for the latter amount to 30,000 euros per year.

➔ Often, both businesspeople and employees are convinced that generating additional sales revenues of 30,000 euros would be enough for the company to earn back the employee's payroll costs. However, the company must actually achieve 120,000 euros in additional sales revenues to cover the costs.

c) A major customer of "Books" goes bankrupt. Outstanding receivables amount to 2,000 euros.

➔ The additional break-even sales volume required to make up for the loss amounts to 8,000 euros.

Example



1. 6. Cost comparison calculation

Speaking of acquisitions, a differentiation can be made between new investments and replacement investments. We talk about a **new investment** if a company plans an investment to introduce a new process or new machinery.

In the case of a **replacement investment** an existing process or old machinery is replaced by new equipment.

In both cases, costs are one of the key factors on which the decision is based:

1. 6. 1. COST COMPARISON CALCULATION FOR NEW INVESTMENTS

When planning new investments the investor is usually faced with a choice of several possible options. The key issue at stake in this case is to find the variant that entails the lowest total costs.

► *Cost comparison calculation for new investments*

Having made a cost comparison calculation it may turn out that a seemingly more expensive investment option, which

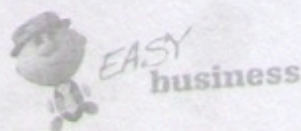
- involves higher purchase costs than another option
- actually pays off in the end because it permits cost savings due to lower running costs (=variable costs).

Referee Herzog

Mr. Herzog's car is getting old. Since his referee job will require him to travel quite a lot, he is considering buying a new car. His wife is happy to use the old one, which will be fine for her short trips to town.

Mr. Herzog has long been dreaming of getting himself a SUV and he requests offers from several car dealers. In the end there are two different models left on his shortlist:

Example



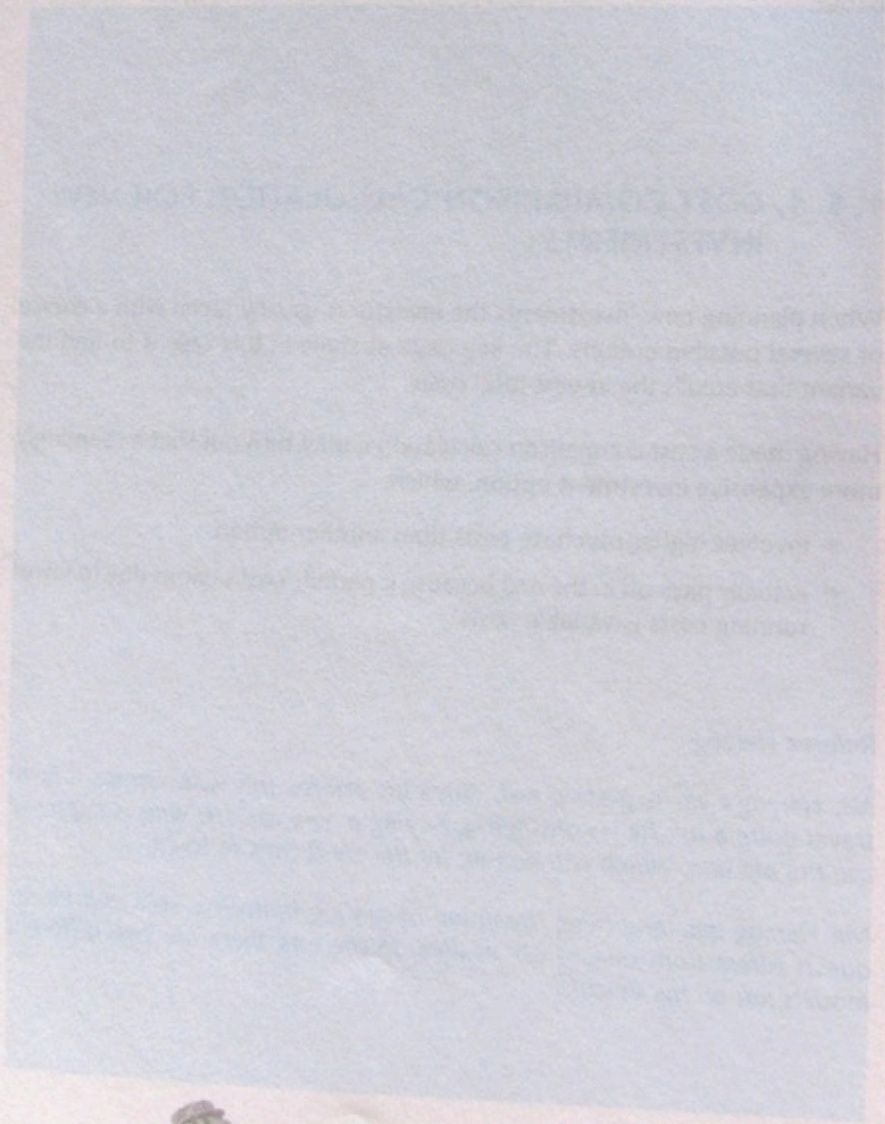
Cost comparison calculation

	"Cheap" model	"Expensive" model
Acquisition costs	16,000 euros	20,000 euros
Variable costs (fuel etc.)	0.45 cents per km	0.30 cents per km

The cost comparison shows that the more expensive car costs Mr. Herzog 4,000 euros more in purchase costs, but then saves him 15 cents per kilometre in terms of variable costs.

Which model should he decide to take?

Your solution



Solution:

To get an answer to this question, we first have to list all costs arising for the two alternative options and compare the result:

Solution



The investment costs are compared as follows:

purchase price „expensive” model	€	24,000
- purchase price „cheap” model	€	20,000
= difference in purchase price	€	4,000

Costs saved per kilometre are calculated as follows:

variable costs “cheap” model per km	€	0.45
- variable costs “expensive” model per km	€	0.30
= cost savings (profit) per kilometre	€	0.15

In a second step we want to find out from which point (how many travelled kilometres)

- ➔ the higher investment costs would be offset by
- ➔ cost savings due to lower variable costs.

Dividing the purchase price difference by the costs saved in terms of variable costs per kilometre, we get the following value:

$$\text{break-even point} = \frac{4,000}{0.15} = 26,667 \text{ km}$$

This means: The investment in the more expensive car reaches its break-even point at 26,667 kilometres. For Mr. Herzog the decision is obvious because he expects to travel at least 120,000 kilometres with his new car. He will buy the “expensive” model.

1. 6. 2. COST COMPARISON CALCULATION FOR REPLACEMENT INVESTMENTS

► Cost comparison calculation for replacement investments

Some investment decisions depend on finding out whether it is more profitable to keep existing aging machinery or replace it by new machinery (= replacement investment). Factors to be taken into account in this case include lower running expenses of new machinery, higher repair costs of older models, efficiency considerations, etc.

Mr. Herzog in our example is also faced with such a decision.

Example

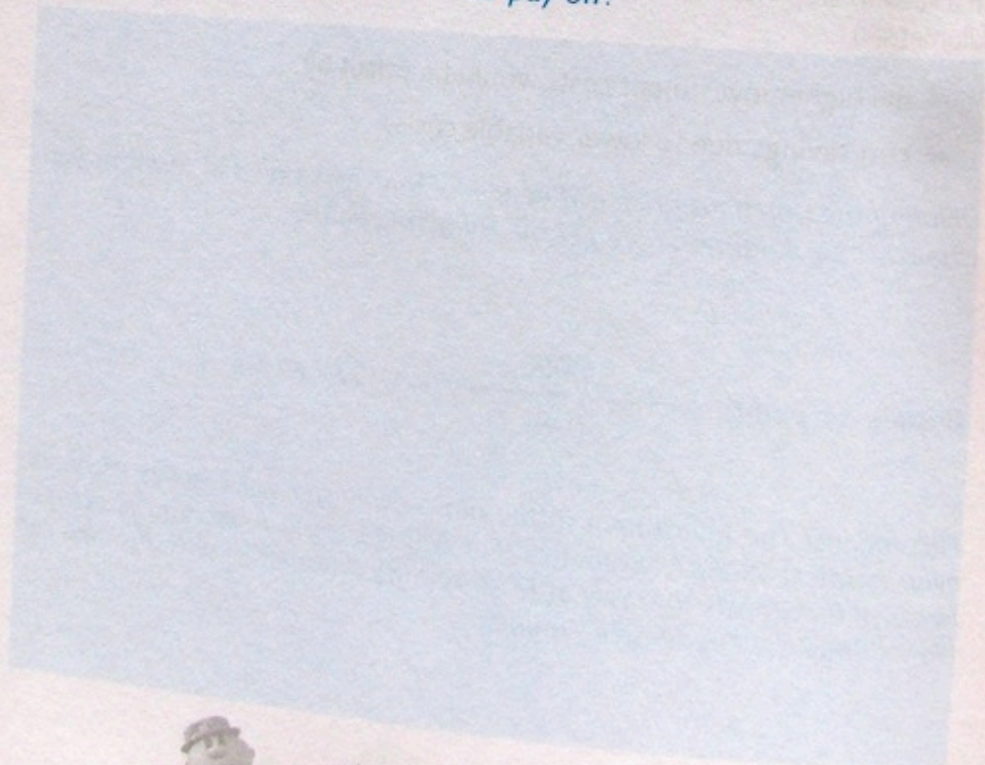


Three years ago Mr. Herzog bought a new car (a SUV), which combines high engine power and high driving comfort, but is also conspicuous for its high fuel consumption. Mr. Herzog's racer gulps a full 14 litres per 100 kilometres. Up to now this was financially feasible despite high fuel prices. But of late the petrol price went up several times in a row and Mr. Herzog does not want to foot the high petrol bill any longer. He is already faced with average travel expenses of 50 euros per referee job.

