

SCORE[®]

Counselors to America's Small Business

ALREADY IN BUSINESS STAGE

- **Preparing Your Balance Sheet**
- ▮ **Preparing for Income/Expense Sheet (P & L)**
- ▮ **Evaluating Your Financial Statements**
- ▮ **Marketing Strategy**

BALANCE SHEET

By Bruce J. Blanding

The basic accounting equation, $Assets = Liabilities + Capital$, is represented on the Balance Sheet. Figure 5-1, below, is an example of a Balance Sheet. Notice the date at the top. On the Profit and Loss Statement, the dates covered a period of time. The Balance Sheet, on the other hand, represents the balance in asset, liability, and capital accounts at a specific time. The Balance Sheet is like a snapshot of that business.

Assets

Anything of value owned or due the company is considered an asset. Generally, on the Balance Sheet, assets are divided into current assets and fixed assets.

Current Assets

Cash and resources that can be easily converted into cash within one year are considered current assets. The cash entry on the Balance Sheet includes all cash the business has on hand and in demand deposits (bank accounts).

Accounts Receivable are the current amounts owed to the business by customers for credit purchases. This figure should be adjusted downward slightly to allow for bad debts or accounts that will turn out to be uncollectible.

Figure 5-1
Balance Sheet - December 31, 200-

| ABC Company | |
|--|--|
| Current Assets | Cash: \$2,320 Accounts Receivable: \$1,460 Inventory: \$9,320 Pre-paid Expenses: \$300 |
| TOTAL CURRENT EXPENSES | \$13,400 |
| Fixed Assets: | Delivery Equipment: \$15,000 Furniture & Fixtures: \$4600 |
| TOTAL FIXED ASSETS | \$19,600 |
| TOTAL ASSETS | \$33,000 |
| Liabilities: | Accounts Payable: \$ 6,430 Notes Payable: \$2,320 Payroll Tax Payable: \$150 Sales Tax Payable: \$1,900 |
| TOTAL LIABILITIES | \$10,800 |
| Capital: | Owner's Equity: 22,200 |
| TOTAL LIABILITIES & CAPITAL | \$33,000 |

PREPARING PROFIT & LOSS STATEMENTS

(ALSO KNOWN AS THE INCOME STATEMENT)

Perhaps the information an owner/manager wants MOST about the performance of the business is its profitability. For a particular period of time, did the company make a profit or experience a loss? The Profit and Loss Statement (sometimes called an Income Statement) describes the net result, over a period of time, of revenue less expenses. The familiar term, "the bottom line" refers to the last line on the Profit and Loss Statement--the one indicating the company's net profit (or loss). Stated simply, the Profit and Loss Statement is represented by the equation:

$$\text{Revenue} - \text{Expenses} = \text{Income}$$

Figure 4-1, below, is an example of the format and types of categories commonly found on a Profit and Loss Statement. The first thing to notice on the statement is the dates on the top. A Profit and Loss Statement always covers a particular period of time--a month, a quarter, a year, etc. This means that revenue and expense items appearing on the statement were actually incurred during the time indicated. The element of time should be kept in mind when examining the various accounts listed on the statement.

Figure 4-1
Profit & Loss Statement - October 1 - December 31, 19-

| | Dollars | Percent |
|---------------------------------|-----------------|-------------|
| Net Sales | \$68,116 | 100.0 |
| Cost of Goods Sold | \$47,696 | 70.0 |
| GROSS PROFIT & SALES | \$20,420 | 30.0 |
| Expenses | | |
| Wages | \$6,948 | 10.0 |
| Delivery Expense | 954 | 1.4 |
| Bad Debts Allowance | 409 | 0.6 |
| Communications | 204 | 0.3 |
| Depreciation Allowance | 409 | 0.6 |
| Insurance | 613 | 0.9 |
| Taxes & License | 1,021 | 1.5 |
| Advertising | 1,566 | 2.3 |
| Interest | 409 | 0.6 |
| Other Charges | 749 | 1.1 |
| TOTAL EXPENSES | \$13,282 | 19.5 |
| Net Profit | \$7,138 | 10.5 |
| Other Income | 886 | 1.3 |
| TOTAL NET INCOME | \$ 8,024 | 11.8 |

Net Sales

"Net Sales" refers to the total sales for a period, less necessary adjustments. To arrive at a Net Sales figure, use the following process:

| Gross Sales | \$XX,XXX |
|---------------------------------|----------|
| Less Sales Returns & Allowances | -X,XXX |
| Net Sales | \$XX,XXX |

Many small businesses treat sales returns and allowances as direct reductions of the sales figure. However, it is advisable to establish a separate account to record Sales Returns and Allowances. This will aid the owner/manager in determining if too much merchandise is being returned.

Another, less frequent reduction to the total sales figure involves the sale of merchandise to be delivered at a later time. The concern on a Profit and Loss Statement is to match revenues and expenses. To record a sale that will be completed later may be misleading. In such a case, it may be advisable to check with an accountant for suggestions on the best way to record the sale.

Cost of Goods Sold

The primary expense incurred in selling merchandise is the cost of the goods sold. The process for arriving at their cost is controlled by the merchandise inventory valuation methods discussed in the previous chapter and is calculated:

| Beginning Inventory | \$XX,XXX |
|--------------------------------|----------|
| Add Merchandise Purchased | +XX,XXX |
| Merchandise Available for Sale | \$XX,XXX |
| Less Ending Inventory | -XX,XXX |
| Cost of Goods Sold | \$XX,XXX |

Start with the beginning inventory, the inventory on hand on the first day of the period covered by the Profit and Loss Statement. Add the total of merchandise purchased during the period, less any items returned to the supplier. The resulting figure represents the merchandise that was available for sale. From this figure, subtract the ending inventory as of the last day of the period covered. The difference is the cost of goods sold. This cost can then be entered on the Profit and Loss Statement, Figure 4-1, above.

Notice the column on the far right of the statement titled "Percent." The various costs of doing business are expressed as a percentage of Sales in this column. The cost of goods sold in this example is 70 percent of sales. This means that 70 percent of sales dollars are eaten up by the cost of the merchandise.

Gross Profit on Sales

The gross profit on sales (or gross margin) in the preceding example is 30 percent. The gross profit on sales is found by subtracting the cost of goods sold from net sales. The percentage is computed by dividing the amount of gross profit on sales by the net sales figures.

Expenses

All business expenses are then recorded on the Profit and Loss Statement, totaled, and the total subtracted from the gross profit on sales. Expenses are often split into two categories to aid in identifying problem areas. One type may be categorized as operating expenses. These expenses generally vary with the level of sales. Sales commission expense, for example, varies relative to the volume of sales. The second expense category is often referred to as fixed (or overhead) expenses. Rental expense, for instance, stays the same from month to month, regardless of the level of sales.

The sample Profit and Loss Statement in Figure 4-1, contains common expense accounts. Wages expense includes all employee reimbursement and comes from the gross salaries account recorded in the Cash Disbursements Journal. Delivery expenses represents costs associated with delivering merchandise to customers. Freight costs associated with receiving merchandise are treated as part of the cost of the merchandise and not included in this category.

Bad debt allowance is an estimate of the amount of Accounts Receivable that will not be paid. While the exact amount that will turn out to be uncollectible cannot be determined in advance, reasonable estimates can be made based on past experience.

Communication expense refers to the various activities involved in conducting business communications--telephone, mail, and related expenses.

Depreciation

The expense item called Depreciation Allowance refers to an account established to recognize the cost of property in generating income. A delivery truck, for example, may be purchased at a cost of \$15,000. Because the truck will be used over a number of years, its cost should be spread over its useful life. This matches expenses with revenues. Because depreciation systems may change through Congressional legislation, always refer to the latest Publication 534 from the Internal Revenue Service.