For this reason Mr. Herzog has been looking for a car with lower fuel consumption. He soon finds what he has been looking for. The hybrid car he is considering consumes only 6 litres of petrol per 100 kilometres. His travel expenses per referee job would drop to a mere 28 euros. However, the new hybrid, though just a small car, would cost him 16,000 euros. After lengthy negotiations he is offered 13,800 euros for his old car.

Would the investment in the new car pay off?

Your solution



Solution:

To answer this question we first have to

- calculate net investment costs
- and the profit per job assignment (due to the replacement investment).
The profit in this case consists in the costs saved in terms of variable costs (i.e. petrol costs) per referee job.

Solution



The investment costs are:

purchase price "new" car	€	16,000
- sales proceeds "old" car	€	13,800
= net investment amount	€	2,200

Costs saved per job amount to:

travel expenses "old" car per job	€	50
- travel expenses "new" car per job	€	28
= cost savings (profit) per job	€	22

In a second step net investment costs are offset against the costs saved per job assignment. Dividing the net investment amount by the costs saved, we obtain the following result:

$$\text{break-even point} = \frac{2,200}{22} = 100 \text{ assignments}$$

This means the break-even point for the investment in the new car would be reached after 100 assignments. Mr. Herzog is convinced that he will be called in to act as referee more than 100 times and therefore decides to buy the hybrid car. This investment has a pleasant side effect: it also puts his environmental conscience at rest.

The approach to the cost comparison calculation (for replacement investments) is the following:

1. Calculation of net investment costs

$$\begin{array}{r} \text{purchase price "new"} \\ - \text{ sales proceeds "old"} \\ \hline = \text{net investment costs} \end{array}$$

2. Calculation of costs saved in terms of variable costs per unit

$$\begin{array}{r} \text{variable costs "old" per unit} \\ - \text{ variable costs "new" per unit} \\ \hline = \text{cost savings (profit) per unit} \end{array}$$

3. Division of net investment costs by costs saved per unit

$$\text{break-even point} = \frac{\text{net investment costs}}{\text{cost savings (profit) per unit}}$$

4. Find out whether the break-even point will be reached

invest-

1. 7. Profit comparison calculation

Just reaching break even is not enough. An investment always has to yield an adequate profit. If you have several investment opportunities, you will want to make a rational decision in favour of the option yielding the highest profit.

► Profit comparison calculation

Referee Herzog

The basic data available for Mr. Herzog's referee job are:

referee training investment costs:	€	5,000
price (revenue) per job:	€	140
variable costs per job:	€	40
contribution margin per job:	€	100
break-even point		50 assignments

Example



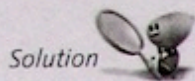
Provided Mr. Herzog does his job well, the football association expects to use his services in up to 80 matches in the period up to the expiry of his referee licence in two years time (renewal then being contingent on a refresher course). To Mr. Herzog it is obvious that 80 assignments are far more than he needs to reach the break-even point. But he wants to know what profit he will be able to make. Could you help him with his calculation?

Your solution



Solution:

In order to calculate the profit, the investment costs of 5,000 euros first have to be offset against the sum total of contribution margins. This total is calculated by multiplying the contribution margin per job by the expected number of job assignments:



contribution margin per job	€	100
x assignments		80 matches
= total contribution margins	€	8,000

Then the profit is calculated by simply deducting the investment costs from the sum total of contribution margins:

total contribution margins	€	8,000
- investment costs	€	5,000
= profit*	€	3,000

* Profit: The term profit can only be used subject to the qualification that there are no overhead costs. The more precise term is "contribution margin".



Referee Herzog - profit comparison calculation (continued)

Mr. Herzog is highly satisfied with a profit of 3,000 euros. He is on the verge of signing up for the referee training course when he hears from an acquaintance that the handball association pays its referees much higher rates. Mr. Herzog does some research and gets the following offer: Training costs amount to 7,000 euros (hence they are 2,000 euros more than the costs of the football referee training). On the other hand, Mr. Herzog would be paid 180 euros per match. The licence is valid for three years and the association expects to use Mr. Herzog's services for 90 matches during this three-year period.

At first sight, this sounds just perfect to Mr. Herzog and he actually considers accepting the handball association's offer. But then he takes a look at the venues for the matches. The locations are much more widespread than the football venues. He therefore has to expect travel expenses amounting to 60 euros per match.

What is the result of the profit comparison for the handball referee job?

A large rectangular area with horizontal lines, intended for writing the answer to the question above.



Your solution
handball

Solution



Solution:

	price (revenue) per job	€	180
-	variable costs per job	€	60
=	contribution margin per job	€	120
x	assignments		90 matches
=	total contribution margins	€	10,800
<hr/>			
	total contribution margins	€	10,800
-	investment costs	€	7,000
=	profit	€	3,800

This means that his profit from the handball engagement would be a respectable 800 euros above the profit he would make as football referee. Should he decide in favour of the handball offer in this case?

You will find an answer to this question in the following chapter.

1. 8. Return on Investment (ROI) profitability analysis of an investment

There is a basic principle that applies to an investment: it must be profitable.

This means that it should yield a higher rate of return than a comparable riskless investment (such as putting the money into a savings account). If you have a choice of two investment projects, you will naturally choose the more profitable option (see also EBC*L Level A – Ratios).

The profitability of an investment - i.e. the return on investment (ROI) - is calculated by setting the expected profit in relation to the invested capital.

$$\text{ROI} = \frac{\text{profit}}{\text{invested capital}} \times 100$$

► Return on investment (ROI)

Referee Herzog - profitability analysis

For the offer he received from the football association Mr. Herzog calculated his potential profit to be 3,000 euros. The capital he would have to invest for the referee training amounts to 5,000 euros.

$$\text{ROI} = \frac{3,000}{5,000} \times 100 = 60\%$$

A ROI (return on investment) of 60% is obviously an excellent rate of return that he would hardly achieve with any other form of investment. But maybe the handball association's offer entails an even higher rate of return?

► Profitability analysis

Your solution
handball



Solution:

Solution



$$ROI = \frac{3,800}{7,000} \times 100 = 54\%$$

The ROI of the handball association's offer is 54%, which is 6% below the rate Mr. Herzog may expect to attain with the football referee job. Hence, the football association's offer is more attractive in the end. Mr. Herzog feels somewhat relieved. After all, to tell the truth he likes football much better.

Note



Note:

In pertinent literature, the ROI formula is often given as follows:

$$ROI = \frac{\text{profit} + \text{interest}}{\text{total capital invested}}$$

Interest paid on borrowed capital is important when comparing investment projects with differing shares of equity and borrowed capital (not relevant with regard to learning catalogue targets).

1. 9. Static and dynamic investment analysis methods

On the preceding pages you were introduced to the following investment analysis methods:

- ➔ break-even calculation
- ➔ pay-back calculation
- ➔ break-even sales calculation
- ➔ cost comparison calculation
- ➔ profit comparison calculation
- ➔ return on investment (ROI) calculation

➤ Overview of investment analysis methods

These are so-called **static methods**. They are called "static" because the time factor is not taken into account. This means they take no account of the fact that

- ➔ the investment must be **paid today**, whereas
- ➔ the **income** accrues **only in the future**.

This time factor is taken into account in the more complex **dynamic investment analysis methods**.

The following example illustrates this approach:

Let us assume that scientist Mr. Roots developed a really potent new hair growth tonic. To make his product ready for the market Mr. Roots has to make an initial investment of one million euros. After five years of development work he expects to sell the patent to a pharmaceutical company for 1.2 million euros.

Example



► *Static investment analysis*

Static investment analysis

Mr. Roots calculates the profit and the ROI and obtains the following values:

Profit:

sales revenues	€	1,200,000
- investment costs	€	1,000,000
= profit	€	200,000

Return on investment, ROI:

$$ROI = \frac{200,000}{1,000,000} = 20\%$$

A profit amounting to 200,000 euros and 20% ROI - this looks quite attractive, doesn't it? Not if you take into account the time factor and the compound interest effect.

Dynamic investment analysis

Applying the dynamic investment analysis method, we would take into account that

► *Dynamic investment analysis*

- Mr. Roots has to invest 1,000,000 euros **today**
- and only receives his profit of 200,000 euros **in five years' time**.

If he invested his million elsewhere, he would, even if we assume a very conservative interest rate of 5% for this period, be able to net a profit of 276,000 euros in five years' time. His million would thus increase to 1,276,000 euros.

Assuming an interest rate of 20%, his profit would amount to a proud 1,488,000 euros. Hence, his capital would amount to 2,488,000 euros and thus would have far more than doubled.

You could also look at it the other way round. If Mr. Roots wanted to know how much capital he requires to have a total capital of 1,200,000 euros after five years, he would have to discount five years accrued interest on this amount. Starting out from a targeted rate of return of 20%, he would require an initial capital of only 482,000 euros.

The discounted value just calculated is the so-called **net present value (NPV)**.

The net present value indicates today's value of future revenues or cash flows.

There are a number of different methods of dynamic investment analysis, the best known including

- ➔ the net present value (NPV) method
- ➔ the internal rate of return (IRR) method
- ➔ the annuity method.

For a more detailed discussion of this subject please refer to pertinent literature or special seminars.

NET PRESENT VALUE METHOD (NPV)

(Not exam relevant)

The net present value method used to calculate the profitability of an investment consists of the following steps:

1. You first have to define the rate of return (= discount factor) you would consider adequate for the respective investment. This rate will depend on the rate of return of other investment options, but also on the risk involved in the investment.
 - For a risky investment, in a new research project, for instance, a rate of return of 20% may appear adequate (however, calculations could also be based on a rate of 10, 40 or 50%).
2. In a next step the excess amount of cash inflows over cash outflows (= cash flow) generated in subsequent years has to be calculated (not taking into account the initial investment amount).
 - *In our greatly simplified example this is a one-off amount of 1,200,000 euros.*
3. This amount is now discounted by the discount factor. Calculation formulas and discounting tables are available for this purpose (to be found in pertinent literature). The amount thus calculated is called the net present value (NPV or current worth).
 - *In our example the net present value is 482,000 euros.*
4. Finally, the invested amount is deducted from the net present value. If this calculation yields a positive value, the investment is profitable. If the resulting value is negative, the investment does not pay off given the current assumptions.

net present value	€	482,000
- invested amount	€	1,000,000
= result	€	- 518,000

The calculated result is clearly negative. Therefore, Mr. Roots should either forget this investment

... or explore the possibilities of "amending" the variables.

possible modifications of variables include:

- ➔ reducing the invested amount
 - ➔ e.g. from 1,000,000 to 800,000 euros
- ➔ increasing the expected revenues
 - ➔ e.g. from 1,200,000 to 1,400,000 euros
- ➔ reducing the time it will take for revenues to accrue
 - ➔ e.g. from 5 years to 3 years
- ➔ reducing the discount factor
 - ➔ e.g. from 20% to 15%

Based on these modified assumptions, the net present value in our case amounts to 920,000 euros. Since the initial investment has been reduced to 800,000 euros, the calculation yields a positive value.

net present value	€	920,000
- invested amount	€	800,000
= result	€	+ 120,000

1. 10. Investment analysis – input variables

The results of an investment analysis depend on the assumptions on which the calculations are based (= the variables). If the individual variables are changed, the results obtained from the calculation may lead to completely different conclusions.

► Investment analysis
- input variables

For a more detailed explanation let us go back to our break-even calculation. The formula reads:

$$\text{break-even point} = \frac{\text{investment costs}}{(\text{price} - \text{variable costs})}$$

Using the example of referee Herzog, this means:

$$\frac{5,000}{(140 - 40)} = 50 \text{ matches}$$

Example of referee Herzog

Let us assume the football association guarantees Mr. Herzog only 35 job assignments (rather than the 50 requires to reach break even).

Example



Mr. Herzog is quite keen on the referee job. But he keeps a sober mind when it comes to this type of decision. What could he do in your opinion?

Your solution



Solution



Solution: Mr. Herzog could try to

- negotiate a reduction in the training costs, having to pay only 4,000 euros instead of previously 5,000 euros;
- negotiate a higher price per job assignment, and for instance ask for 160 euros instead of 140 euros per match;
- try to reduce travel expenses – using public transport he could reduce average costs per match from 40 to 30 euros.

Let us see what effect these changes would have on the break-even point:

$$\text{break-even point} = \frac{4,000}{(160 - 30)} = 31 \text{ assignments}$$

Given these assumptions, the break-even point would be reached at about 31 matches. The 35 assignments Mr. Herzog is guaranteed would therefore be sufficient to reach break even.

In order to arrive at this result, Mr. Herzog "amended" the variables (= modifiable parameters) of his break-even calculation. These include

- the investment costs (were reduced)
- the price (was increased) and
- the variable costs (were reduced)

Of course, this approach only makes sense if the assumptions remain realistic even after amending the individual parameters.

Note:

Note



Allegedly there are people (managers, company founders) who developed to perfection the art of artificially calculating a profit into a project. Of course, the opposite practice of calculating a loss into unloved projects is equally encountered.

1. 11. The limitations of investment analysis

Learning target:

- ▶ *Being able to explain the limitations and problems of investment analysis*

The main problem: the future

When it comes to prices and costs, an investment analysis is always based on assumptions for the future. Hence, there is a risk that the result of such a calculation turns out to be wide of the mark because

- ➔ assumptions regarding investment costs and fixed costs arising in the future were too low or too high
- ➔ expectations regarding the obtainable price (sales revenues) were too optimistic or pessimistic
- ➔ variable cost estimates were too low or too high (e.g. low raw material or energy costs).

Unless the crystal ball providing us with reliable forecasts for the future is finally invented, the future will always involve an element of insecurity in terms of possible price reductions or cost increases. An investment therefore always involves an entrepreneurial risk.

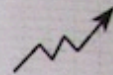
Example of referee Herzog

Mr. Herzog has no absolute guarantee that the price paid per assignment will not be reduced in the future (e.g. to 120 euros), much less that the petrol price will remain the same. A drastic petrol price increase necessarily results in a perceptible increase in travel expenses (e.g. to 60 euros). If both these risk factors came to bear, our calculation would yield quite a different picture.

"Soft facts" that cannot be appraised in monetary terms

Furthermore, there are factors such as the fun factor, family happiness and the like that cannot be weighed and assessed in economic (= arithmetic) terms. Hence, other non-monetary factors may also have to be taken into account in making a decision.

Learning targets



- ▶ *The limitations of investment analysis*

Example



Example



Example of referee Herzog

Mr. Herzog derives such a great deal of pleasure from putting on his black referee kit and bossing other people around on the football field that the money he gets for his job is of subordinate importance. The fun factor and his personal motives are not taken into account in the break-even calculation.

Or, looking at things from quite a different angle: Mr. Herzog would have to spend a lot of time on his referee hobby, and this could jeopardise his marital bliss and family life. How is this risk to be taken into account?

Another example: buying a new car

From an economic viewpoint, the purchase costs and fuel expenses are easily quantifiable decision-making criteria. But how to take into account factors such as

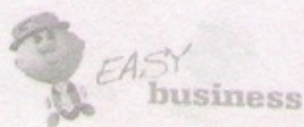
- the colour
- the beautiful design
- the prestige the car will gain you with your friends
- the trust to be placed in the salesperson?

Business economics only offers solutions to problems that can be solved using quantitative methods. All decision making that goes beyond these quantifiable problems is necessarily based on gut feeling and subjective trade-offs. This even applies to big investments worth millions made by large industrial groups.

Intentional or unintentional disregard of time "invested":

One factor has been intentionally left out of account in all the calculations regarding Mr. Herzog's project, and that is the time factor. But Mr. Herzog earns something like 20 euros per hour in his usual profession and he might well take this into account in his investment analysis. But then he'd better not start calculating at all. Considering this aspect, his referee job would hardly prove profitable, indeed it would more likely turn out to be a losing proposition.

As a matter of fact, we frequently find in practice that people forget to factor in personnel expenses for own work. The owners of small businesses in particular often fail to include their own working hours as a cost factor.



This approach is definitely not a very rational one, but it often spares the entrepreneur some rather frustrating insights.

Notwithstanding the above limitations and shortcomings, investment analysis provides important evidence on which different options can be evaluated. No project should be started without making use of this type of decision-making aid.

In summary, the limitations of investment analysis are as follows:

- ➔ the future cannot be forecast with any degree of confidence
- ➔ the soft facts cannot be weighed in monetary terms
- ➔ some factors are intentionally or unintentionally left out of account (the time invested by the entrepreneur, for instance).

However, the most important factors not taken into account in this type of calculation are all the different options foregone once you have made a decision in favour of a certain project. This consideration brings us to a further key concept, namely that of opportunity costs.

1. 12. Opportunity costs

Learning target:

- Being able to explain the term "opportunity costs"

Opportunity costs may be described as the "cost of opportunities foregone". This is one of the most decisive factors, but it is a factor that is all too often ignored, even by business economists.

An entrepreneur considers launching an advertising campaign to enhance awareness of his company. He obtains a cost estimate from a public relations agency. Costs would amount to 10,000 euros. The entrepreneur is shocked by this amount and politely declines the offer.

The entrepreneur is faced with the alternative:

- ➔ option 1: taking action
- ➔ option 2: not taking action or taking different action

It is obvious that taking action (= launching the campaign) would involve costs amounting to 10,000 euros.

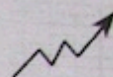
Less obvious is that the alternative of not taking action may be the cause of enormous costs, namely in the form of costs of opportunities foregone:

- ➔ to enhance awareness of the company through public relations work
- ➔ thus acquiring additional customers and,
- ➔ in further consequence, achieving higher profits, which may far exceed the costs of the advertising campaign.

In fact, doing without advertising may even mean the end of a company – there is definitely a lot of truth in the saying "advertise or die".

Opportunity costs can therefore be seen as the "costs of benefits foregone". Opportunity costs arise wherever decisions are taken. They should always be taken into consideration, even though it is quite difficult to quantify these costs with any degree of accuracy.