What Can Be Depreciated

Depreciable property is property for which a depreciation deduction is allowed. Many different kinds of property can be depreciated, such as machinery, buildings, and equipment.

Property is depreciable if it meets these requirements:

- 1) It must be used in business or held for the production of income;
- 2) It must have a determinable life of longer than one year; and
- 3) It must be something that wears out, decays, gets used up, becomes obsolete, or loses value from natural causes.

In general, if property does not meet all three of these conditions it is not depreciable.

ACRS Method

ACRS (accelerated cost recovery system) is mandatory for most tangible depreciable assets placed in service after 1980. Other methods require you to make determinations on matters such as useful life and salvage value. Under ACRS, salvage value and useful life are not relevant.

ACRS allows you to recover the unadjusted basis of recovery property over a recovery period. Your property's recovery period is determined by its class life. Generally, the class life of property places it in a 3-year, 5-year, 10-year, 15-year, or 18-year class. A recovery percentage for each year of the recovery period is prescribed for figuring your ACRS deduction. The deduction is figured by multiplying your unadjusted basis in the property by the applicable recovery percentage. (For detailed information on ACRS see Internal Revenue Service Publication 534.)

Recovery Property

Recovery property is tangible, depreciable property that was placed in service after 1980 and that is not excluded property. It usually includes new or used property acquired after 1980 for use in trade or business or to be held for the production of income. Property acquired and used for any purpose before 1981 is not recovery property.

Unadjusted Basis

The ACRS deduction is figured by multiplying the unadjusted basis in recovery property by its applicable percentage for the year. Salvage value is disregarded under ACRS. The unadjusted basis may not be reduced by any salvage value when figuring deductions under ACRS.

Recovery Periods [NOTE: THERE HAVE BEEN IRS REVISIONS TO THIS SECTION]

Each item of recovery property is assigned to a class of property. These classes of recovery property establish the recovery periods over which the unadjusted basis of items in a class are recovered. The six classes with examples of inclusive property are:

- 1) 3-year property (automobile and light-duty trucks)
- 2) 5-year property (office furniture and fixtures)
- 3) 10-year property (manufactured homes)
- 4) 15-year real property (real property placed in service before March 16, 1984)
- 5) Low-income housing
- 6) 18-year real property (real property placed in service after March 15, 1984)

Classes of Recovery Property

The class to which an item of recovery property is assigned is determined in part by whether it is section 1245 or section 1250 class property.

Section 1245 class property is any depreciable property that is:

- 1) Tangible personal property;
- 2) A special purpose structure or storage facility that is also depreciable tangible property. A building or its structural components may not be included. The facility must be an integral part of a certain business activity, such as a research facility used in connection with this activity, or a bulk storage facility for replaceable commodities used in connection with this activity. Such an activity includes manufacturing, production, extraction, or the furnishing of transportation, communications, electrical, energy, gas, water, or sewage disposal services;
- 3) A single purpose agricultural (livestock) or horticultural structure;
- 4) Or a storage facility (other than a building or its structural components) used in connection with the distribution of petroleum or any primary product of petroleum.

Section 1250 class property is all depreciable real property not classified as section 1245 property or an elevator or an escalator.

Excluded Property

VACRS may not be used for certain property placed in service before 1981 but transferred after 1980. Property that does not come under ACRS must be depreciated under other methods of depreciation, such as straight line or declining balance. In addition, owners may elect to exclude certain property from the application of ACRS.

Election to Exclude Certain Property

If you depreciate property under a method of depreciation not based on a term of years, such as the unit-of-production method, you may elect to exclude that property from ACRS. A depreciation deduction under the unit-of-production method is figured by dividing the cost or other basis (less salvage) by the estimated number of units to be produced during the life of the asset. The resulting amount is applied to the units produced in a year to arrive at the depreciation for that year.