Learning targets



- Opportunity costs

Example



Example



Examples of opportunity costs:

A sales representative decides against travelling a long way to visit a customer. Travel expenses would be more than 1,000 euros.

- ➔ **Opportunity costs:** An order by this customer may well bring 100,000 euros in sales revenues.

A branch manager decides against employing a further sales assistant; the latter would involve daily costs of 200 euros.

- ➔ **Opportunity costs:** Every day about ten customers with a potential sales volume of 80 euros per customer leave the shop without buying anything because they could not be served in time.

A company decides to drop a planned employee incentive programme that would cost 50,000 euros.

- ➔ **Opportunity costs:** The costs caused by fluctuation, inner resignation, mobbing, withholding of ideas, etc. are very much higher.

Management talk: *The term opportunity costs can be used to good effect when pleading in favour of a project, arguing for instance: "I am aware that this project entails x euros in costs. However, we also have to be aware of the opportunity costs arising if we drop it."*

1. 13. Investment analysis – summary

Investment analysis serves to assess the quantitative effects (= those that can be measured in monetary terms) of an investment project. It is a tool that allows us to judge the expediency of an investment decision. It is used to compare the return generated by an investment with its cost.

As regards costs, we basically differentiate between

- the investment costs and the fixed costs and
- the variable costs.

The return on an investment may consist of

- actual income or revenues, but also
- cost savings (e.g. due to the replacement of a machine with high running expenses by a new, more cost-efficient machine).

The information required for carrying out an investment analysis consists of the above named factors or key data.

We differentiate between two basic types of investment analysis: **static and dynamic methods of investment analysis**.

Dynamic investment analysis methods additionally take into account the time factor, meaning that future additional revenue flows are discounted to the present value at the date at which the investment is made.

We differentiate between the following investment analysis methods:

→ **Break-even calculation**

Serves to calculate the number of units (unit sales) at which all costs have been earned and the investment returns a profit.

The equation to calculate the break-even point is:

$$\text{break-even point} = \frac{\text{investment costs}}{(\text{price} - \text{variable costs})}$$

→ **Pay-back method**

Serves to determine how long it will take (days, months, years), until the costs of an investment have been earned back and the investment returns a profit.

$$\text{pay-back period} = \frac{\text{investment costs}}{(\text{CM per unit} \times \text{expected number of units sold per period})}$$

→ **Break-even sales method**

Serves to calculate the sales volume at which all the costs involved in the investment have been earned.

$$\text{break-even sales} = \text{break-even unit sales} \times \text{price per unit}$$

Break-even sales can also be calculated on the basis of the contribution margin percentage (see above).

→ Cost comparison calculation

Serves to determine the point at which an investment in more expensive (new investment) or new (replacement investment) plant and equipment starts to return a profit because of variable costs saved.

Method of cost comparison calculation (for replacement investments)

1. Calculation of net investment costs

$$\begin{array}{r} \text{purchase price "new"} \\ - \text{sales revenues "old"} \\ \hline = \text{net investment costs} \end{array}$$

2. Calculation of cost savings in terms of variable costs per unit

$$\begin{array}{r} \text{variable costs "old" per unit} \\ - \text{variable costs "new" per unit} \\ \hline = \text{cost savings (profit) per unit} \end{array}$$

3. Division of net investment costs by costs saved per unit

$$\text{break-even point} = \frac{\text{net investment costs}}{\text{cost savings (profit) per unit}}$$

4. Find out whether the break-even point will be reached

FINANCIAL PLANNING / BUDGETING



General Learning Objectives

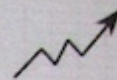
- ▶ *Being able to explain the objectives, the structure and the instruments of financial planning or budgeting*
- ▶ *Being able to explain the objectives and the layout of the budgeted profit and loss account, the budgeted balance sheet and the liquidity plan*
- ▶ *Being able to calculate target ratios regarding profitability, liquidity and productivity and derive conclusions from these ratios*

2. 1. Financial planning – overview

Learning targets:

- Being able to explain the purpose of financial planning or budgeting
- Being able to explain the difference between statutory financial accounting, cost accounting and company-internal financial planning
- Being able to explain the logical procedure of financial planning

Learning targets



Using the example of referee Herzog, the importance of anticipatory financial planning will be shown on the following pages. Tools and methods will be used in this process that are already well known to trainees of EBC*L Level A. These include the balance sheet, the profit and loss account, the key ratios, and the liquidity and cash-flow analysis.

In a first step, a differentiation is made between external accounting (= **financial accounting**) and internal accounting methods (= **cost accounting, financial planning**).

2. 1. 1. EXTERNAL ACCOUNTING

The key financial accounting instruments are the annual financial statements. These provide information regarding

- the company's performance in the past business year – whether it became richer or poorer – in other words, whether it made a profit or a loss (profit and loss account)
- the company's assets and capital (balance sheet)

➤ Financial accounting

The figures stated are actual figures from the past and present for which evidence is provided as of the balance sheet date.

The annual financial statements provide the basis for calculating the key ratios indicating the profitability and productivity of a company and its liquidity situation.

This information is not only of interest to the management, but also to external parties such as banks, suppliers and government entities. In order to create

the basis for a common tax base and rapid orientation, balance sheets and profit and loss accounts must be drawn up in line with uniform legal provisions. The structure and layout of annual financial statements, the balance sheet date and certain calculation methods (e.g. amortisation and depreciation rules) are regulated by law.

2. 1. 2. INTERNAL ACCOUNTING

Above and beyond the information provided by financial accounting and reporting, the entrepreneur or the company management will require more detailed information regarding the company.

This includes:

➤ *Cost accounting*

1. All information derived by means of **cost accounting**, namely
 - ➔ WHICH costs and revenues (cost element accounting) will accrue
 - ➔ WHERE (cost centre accounting / profit centre accounting) and
 - ➔ WHAT FOR (cost unit accounting)

(see EBC*L Level A).

➤ *Company-internal financial planning*

2. The financial forecasts for the near-term and long-term future. These are subsumed in the term **financial planning**.

In order to secure the continued existence of a company and plan its future success, the management should endeavour to assess as exactly as possible:

- ➔ The amount of profit or loss the company is expected to generate in the year to come. This projection is made by drawing up the **budgeted profit and loss account**.
- ➔ The company's assets and the amount of equity and borrowed capital at the end of the planning year. This projection is made by drawing up the **budgeted balance sheet**.
- ➔ The development of cash flows in the course of the year and whether there is a risk of a serious liquidity bottleneck in this period. This projection is called a **liquidity plan**.

There is no statutory obligation for companies to perform cost accounting or financial planning. Consequently, there are no binding standards defining the structure and content of these instruments. Hence, it is left to the discretion

of the individual company to decide

- on the layout of its budgeted profit and loss account,
- the way it calculates projected amortisation and depreciation and
- which items to include in the budgeted balance sheet (capitalise) and which to leave out of account.

This freedom of scope is the reason why it is difficult to compare the budgeted profit and loss accounts of different companies.

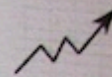
Before we go into greater detail, we will show, using the simple and straightforward example of referee Herzog, that financial planning is actually a completely logical and transparent process.

2. 2. Financial planning – instruments

Learning targets:

- ▶ Being able to explain the purpose, the structure and the key terms of a budgeted profit and loss account (based on the knowledge specified in the Learning Targets Catalogue of EBC*L Level A)
- ▶ Being able to explain the purpose, the structure and the key terms of a budgeted balance sheet (based on the knowledge specified in the Learning Targets Catalogue of EBC*L Level A)
- ▶ Being able to calculate and explain the key financial ratios listed in the Learning Targets Catalogue of EBC*L Level A on the basis of a budgeted balance sheet and a budgeted profit and loss account (target ratios)
- ▶ Being able to explain the purpose, the structure and the key terms of liquidity planning
- ▶ Being able to explain the difference between income (revenues) and inflows of funds
- ▶ Being able to explain the difference between expenses and outflows of funds
- ▶ Being able to explain the term "cash flow"
- ▶ Being able to explain the terms "excess liquidity" and "funding gap" (or "liquidity bottleneck") within the context of liquidity planning

Learning targets



2. 2. 1. CASE STUDY: FINANCIAL PLANNING BY REFEREE HERZOG

Mr. Herzog finally decided to start out on his referee career with the football association and to invest 5,000 euros in his training. Being a person who thinks ahead, Mr. Herzog would like to know whether he will have to expect a profit or a loss in his first year as referee. He therefore compares his prospective revenues with the expenses he has to incur.

- ▶ Logical procedure of financial planning

Example



2. 2. 2. BUDGETED PROFIT AND LOSS ACCOUNT

The one-off costs of his referee training (= investment costs) amount to 5,000 euros. His licence is valid for two years. Mr. Herzog starts out from the following assumptions:

	price (revenue) per job	€	140
-	variable costs per job	€	40
=	contribution margin per job	€	100
x	job assignments per year		40 matches
=	total contribution margins	€	4,000

If Mr. Herzog deducted the full amount of training costs of 5,000 euros from this balance, he would arrive at an amount of minus 1,000 euros (= loss). However, since his licence is valid for two years, he divides the training costs by two and thus takes into account only 2,500 euros in costs for this year.

► Budgeted profit and loss account

	price (revenue) per job	€	140
-	variable costs per job	€	40
=	contribution margin per job	€	100
x	job assignments per year		40 matches
=	total contribution margins	€	4,000
-	pro-rata training costs	€	2,500
=	result (profit) year 1	€	1,500

Mr. Herzog is satisfied: "Not bad if your favourite hobby even yields a profit."

► Liquidity planning

2. 2. 3. LIQUIDITY PLANNING

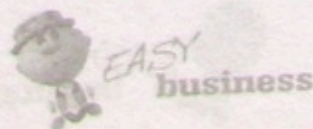
Two months later Mr. Herzog's satisfaction has turned to displeasure. He successfully finished his training and proved his worth in three matches. But he has not yet seen a cent from the football association. Having bitterly complained about this, he is informed that he obviously failed to read the small print in his contract, which says that the premiums are collected and disbursed on a quarterly basis. This means he has to wait a further month until he gets his first payment.

This gets him into liquidity problems because he had a credit balance of just 5,100 euros on his savings account at the beginning of the year. This was enough to finance his training and the travel expenses for his first jobs. But now his credit is exhausted and more than that, his account is 20 euros

in the red. To make ends meet he has to ask his best friend for a loan.

Mr. Herzog never wants to get into this kind of bother again – caused, to boot, by his hobby! He therefore decides to plan his finances more efficiently in the future. He draws up a liquidity plan in which he compares his actual income (=cash inflows) with his current expenses (= cash outflows) on a month-for-month basis. He starts his compilation retroactively with his referee training.

1. His starting capital (= savings) for the "referee undertaking", as he calls it, amounted to 5,100 euros.
2. In January he took his training course, which involved costs of 5,000 euros that had to be paid immediately.
3. In February he was called in to one match, in March he already got two assignments. Travel expenses amounted to 40 euros per match, hence he had cash outflows amounting to 120 euros in these two months.
4. In April he receives the first payment in the amount of 420 euros from the football association. The amount is disbursed retroactively for the past quarter (January to March).
5. The assignment plan for the rest of the year is as follows:
 - a. From April to the end of June is the main football season. In this period he can expect to be assigned six jobs per month.
 - b. July is mid-season break and there will be no assignments.
 - c. In August and September he can again expect to be called in for six matches a month. Four assignments are scheduled for October and three for November.
6. The football association disburses the payments retroactively on a quarterly basis, i.e. in April, July, October and January of the following year.



Based on these data, Mr. Herzog's liquidity plan is as follows:

	January	February	March	April	May	June
Cash inflows	5,100	0.	0	420	0	0
Cash outflows	- 5,000	- 40	- 80	- 240	- 240	- 240
Cash flow	+ 100	- 40	- 80	+ 180	- 240	- 240
Liquid funds	+ 100	+ 60	- 20	+160	- 80	- 320

	July	August	September	Oktober	November	December
Cash inflows	2,520	0	0	1.680	0	0
Cash outflows	0.	- 240	- 240	- 160	- 120	0
Cash flow	+ 2,520	- 240	- 240	+ 1.520	- 120	0
Liquid funds	+ 2,200	+ 1,960	+ 1,720	+ 3,240	+ 3,120	+ 3,120

Explanation of the liquidity plan:

In January the cash inflow of 5,100 euros from Mr. Herzog (= savings) compares with cash outflows in the amount of 5,000 euros for the referee training. This results in a positive cash flow of 100 euros. Liquid funds at the end of the month amount to 100 euros (= excess liquidity/liquidity surplus).

Note: The excess amount of cash inflows over cash outflows is called cash flow. In practice, more detailed liquidity plans differentiate and show cash inflows by their source, e.g. sales revenues by product/product category, sale of fixed assets, equity contributions, subsidies, etc.

February

In February Mr. Herzog had his first assignment and cash outflows of 40 euros for travel costs. As yet, there are no cash inflows. He therefore has a negative cash flow of 40 euros; liquid funds drop to 60 euros.

March

In March Mr. Herzog is called in for two matches and he again has a negative cash flow of 80 euros this time. He thus records a negative balance or shortfall of 20 euros on his account (= liquidity bottleneck).

April

In April Mr. Herzog can finally expect the cash inflow of 420 euros from the football association for his referee jobs in the first quarter. This amount compares with cash outflows of only 240 euros. He therefore records a positive cash flow amounting to 180 euros and a liquidity surplus of 160 euros.

May / June

In both these months the cash flow is negative, resulting in a serious liquidity bottleneck of 320 euros in June.

He absolutely has to make provisions for these two months. His landlord will not tolerate it if he gets into arrears with his rent again – and Mr. Herzog would not want to jeopardise his cosy flat for his much beloved hobby.

July – December

From July, when he receives a respectable 2,520 euros for 18 assignments in the second quarter, his liquidity situation eases and Mr. Herzog can now expect a liquidity surplus in each of these months.

Mr. Herzog ends the year with a liquidity surplus of 3,120 euros. In January of the following year he can expect to receive another 980 euros for the quarterly payment for the period October to December.

Advantages of liquidity planning

For Mr. Herzog, liquidity planning has one important benefit: it spares him unpleasant surprises and he can plan in good time how he will bridge the months in which he has to expect a liquidity bottleneck.

He could, for instance, ask the association to make an exception and remit payment for his April assignments at the beginning of May. Another option would be to ask his bank for a bridge loan, which he would certainly be granted as he is able to show that the liquidity bottleneck is only short term in nature.

2. 2. 4. BUDGETED BALANCE SHEET

Mr. Herzog now also wants to find out what effects his football hobby will have on his assets and financial situation. For this purpose he prepares an opening and a closing balance sheet.

Opening balance sheet

➤ Opening balance sheet

Assets		Capital	
bank / cash in hand	€ 5,100	own funds	€ 5,100
		borrowed funds	€ 0
total assets	€ 5,100	total capital	€ 5,100

Budgeted balance sheet (presumable closing balance sheet at the end of the year)

➤ Budgeted balance sheet

Assets		Capital	
licence	€ 2,500	own funds	€ 6,600
accounts receivable	€ 980	borrowed funds	€ 0
bank / cash in hand	€ 3,120		
total assets	€ 6,600	total capital	€ 6,600

A comparison of Mr. Herzog's equity (= wealth) at the beginning and the end of the year shows a surplus of 1,500 euros. This amount is the profit he made.

equity closing balance sheet	€ 6,600
- equity opening balance sheet	€ 5,100
= profit	€ 1,500

Note regarding Mr. Herzog's referee licence

The licence is valid for two years, therefore Mr. Herzog wrote it off to 50 per cent. However, it is questionable whether Mr. Herzog would be allowed to capitalise the licence in official annual statements (as it cannot be classified as a disposable asset) or whether the full amount of the costs would have to be booked as expenses. However, in the case of an internal budgeting balance sheet the planning person is free to decide which items to include and which to leave out of account.

Note



2.2.5. TARGET RATIOS

Last but not least, Mr. Herzog wants to know whether his investment in the referee training will turn out to be profitable in the end.

To answer this question, he compares the profit at the end of the year with the invested capital.

$$\text{profitability (ROI)} = \frac{1,500}{5,000} \times 100 = 30\%$$

► Profitability (ROI)

Mr. Herzog calculates a ROI of 30%. He is more than satisfied with this rate. After all he knows that he gets a mere 3% interest on his savings account at the bank, in which he has deposited his savings to date.

Additionally, his liquidity situation promises to be excellent by the end of the year: 3,120 euros of liquid funds, further accounts receivable in the amount of 980 euros due in the following month and no accounts payable on the liability side.

► *Purpose of financial planning*

The example of Mr. Herzog illustrates

- ➔ the great importance of anticipatory financial planning because unexpected liquidity bottlenecks may rapidly lead to the downfall of a company, and
- ➔ that financial planning is a practical application of the business management instruments introduced in EBC*L Level A. These include the balance sheet, the profit and loss account, the key ratios and the (comprehensive) cash flow analysis (liquidity plan).

2. 2. 6. SUMMARY: INSTRUMENTS OF FINANCIAL PLANNING

1. BUDGETED PROFIT AND LOSS ACCOUNT

By preparing a budgeted profit and loss account you can find out whether the business will generate a profit or a loss in the upcoming business year. Basically, expected revenues are offset against expected expenses, the balance indicates the projected profit or loss.

$$\begin{array}{r}
 \text{expected revenues} \\
 - \text{expected expenses} \\
 \hline
 = \text{projected profit (projected loss)}
 \end{array}$$

► Budgeted profit and loss account

The budgeted profit and loss account is drawn up applying more or less the same rules as those used by the accounting department in preparing the annual profit and loss account:

- ➔ It is prepared taking into account business transactions that make the company richer (= revenues) or poorer (= expenses).
- ➔ The purchase of assets with a lasting value (which are therefore capitalised in the balance sheet) is taken into account in the profit and loss account in the form of write-offs. The applicable write-off rates for the respective budget year have to be calculated and taken into account.

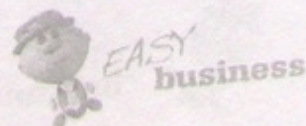
2. LIQUIDITY PLAN

In a monthly liquidity plan

- ➔ the expected cash inflows are offset against
- ➔ the expected cash outflows.

The result is called cash flow.