Dispositions

Gain or loss from an asset is usually recognized on its disposition or retirement. Nonrecognition rules may, however, allow the postponement of some gain. (See Internal Revenue Service Publication 544, "Sales and Other Dispositions of Assets".)

Other Depreciation Methods

Before ACRS was enacted, other methods were used to figure depreciation. If property was placed in service before 1981, or if the property does not qualify for ACRS, these methods must be used.

However, these methods may not be used for property that qualifies for ACRS. Because some states do not accept the ACRS method for state taxes, check with your state tax office to determine how to reconcile state requirements with the ACRS method now required by the Federal Government.

There are many different methods of figuring depreciation. Any method that is reasonable may be used if it is applied consistently. These methods, such as the straight-line method, the sum-of-the-years-digits methods, and the declining-balance method are not discussed here. They are described in numerous references, including SBA's Business Development Booklet SBMS No. 32, Financial Recordkeeping for Small Stores.

Remaining Expenses

Insurance expense includes the cost of various insurance policies. If an insurance policy premium is paid for a period exceeding the period covered by the Profit and Loss Statement, include only the portion paid for the statement period. The remaining portion of the paid premium becomes a temporary asset called Prepaid Insurance (or Prepaid Expenses) and would be recorded on the Balance Sheet.

Taxes and Licenses expense includes governmental fees, license fees, sales taxes, etc. It does not include tax on business income. Income tax is computed on the Net Income.

Advertising expense includes all costs associated with advertising the business. Again, prepaid advertising is not included as an expense, but treated as an asset and recorded on the Balance Sheet. Interest expense is the interest paid on any loans during the period covered by the statement. Other charges are a category used to record miscellaneous expenses that are incurred. Total expenses are derived by adding all the expenses listed on the statement.

Net profit can then be determined by subtracting total expenses from Gross Profit on Sales. Net profit can be thought of as operating income or profit earned on operations. Total Net Income is the sum of Net Profit and Other Income.

EVALUATING FINANCIAL STATEMENTS

There are a number of simple ratios that are calculated to determine the strength of a business. They are calculated from the Assets & Liabilities (Profit & Loss) Statement

CURRENT RATIO

- measure the ability of the company to pay current bills.

| | |
|-------------------------------|---|
| Current Ratio | |
| = Current Assets | |
| | Current Liabilities |
| Cash + Receivable + Inventory | = Accounts Payable + Short Term Borrowing |
| Typically between 1.0 and 2.0 | |

QUICK RATIO

- measure the ability to pay immediate obligations promptly without causing any disruption in the business.

| | |
|---|---|
| Quick Ratio | |
| = Current Assets - Inventory | |
| | Current Liabilities |
| Cash + Receivable | = Accounts Payable + Short Term Borrowing |
| As close as 1.0 as practical, not less than 0.5 | |

DEBT TO NET WORTH RATIO

- indicate the relationship between the business debt & the owner's equity. High ratios are not conducive to bank borrowing & often are a cause for loan refusal.

| | |
|---|----------------|
| Debt Ratio | |
| = Total Liability | |
| | Owner's Equity |
| Usually not higher than 3 to 5 in a small company | |

WORKING CAPITAL TURNOVER

- measures how efficiently the business is using its available assets

| | |
|---|---------------------------------|
| Turnover = Efficiency | |
| = Net Sales for Year | |
| | Average Current Assets for Year |
| Varies widely by industry and business; ask banker for a target | |

OPERATING RATIO

- measure the frequency of inventory turn-over. The higher the turnover, the better utilization is made of the money invested in inventory. Inventory includes the cost of warehousing & maintenance

| | |
|---|----------------------------|
| | |
| Operating Ratio | = Costs of Goods Sold |
| | Average Value of Inventory |
| Also varies widely by industry; ask banker for a target | |

MARKETING STRATEGY

MARKETING STRATEGY

The following modules have been designed to help you develop a marketing strategy as they relate to your business.

Make your choice by clicking on the key word in color.

- **Evaluate** your line of products or services to see how it meets the needs of your market.
- **Identify** that segment of the total market that is most likely to buy your product or service.
- **Determine** the best price at which you should sell your product or service.
- **Select** the marketing channel that is most suitable for your business.
- **Differentiate** among the various available advertising media with respect to cost, audience quality, and probable sales from each advertising dollar.
- **Understand** the principles of direct selling so that these principles can be applied to any aspect of your marketing message.

In only two years twenty million people visited the National Air and Space Museum in Washington, D. C. Sidewalk vendors do very well around the museum. With enormous traffic, the glittery trailers and hawkers' shouts of "Hot Dogs Here!" "Fresh Pizza!" "Cold Ice Cream" and "Hey, Souvenirs!" the vendors have combined locations, products, and customers for steady profits. This shows the simplest and the ultimate in marketing. All the elements of marketing are here--a plan, survey, product selection, pricing, location, advertising and it is still the basic transaction, person to person, often with hectic bargaining. Marketing is such an all inclusive concept.

As the operator of a small business, you can control some elements of marketing more closely than others. Obviously, if you are already in business, you have made basic decisions about what your product will be; you have established basic prices for your goods or services; and you probably have some ideas about how to promote your business.

Marketing involves not only making the initial decisions about each of the above elements, but also reviewing those decisions periodically to be sure that your business is operating as profitably as you had planned.

MARKETING STRATEGIES I

Your Product

What Is Your Product?

If you are now operating a business, you already have a basic idea of what your product is. Your selection of a business was based upon some prior experience with it--either an idea you had or a skill that you possessed. You wanted to go into business for yourself so that you could put your

ideas into practice and take advantage of the potential income that results from operating your own business.

Defining Your Product

When defining precisely what your product will be, whether goods or services, you must first evaluate the potential market in the area where your business will be located and then tailor your line of products to the needs of that area. For example, if you were planning to open a record shop in a predominantly student-populated neighborhood, you would want to find out whether those particular students listened to classical, jazz, hard rock, or other types of music. You would also want to know if most students preferred disc, cassette, or eight-track tapes. Would they need accessories such as phonograph cartridges or blank tapes?

Reevaluation and Change

Once the decision about your product or service line has been made, it must be constantly reevaluated. Use your sales and inventory records to determine which items sold quickly and returned a good profit. These same records can help you spot slow-moving or unpopular items so that you can remove them from your inventory and replace them with more profitable items.

You must also be able to anticipate changes in either your market or your product so that you can react to them to ensure your continued success. Changes can come in many forms. Your basic market can shift in character; for example, the neighborhood constituting the market area for a record shop can become older (or younger), causing the demand for certain types of music to change.

Your product itself can change due to technological advances, changes in fashion or taste, or changes in general economic conditions.

Competition

Competition can frequently alter your marketing decisions. To market any product or service effectively, you must know your competition and the advantages that they offer, as well as the advantages that you offer or the steps you must take to gain a competitive edge. Too often, people tend to look upon competition solely as a question of price. Yet a competitive edge often can be gained in other ways such as offering better customer service, a superior location, or more effective advertising. Marketing support activities such as credit availability, product service, warranty, customer advice, or a more attractive buying atmosphere can also help you gain a competitive edge.

Know Your Customer

"Beauty is in the eye of the beholder." This old adage can be applied to any characteristic of the product or service that you sell. The dress you sell is only beautiful if your customers think it is. The shoes you sell are comfortable only if your customers think they are. The storm windows you sell are economical only if your customers think they are.

Your own opinions, the opinions of experts, or sometimes even the facts are of secondary importance in selling your product or service. What the customer thinks is of primary importance. Certainly, facts or expert opinions can and should be used to influence your customers' thinking. But, in the final analysis, only their own thinking will determine what they buy.