► Liquidity plan



➤ *Cash flow*

$$\begin{array}{r} \text{expected cash inflows} \\ - \text{expected cash outflows} \\ \hline = \text{cash flow} \end{array}$$

- *Difference income (revenues) and inflows of funds*
- *Difference expenses and outflows of funds*

Please note in this context that

- ➔ income or revenues do not necessarily generate a cash inflow immediately (for instance payments received on a quarterly basis);
- ➔ expenses do not necessarily entail a cash outflow (e.g. write-offs).

Another fact to be considered is that investments immediately result in a cash flow in the full investment amount (but the profit is not reduced by this full amount).

- *Excess liquidity – funding gap (liquidity bottleneck)*

By summing up cash and cash equivalents at the beginning of the period and the planned cash flows, we are able to calculate whether there will be excess liquidity or a funding gap (= liquidity bottleneck) in the respective months. If the planning figures indicate a liquidity bottleneck in a specific period, timely planning permits us to take adequate counteraction.

3. BUDGETED BALANCE SHEET

- *Budgeted balance sheet*

A budgeted balance sheet indicates,

- ➔ the value of assets at the end of the respective year
- ➔ the expected amount of debt
- ➔ the expected amount of equity,
- ➔ and whether equity – by comparison to the beginning of the year – will have increased (profit) or decreased (loss).

4. TARGET RATIOS

- *Target ratios*

Calculating the target ratios based on the budgeted profit and loss account and the budgeted balance sheet helps to find out whether a company will be able to achieve its primary corporate goals in terms of profitability, liquidity and productivity – provided everything develops as planned.

The most important key ratios include:

- ➔ equity ratio
- ➔ debt ratio
- ➔ the liquidity ratios, i.e. the cash ratio, quick ratio and current ratio
- ➔ return on equity
- ➔ return on total investment (ROI)
- ➔ return on sales

These key ratios are discussed in detail in the context of EBC*L Level A.

2. 3.

Financial planning in practice – budgeting

2. 3. 1. BUDGETED PROFIT AND LOSS ACCOUNT

As already mentioned, financial planning is not subject to statutory rules and regulations. Therefore, the budgeted profit and loss account can be designed in the way that appears most expedient for the respective company.

► *Budgeted profit and loss account*

Below you will find a model budgeted profit and loss account. Subsequently, the individual items will be briefly discussed:

Budgeted profit and loss account	Target values
Sales revenues	450,000
- Sales deductions (discounts)	20,000
- Cost of sales	80,000
- Cost of production	0
= Contribution margin (gross yield)	350,000
+ Other operating income	0
- Personnel expenses	200,000
- Other operating expenses	45,000
= Cash flow from operating activities	105,000
- Depreciation and amortisation	12,000
= Operating result	93,000
+ Financial income	2,000
- Interest and other financial expenses	8,000
= Profit on ordinary activities	87,000
+ Extraordinary income	0
- Extraordinary expenses	0
= Profit for the year before tax	87,000
- Tax on income	17,400
= Profit for the year after tax	69,600

All the above terms are known from the chapters on financial accounting, key ratios and cost accounting of EBC*L Level A. The only unfamiliar feature is that they have been combined in the context of a budgeted profit and loss account.

In a first step the **contribution margin** is calculated: This term denotes sales revenues from core activities less costs directly attributable to the products, such as the costs for the procurement of goods or direct cost of production (often, this result is called **gross yield**).

➤ *Cash flow*

The **cash flow from operating activities** is calculated by adding other operating income to the contribution margin and deducting all other costs that actually result in cash outflows. The cash flow from operating activities indicates the excess balance of cash inflows over cash outflows (it roughly corresponds to the term **EBITDA**, earnings before interest, depreciation and amortisation, which is frequently used today).

➤ *Difference
expense – cash outflow*

In a next step, accounting transactions other than those resulting in actual cash flows are deducted from the cash flow from operating activities. These primarily include depreciation and amortisation (= expenses that do not immediately entail a cash flow). With this step we arrive at the **operating result** (also called **EBIT**, earnings before interest and tax).

From this point the budgeted profit and loss account follows the pattern known from financial accounting and reporting rules: The **profit on ordinary activities** (earnings before tax) is calculated by taking into account financial income and expenses. In a next step extraordinary income and expenses, if any, are added and deducted, which brings us to **the profit for the year before tax**, and, taking into account tax on income, **the profit after tax**.

The unorthodox structure of a budgeted profit and loss account has one great advantage: It gives an immediate overview of all information of material importance for the company:

- ➔ If the **contribution margin** is low or even negative, the company is in massive danger. All alarm bells should immediately start ringing.
- ➔ If the **cash flow from operating activities is negative**, this is also to be read as cause for serious alarm. In addition, the company will have to check immediately whether it has sufficient liquid reserves to cover the negative cash flow or whether additional financing resources must be tapped (e.g. by taking up a loan).
- ➔ If, however, the **cash flow from operating activities is positive** but the operating result is negative, this indicates that the company is still able to finance all actual cash outflows from cash inflows. But in this case the loss in value of the assets is not covered (= the company lives off its substance), which is naturally an unacceptable situation in the long term.

- ➔ In the **profit on ordinary activities** the financial result has been taken into account. Adjusting this item for extraordinary items we arrive at the profit for the year. If a profit is only attained thanks to a clearly positive financial or extraordinary result, it is certainly worthwhile to have a closer look at the efficiency of the core business.

For existing companies it definitely makes sense to use the latest profit and loss account data as a basis and compare them with the projected figures. In addition, changes can be expressed in percentage rates to present them in an even more transparent way.

Example:

BUDGETED PROFIT AND LOSS ACCOUNT

	Actual	Target	Change in %
Sales revenues	360,000	450,000	25%
- Sales deductions (discounts)	30,000	20,000	-33%
- Cost of sales	60,000	80,000	33%
- Cost of production	0	0	
= Contribution margin	270,000	350,000	30%
+ Other operating income	0	0	
- Personnel expenses	180,000	200,000	11%
- Other operating expenses	40,000	45,000	13%
= Cash flow from operating activities	50,000	105,000	110%
- Depreciation and amortisation	10,000	12,000	20%
= Operating result	40,000	93,000	133%
+ Financial income	2,000	2,000	0%
- Interest and other financial expenses	8,000	8,000	0%
= Profit on ordinary activities	34,000	87,000	156%
+ Extraordinary income	0	0	
- Extraordinary expenses	3,000	0	-100%
= Profit for the year before tax	31,000	87,000	181%
- Tax on income	6,200	17,400	181%
= Profit for the year after tax	24,800	69,600	181%

Example



This may well remind heads of department of their annual budget calculations. Target values are defined on the basis of actual values. This can be done by stating absolute values:

- ➔ Sales revenues must be increased to 450,000 euros, the contribution margin to 350,000 euros.

Another frequently observed approach is to state the targets in percentage values:

→ Sales revenues are to be increased by 25%, the contribution margin by 30%.

2. 3. 2. BUDGETED BALANCE SHEET

► Budgeted balance sheet

The budgeted balance sheet has the same layout as the balance sheet prepared for accounting and reporting purposes. However, assets and liabilities are not listed side by side but one below the other. Among other things, this approach has the effect of permitting an easy comparison of target values and actual values.

Example:

Example



budgeted balance sheet			
	Actual	Target	Change in %
ASSETS			
Real estate	100,000	95,000	-5%
Plant and equipment	50,000	70,000	40%
Machinery and vehicle fleet	80,000	90,000	13%
Inventory	60,000	50,000	-17%
Accounts receivable	20,000	12,000	-40%
Securities	0	10,000	
Liquid funds	40,000	70,000	75%
TOTAL ASSETS	350,000	397,000	13%
LIABILITIES			
Equity	100,000	172,000	72%
Bank loans	120,000	110,000	-8%
Provisions	25,000	25,000	0%
Accounts payable	105,000	90,000	-14%
TOTAL LIABILITIES	350,000	397,000	13%

2. 3. 3. LIQUIDITY PLAN

A liquidity plan can be prepared in great detail, showing all payment flows irrespective of whether these cash flows have the effect of increasing or reducing profit or have no effect on profit.

Example:

LIQUIDITY PLAN				
	Month 1	Month 2	Month 3	Month ...
Cash and cash equivalents at the beginning of the period				
Cash inflows from ...				
Sales revenues				
Interest received				
Accounts receivable				
Sale of fixed assets				
Sale of securities				
Others				
Total CASH INFLOWS				
Cash outflows for ...				
Personnel expenses				
Material expenses				
Goods purchased				
Interest paid				
Purchase of fixed assets				
Purchase of securities				
Repayment of loans				
Others				
Total CASH OUTFLOWS				
Cash flow				
Cash and cash equivalents at the end of the period				

Example



This procedure on the one hand serves to calculate the cash flow generated on a monthly basis, on the other hand it permits us to forecast the liquidity situation and potential excess liquidity situations or funding gaps. In the event of a potential **funding gap**, action must be taken by either

- making provisions for changing the pattern of cash inflows and outflows (e.g. by delaying investments or negotiating pre-payments, etc.) or
- providing for additional finance to avert a liquidity crisis.

A large, empty grid with approximately 12 columns and 20 rows, intended for budgeting or cash flow forecasting. The grid is faintly visible and occupies the central portion of the page.