Customer-Oriented Product Decisions

The easiest and most profitable products or services to sell are the ones your customers want to buy. Although their buying habits can be influenced through a manufacturer's advertising effort or your own persuasiveness, the surest path to marketing success is to identify your customers' needs and desires and shape your line of products or services accordingly.

1. The nature of your business should reflect primarily:

- your personal preferences
- the needs and desires of your customers

2. The most important element to consider in determining the products or services you offer is:

- nationwide fads and trends
- the needs and desires of your potential customers

MARKETING STRATEGIES II

Know Your Market

Few small businesses can sell to everyone. Most are limited by geography or capital to some portion of the total market. In order to develop and implement a marketing strategy, you must be able to identify that segment of the total market toward which you should direct your marketing effort. For example, a small corner grocery would not ordinarily try to attract business from the other side of town. Nor would a shop specializing in small children's apparel attempt to attract college students.

In some cases, the identity of the segment is fairly obvious. To the local retail or service establishment such as the drugstore, grocery store, dry cleaner, or service station, the market is almost every household in the local area, since almost everyone needs these products and services.

Market segments can be classified in a number of ways, such as age groups, income levels, or specific interests. A retailer of fine jewelry would be interested in the market segment comprised of the upper and upper-middle economic classes. A costume jeweler would direct its efforts toward the middle-income market segment. An audio equipment dealer might be interested primarily in the youth market, and a home furnishings store would be more interested in adults. A sporting goods shop would direct its efforts toward the athletically inclined, while the bookstore would seek the scholar.

Factors such as age, income, and special interests affect the demand for the products or services that you sell and the way you must try to sell them. People's buying needs and wants are influenced by a number of other factors as well, such as current fads, fashion trends, media publicity, advertising, and the opinions of friends and neighbors. Plan your product or service line so that it is geared to your market and keep abreast of those factors that cause your customers' tastes to change. You should keep abreast of all indicators of change such as:

- Changes in manufacturers' offerings.
- Views of opinion-makers in your industry.
- Opinions of influential media such as magazines, newspapers, radio, or television.
- The experience of businesses selling to a comparable market segment in other areas.
- The experience of your competitors.

The list could go on forever. The important factor to remember is that you must be able to identify the influences that shape thinking in your market segment and then keep informed about these influences so that you can adjust your line of products or services accordingly.

Your Marketing Strategy

In order to develop a marketing strategy, you must be able to clearly define the particular market to which you wish to appeal. You must know the customers to whom you want to sell and you must know how your product or service appeals to their particular wants. Will it sell because it is more economical? Or more attractive? Perhaps it is more reliable than the product or service your competition offers. Perhaps its quality is superior or it enhances the buyer's status or self-image.

1. List three factors which can define your market.
2. Which is usually the more successful approach to the selection of products or services to offer your market?
 - Offer those products or services that you prefer to sell.
 - Offer those products or services that your customers prefer to buy.

Competition

No aspect of marketing can ignore competition. Just as competition affects the price you charge for your product or service and the methods you choose to market it, competition also influences the line you will offer.

To protect yourself from competitors, you must stay a step ahead in every aspect of your marketing operation, including the selection of your product or service line. Frequently, this requires a further definition or review of what you are selling.

The record shop mentioned earlier must realize that it is in the recorded music business, not just the record business. The recorded music business includes cassettes, tapes, and cartridges. The "record" shop that failed to offer these items would soon lose business to competition.

Furthermore, the record shop must assess its competition in other areas. Perhaps some are offering stereo equipment or car stereo equipment which the shop might also consider offering its customers. Or perhaps competitors offer customers the opportunity to preview records before buying them. Some competitors may offer more personal service. And, of course, some competitors may simply offer lower prices.

Granted, competition cannot always be met in every way in which it is possible to compete, but the small business person must continually be aware of the competition and what it is doing so that

competition cannot get the upper hand. Your product or service lines can usually be tailored to provide a uniqueness which will appeal to the market you are trying to reach, whether or not that uniqueness is in product selection, service, price, location, or some other quality.

New Products or Services

There are times when, based upon your analysis of previous performance, industry trends, or market conditions, you will want to consider adding to or modifying the products or services you offer.

Market Tests

Since the ultimate test of the value of any new product or service is your market's reaction to it, you are usually well-advised to make some sort of market test before committing yourself to any major change in your line. For example, a women's dress shop may be interested in adding a higher priced designer group, a sporting goods store might be considering the addition of camping equipment, or a restaurant might be considering supplementing its basic "meat-and-potatoes" menu with quiche or crepes. In each case, a tryout for a predetermined period of time can give you an idea of the likely success of a major commitment.

Object of Market Test

One factor must be borne in mind, however, when conducting a market test of a new product or service. This is whether or not you expect the added line to create additional sales with your present customers or to attract new customers.

For example, if a fast food shop added salads to its basic hamburger menu, there may be little gain if this simply makes salad customers out of hamburger customers. In fact, it might even reduce the average check, resulting in a loss. However, if it causes hamburger customers to buy a salad also, or attracts new customers to the shop, it will probably prove to be a profitable addition.

Promotional Support

If the change in your product line is expected to increase sales among present customers, they must be aware that you are offering the additional product. In other words, your sales force must make the effort to suggest the new items to present customers as they purchase your current offerings. Also, announcements must be made, perhaps in the form of in-store signs, window displays, or even advertisements.

If a product innovation is expected to attract new customers, some form of promotional effort must accompany the introduction. Otherwise, the "new customers" will have no way of knowing that you are offering them the product and your effort will be wasted. While the cost of the promotional effort may exceed the profit potential of the market test, the knowledge gained can be rewarding in the long run. It will alert you to potentially profitable products while deterring you from investing in those that offer little hope of marketing success.

As discussed previously, a market test is generally conducted for a predetermined length of time. For instance, a sandwich shop may offer homemade soups for two months to see how well they are received. At the end of the two-month period, the sales checks can be analyzed to see if soup is being purchased in addition to a sandwich or instead of a sandwich. After this analysis, a decision can be made as to whether the addition of soup to the menu has increased profits

sufficiently to warrant becoming a permanent offering. Similar examinations of test results can be made for almost any product or service being considered.

1. New products or services should be offered:
 - only after careful research
 - because the competition has introduced them
 - because the business owner desires them

2. When conducting a market test, it is best to:
 - simply offer the product for sale
 - make some promotional effort in connection with the test

In marketing, trial and error is often the most practical decision making technique. The men's clothing store that stocks only blue shirts will never know the profit potential from other colors. In fact, the owner might think that blue is the only color men buy because blue is the only color the store ever sells! The easiest product to sell is the one that the public wants to buy. You will never know what they want to buy unless you give them a chance to buy it!

MARKETING STRATEGIES III

Your Price

Cost, Competition, Customer

Establishing prices involves three primary considerations. These are as follows:

- Your cost
- Your competition
- Your customer

Minimum Price

In normal circumstances, cost can be considered a minimum price. Certainly, when closing out a product line or reducing a surplus in inventory, you may temporarily sell below cost. But pricing below cost can never be a continuing formula for prosperity. Nor can selling at your cost be expected to make you prosperous.

Competitive Prices

If you cannot sell below cost, then how far above cost can you sell? This will be influenced by your competition. Perhaps your product has certain advantages that justify a higher price. Perhaps you plan to sell below competition to capture the largest possible share of the markets. But there is a delicate balance involved in selling below competition. Will the increased number of units sold result in enough additional profit to warrant cutting prices? And, will a lower price give your products an unfavorable image?