2. 4. The main problem of financial planning: the uncertainty of the future

Learning target:

- *Being able to explain the major problems of financial planning*

The example of Mr. Herzog shows that financial planning can produce a wealth of valuable information. However, we must not overlook the fact that – as in every type of planning – the future constitutes an aspect of uncertainty that should not be underestimated. Financial planning requires assumptions to be made regarding:

- ➔ marketable volumes
- ➔ achievable prices
- ➔ costs for the procurement of goods, personnel, energy, interest payments, etc.
- ➔ necessary investments

Only in very few cases will these assumptions actually be met as forecast. A sharp price decline may reduce profits or profits may surge skywards due to unexpected rush demand by customers (provided a company has the capacities to deal with such an onrush).

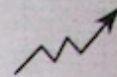
Uncertainties such as these always have to be taken into consideration. Financial planning is therefore an ongoing process that requires regular revision and updating.

Referee Herzog – what may the future bring?

Mr. Herzog also has to consider a number of imponderables:

- ➔ *The football association might train too many referees. This would give rise to excess supply and entail a lower number of assignments.*
- ➔ *The football association might not be satisfied with Mr. Herzog's performance and require him to undergo further training he has to pay out of his own pocket.*
- ➔ *The football association might encounter financial problems and have to cut costs and therefore also the rates paid for the referee assignments.*

Learning targets



- *Problems of financial planning*

Example



The main problem of financial planning: the uncertainty of the future

- ➔ *The football association might turn out to be an unreliable debtor, resulting in the commissions being paid semi-annually rather than quarterly.*
- ➔ *Petrol prices and road charges might go up, resulting in higher travel expenses.*
- ➔ *In April, the beginning of the season to boot, Mr. Herzog might break a leg and have to take a break until August.*
- ➔ *Conversely, it is conceivable that Mr. Herzog might rapidly advance to the status of a star referee and get double the number of jobs and this at 30% higher rates.*
- ➔ *and many more ...*

Each of the above listed events would completely throw over Mr. Herzog's financial plan. Mr. Herzog therefore decides to review the entire set of data at the end of each month and update his financial plan accordingly.

FINANCING



General Learning Objective

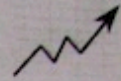
- ▶ *Being able to explain the different possibilities of corporate financing*

3. 1. Financing – basics

Learning target:

- *Being able to explain the basic difference between equity and debt financing*

Learning targets



If a company experiences a liquidity bottleneck, it is compelled to raise additional capital to bridge the gap.

Additional capital may also have to be raised if a company is unable to finance a planned expansion from its own resources or if it has to invest in new plant and equipment.

Basically, there are two financing options:

- ➔ equity financing
- ➔ debt financing

3. 2. Equity financing

Learning targets:

- Being able to name and explain different equity financing options
- Being able to explain the terms "shares" and "new shares"
- Being able to explain the term "undisclosed partnership"

The term "equity financing" denotes the act of raising additional capital through equity investments. This capital may be contributed by the entrepreneurs or existing shareholders (partners) or by persons or institutions that were hitherto not linked with the company. In return, the latter acquire a share in the company (profit, company value). The primary advantage of equity financing as compared to debt financing is that it involves no current interest expenses and capital repayments. A heavy burden of fixed costs due to interest and capital repayments may ruin a company in times of crisis.

If a company needs additional capital (e.g. raised by taking in further partners), the capital increase often takes the form of a reorganisation, for instance:

- ➔ a sole proprietorship is converted to a limited partnership
- ➔ a general partnership is converted to a public limited company

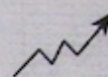
Another option is to take in so-called **undisclosed partners** against a participation in the company's profit.

For the advantages and disadvantages, rights and responsibilities under the individual legal forms see EBC*L Level A, Business Law.

3. 2. 1. NEW SHARES

Public limited companies have the possibility to raise additional funds by issuing new shares (= **issuance of new shares**). This transaction is also called **capital increase**. The capital raised is equity capital. The new shareholders acquire a participation in the company and benefit from profit distributions (= dividend) and a rising share price (= price gains). Moreover, they usually have voting rights in the general meeting of shareholders.

Learning targets



- Equity financing

- New shares

The shareholders, in their role of business partners, run a risk of "leaving empty handed" if the company fails to generate a profit or, indeed, makes a loss or if the share price declines (=price loss).

3. 2. 2. VENTURE CAPITAL

(Not exam relevant)

In recent years the term **venture capital** (= risk capital) has become widely used. It is frequently encountered in the context of so-called venture capital funds acquiring an interest in highly risky businesses (predominantly in the high-tech sector). In many cases these venture funds not only bring in capital, but also offer comprehensive consulting services. The venture capitalist's participation in the company is usually for a restricted period of time. As a rule, they expect to sell their interest in the company at a high profit within just a few years.

3. 3. Debt financing

Learning targets:

- Being able to name and explain different debt financing options
- Being able to explain the terms "creditworthiness/credit rating" and "credit assessment"
- Being able to explain the term "bank loan"
- Being able to explain the terms "nominal rate of interest" and "effective rate of interest"
- Being able to explain the term "overdraft facility"
- Being able to explain the term "supplier credit"
- Being able to explain the term "bond"
- Being able to explain the term "leasing"
- Being able to explain the term "factoring"

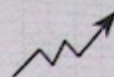
If equity financing is not possible or not desirable, a **debt financing** solution will have to be considered. There are different types of debt financing, i.e. bank loan, overdraft facility, supplier credit, leasing, bonds and factoring.

The prerequisite for obtaining debt finance is a satisfactory creditworthiness (= **credit rating**). In order to verify the creditworthiness of a company, the financial institutions will

- ➔ analyse the company's economic situation and its future prospects (balance sheet, profit and loss account, ratio analysis, sector analysis, business plan)
- ➔ demand collateral
- ➔ examine the quality of the management (technical and business management know-how, personal trustworthiness, etc.)

Note: The credit assessment has gained significance since the European Parliament passed the so-called **Basel II Directive**. Although it only requires banks to perform an in-depth credit assessment for large credit exposures, banks have adopted the practice of assessing the borrowers' credit standing for smaller loan amounts as well.

Learning targets



➤ Debt financing

➤ Credit rating

Note



3. 3. 1. BANK LOAN

➤ *Bank loan*

The classical form of debt financing is taking out a loan from a bank. As a rule, banks will grant such a loan only after having made a credit assessment.

The bank grants a loan under the condition that

- ➔ the borrower pays interest on the loan amount, and
- ➔ repays the entire loan amount.

Repayment of the loan may take different forms:

- ➔ regular loan instalments (monthly or quarterly) falling due from the date the loan is taken out
- ➔ loan instalments starting to fall due with a few months delay
- ➔ the loan amount only has to be repaid at the end of the agreed loan term (bullet loan)

Taking out a loan may involve the following types of costs:

- ➔ interest
- ➔ loan commission falling due upon conclusion of the loan agreement
- ➔ fees (one-off and regular)
- ➔ credit tax

➤ *Nominal rate of interest*

When comparing different loan offers it is important that one thing is taken into account: A seemingly advantageous offer (only $x\%$ interest) may ultimately turn out quite expensive due to high extra fees and charges. In order to render loan offers comparable it is recommended to calculate the so-called effective rate of interest, in which all credit costs (fees, commission, charges, etc.) are taken into account. We therefore differentiate between the **nominal rate of interest** and (the higher) **effective rate of interest**.

➤ *Effective rate of interest*

3. 3. 2. OVERDRAFT FACILITY

➤ *Overdraft facility*

One of the most frequent types of loan is the credit in current account. It means that the company draws on a credit line (also called an overdraft facility), which banks grant companies on their current account. To be granted this credit line the company – like a private individual – has to set up an account with the bank. Through this account the company is then able to transact incoming and outgoing payments.

Incoming and outgoing payments on a company's current account may sometimes result in a credit balance, sometimes in a debit balance. Depending on whether the balance is positive or negative, the bank credits or debits interest to the account. This interest is calculated on a daily basis and is usually very low on credit balances and extremely high if the account goes into the red.

Example:

Interest on credit balance: 0.25%

Interest paid on overdraft: 13%

Considering its usually high interest charges, a credit line or overdraft facility is only recommended for meeting short-term capital requirements. However, this credit variant is quite popular with businesses because the overdraft facility can be utilised more or less automatically and without any formal barriers. Once a company has set up a bank account and negotiated a credit line (= maximum debit balance permitted to accumulate on the account), it need not call on the bank for a loan every time extra funds are needed.

The overdraft limit depends on the company's credit rating or creditworthiness. In the case of small companies, the credit line will be limited to a few thousand euros, whereas large corporations may be granted facilities extending to several million euros.

3. 3. 3. SUPPLIER CREDIT

We speak of a supplier credit (or trade loan) if a company exploits the payment periods allowed by its suppliers. By delaying the outflow of funds as long as possible, the company gains a certain time buffer.

Example:

Payment is due within 10 days without any deductions. Thereafter, the supplier charges the company interest at a rate of 2% per month. Obviously, the 10 days allowed for payment should be exploited to the last day.

But frequently companies also put up with paying default interest – often because they are not aware that "interest at the rate of 2% per month" actually means a horrendous annual rate of 32%.

Example



► *Supplier credit*

Example



3.3.4. LEASING

► Leasing

This financing variant has established itself as a popular alternative to the classical bank loan. However, its purpose is less to provide funds to bridge liquidity bottlenecks than to finance investments. The range of possible leasing objects includes everything from computers and vehicles to real estate and even turn-key production plants.

The term "leasing" denotes a special form of hire contract concluded between the lessor and the lessee. This means that the leased property (leased object) remains in possession of the lessor.

The agreement gives the lessee the right to use the leased object (e.g. a car) and in return requires the lessee to pay a leasing rate, which covers the costs for financing the property, the administrative expenses and the risk incurred by the lessor.

The lease contract may include additional agreements, for instance,

- ➔ whether the leasing object has to be returned to the lessor upon expiry of the lease contract or may be bought by the lessee for a specified amount;
- ➔ whether insurance contracts are to be concluded to cover the risk of accidental loss (e.g. the total loss of a car);
- ➔ etc.

A vast number of different leasing variants has evolved in the course of time. One reason for this great variety is that resourceful tax experts came to consider leasing a fiscally advantageous financing variant. But the tax authorities did not take very long to close these tax loopholes as they emerged.

Companies are often faced with the alternative of financing an investment either by taking up a loan or through leasing. The following decision-making criteria must be considered in this context:

- ➔ a comparison of the effective rate of interest
- ➔ accounting policy aspects; for instance, if a car is financed through a loan, both the car and the loan are shown in the balance sheet; if it is leased, only the leasing rates are shown as expenses;
- ➔ tax aspects

We have to look at the individual case to decide which of the two, leasing or credit financing, is the better option.

3. 3. 5. SALE AND LEASE BACK

(Not exam relevant)

This is a more complex leasing variant under which a business sells a fixed asset item (e.g. the vehicle fleet, machinery) to a leasing company and then hires or leases the objects back from this company. This approach serves short-term fund raising purposes. Many airlines have taken recourse to sale and lease back to bring them through times of crisis. Accounting policy considerations may also recommend this approach.

► *Sale and lease back*

3. 3. 6. BONDS

Banks, when granting large credits to companies, usually secure themselves certain information and decision-making rights. Notably large corporations aim at reducing the resulting dependency on banks and, rather than borrowing from banks, raise the money for investments from private individuals or other institutions. This is done by issuing so-called **bonds** (=issuance of bonds). Bonds are securities by which the issuer confirms to the bondholder that the latter

► *Bonds*

- lent the company a specified amount of money and that this amount will be repaid after a certain period of time (at maturity)
- will receive a guaranteed rate of interest on this amount of capital.

Bonds issued by companies (= corporate bonds) usually boast a higher rate of return than traditional savings accounts or bonds issued by the state (= government bonds). The higher yield of corporate bonds is due to the higher risk investors incur when buying these bonds. If the company defaults, the bondholders' money is also gone. For the companies, bonds are debt capital. Bonds are issued to third parties / institutions and – similar to shares – are partly exchange traded.

3. 3. 7. FACTORING

► *Factoring*

We speak of "factoring" if a company sells receivables due from its customers to a so-called factoring company (usually a bank).

Example: A company has carried out an order worth 10,000 euros and has already invoiced this amount. Owing to a special agreement, the amount will fall due only in six months' time.

The company now sells this account receivable to a factoring bank. The latter, rather than paying the full 10,000 euros, withholds a certain share for:

- interest
- incurring the (customer's) default risk
- administrative expenses

For the company, this financing variant has the **advantage** that it immediately gets the money and does not have to wait for the receivables to be paid by the customer, does not have to worry about payment reminders (dunning), and is no longer exposed to the risk that the customer could go bankrupt.

However, these advantages are partly offset by an important **disadvantage**: In collecting their claims the factoring banks don't exactly treat their debtors with kid gloves. Hence, there is a risk the company will upset customers and lose them as a result.

CASE STUDY

PROFESSIONAL REFEREE



4. 1. Case study: professional referee

Finally, you now get a chance to test the knowledge you have acquired by applying it to the example of Mr. Herzog. This time, however, we make a small enterprise of Mr. Herzog's refereeing hobby: Mr. Herzog becomes a professional referee.

Note 1: Our example has now become a little more complex and ideally you should work it through together with a trainer. If you want to try it on your own, you will find the solutions at www.easybusiness.at/book

Note 2: You won't be set such a complex task in the EBC*L exam.

Note



4. 1. 1. MR. HERZOG BECOMES A PROFESSIONAL REFEREE

Mr. Herzog has gained an excellent reputation as a referee over the past three years. Time and again people suggest to him that he should give up his "ordinary" job and earn his living as a professional referee. For Mr. Herzog that would be a dream come true. But he has a wife and two small children to support and he doesn't want to decide in a rush. "Better calculate ten times than be off the mark once", is his motto.

If he wanted to set up shop as a professional referee, he would have to make quite a few investments. He starts out from the following assumptions:



→ Costs of training course for professional referee and referee licence (valid for four years) are capitalised and written off over four years.	€ 10,000
→ A comfortable and safe car for his numerous trips. He expects to drive the car for four years.	€ 40,000
→ A computer with large-screen monitor; expected useful life: 4 years	€ 2,000
→ Small office – monthly rent	€ 400
→ Internet fee, monthly	€ 30
→ Mobile phone costs (lump sum), monthly	€ 50
→ Other current expenses per month	€ 100
→ Interest on loan (per year)	€ 3,000
→ Travel costs and accommodation per match	€ 200

Mr. Herzog needs 2,000 euros per month to cover his private fixed costs (Note: Full amount has to be taken into account as ordinary cost factor in the budgeted profit and loss account; tax issues are not relevant in this example).

In June Mr. Herzog plans the following investments:

→ Large-screen television for video analysis of the matches; useful life: five years	€ 1,500
→ Washing machine and drier (he wants to wash his work clothes himself); useful life: 8 years	€ 800

Mr. Herzog has saved quite a bit of money in recent years and has 18,000 euros in his savings account.

From his bank he already has a commitment for a loan in the amount of 40,000 euros. The interest he has to pay on this loan amounts to 3,000 euros annually – as taken into account in the table. This first payment only falls due in December of the first year. (Note: The loan is a bullet loan, which means that the capital is repaid at the end of the loan term).

With a total capital of 58,000 euros, Mr. Herzog is able to cover the basic investments in his training, a car and the computer. Additionally, he has 6,000 euros in cash left.

The national football league pays 1,500 euros per match.

Payments are made retroactively every four months (beginning of May/ beginning of September / beginning of January).

As a professional referee Mr. Herzog gets a binding commitment for 48 matches per year. These are distributed as follows:

Month	Matches	Month	Matches
January	0	July	5
February	2	August	4
March	5	September	5
April	5	October	5
May	5	November	5
June	5	December	2

4. 1. 2. TASKS: FINANCIAL PLANNING / BUDGETING

1. Draw up a budgeted opening balance sheet as of the beginning of the year. (01 Jan. 200x).

(Note: The solution is given on the last page; please have a try before you look it up. However, to make sure that your basic data are correct, you should compare your solution with the sample solution before you start the remaining task blocks).

2. Draw up a budgeted profit and loss account (in report form).
 - Also calculate the contribution margin (gross yield) and the cash flow.
3. Draw up a monthly liquidity plan for the first business year.
 - Find out in which months Mr. Herzog will have excess liquidity and in which a funding gap.
4. Draw up a budgeted balance sheet as of the end of the year (31 Dec. 200x).
5. Calculate the following target ratios and comment on them:
 - Return on equity (based on the budgeted profit and loss account and the budgeted opening balance sheet)
 - Equity ratio (based on the budgeted balance sheet as of the end of the year)

4. 1. 3. TASKS: INVESTMENT ANALYSIS

6. Calculate the break-even point for one year (all fixed costs have to be taken into account on a pro-rata basis for 1 year).
7. Calculate break-even sales for one year.
8. Name three variables that can be changed to obtain more favourable values.

4. 1. 4. TASKS: BUSINESS PLAN / MARKETING

9. Develop a corporate vision for Mr. Herzog as referee.
10. Develop a corporate design for Mr. Herzog as referee.
11. Who could Mr. Herzog's stakeholders be?
12. Who is Mr. Herzog's customer? Which needs does the latter have?
13. Which marketing measures would you recommend for Mr. Herzog?
14. Take Maslow's hierarchy of needs and explain which of Mr. Herzog's needs the referee job would fulfil.

Year	Revenue	Costs	Profit
2013			
2014			
2015			
2016			
2017			
2018			
2019			
2020			

4. 1. 5. SOLUTION TO ITEM 1, FINANCIAL PLANNING: BUDGETED OPENING BALANCE SHEET

REFEREE HERZOG: BUDGETED OPENING BALANCE SHEET

ASSETS	
Training and licence	€ 10,000
Car	€ 40,000
Computer	€ 2,000
Cash in hand	€ 6,000
TOTAL ASSETS	€ 58,000
LIABILITIES	
Equity	€ 18,000
Bank loan	€ 40,000
TOTAL LIABILITIES	€ 58,000

Explanation:

This balance sheet was drawn up on the assumption that the initial investments in Mr. Herzog's training, the car and the computer were already made.

Note: The training including the licence was capitalised in the balance sheet. The sum of 10,000 euros is written off over 4 years. It is doubtful whether Mr. Herzog would be allowed to capitalise these expenses in an official (external) balance sheet. In an internal balance sheet (= financial planning) this is left to the discretion of the planner.

TO CONCLUDE PLEASE NOTE:

As mentioned above, you can get the solutions to the remaining items either from your favourite trainer or call them up on the Internet at www.easybusiness.at/book



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