Customer Reaction

How will your customers react to prices higher than competition? Will they recognize the advantages of your product and pay the premium? Can they be persuaded by salespeople that your product is worth a little more? On the other hand, your product may be no better than that offered by competition. Nor can you point to any significant advantages in the product support that you offer such as service, delivery, or credit terms. How large a discount will be necessary to attract customers away from your competition? How much will it cost to tell the market that you sell for less?

Establishing a Price Floor

The first step in pricing is to determine your product cost, the floor below which prices cannot fall. All costs can be classified as variable or fixed (overhead). Variable costs are the out-of-pocket costs or costs of doing business that you incur with each unit of your product that you sell. They include the purchase price of goods acquired for resale, sales commissions, and any product preparation charges such as alterations or delivery costs.

Fixed costs are the costs of being in business. These costs include such items as rent, administrative salaries, equipment depreciation, and office expenses. They go on from month to month with little variation due to sales.

Consider a product that sells for \$1.00. You buy it for \$0.50, pay a \$0.06 commission on every sale, and incur delivery costs of \$0.04 on every sale. Each time you sell one unit you realize \$1.00 in revenue and incur \$0.60 ($\$0.50 + \$0.06 + \0.04) in out-of-pocket costs.

Each \$1.00 sale provides \$0.60 to pay your variable costs. The balance of \$0.40 ($\$1.00 - \0.60) contributes to covering your overhead and, once your overhead is covered, producing a profit.

Unit Contribution

The difference between the selling price and the variable cost can be called the unit contribution.

Unit Selling Price

- Unit Variable Cost

MARKETING STRATEGIES IV

PROMOTION

Promotion of your products or services involves two elements, both of which relate your selling effort to your market.

What is your product message? Describe your product or service so that your customers will recognize the benefits they can expect from purchasing it.

How will you deliver the message? Select marketing channels that will reach your audience. Advertise to a large audience through radio, television, or newspapers. Use merchandising activities such as displays and product support activities. Utilize direct face-to-face selling. Or do you consider your location alone sufficient to attract all the customers that you need?

Frequently, a combination of efforts is necessary for success. Through advertising, you attract a certain number of potential customers to your business. Once there, displays and merchandising aids heighten the customer's interest in buying. Finally, a salesperson takes the time to present and demonstrate your product to close the sale.

All marketing, from large-scale advertising to direct person-to-person contact, must be aimed at satisfying the purchaser's buying motives. Therefore, the buying motives of the audience you are trying to reach must be understood before you can select the product message and media channel which will best serve your needs.

Buying Motives

Why do people buy? Not so much for the sake of owning specific things, but to satisfy certain basic needs or wants. Some of these basic needs or wants are relatively simple, such as physiological needs -- clothing to keep warm, food to avoid hunger, or medicine to relieve pain.

People's buying motives are also determined by wants. A desire for comfort or an interest in styling will often dictate people's preference in furniture, cars, and clothing.

As a marketer, you must convince potential customers that your product or service meets their needs and wants and that it satisfies one or more of their buying motives. You can do this only by relating your product to their needs and wants, and by proving how it will satisfy their buying motives.

Product Features and Benefits

The product or service that you sell may have any number of features that appeal to your market. A feature is usually a specific product characteristic. A temperature control could be a feature of a clothes washer. A remote channel selector could be a feature of a television set. A 1,000 watt capacity could be a feature of a hair drier.

But what do these features mean to the buyer? How do they satisfy buying motives? With relatively simple products, the buyer is often familiar with the advantages that the features offer. In many other cases, you may have to explain how the features of your product satisfy the customer's buying motives.

Features Related to Buying Motives

Any description of features must be related to the prospect's buying motives. The temperature control of the washer provides protection for the owner's fabrics. The remote TV channel selector offers the convenience of channel changing without leaving your seat. The key words are protection and convenience--basic buying motives or benefits that people look for when they buy a wide variety of products or services, not just washers or television sets.

Suppose you sell insulated windows with flexible vinyl glazing. Mr. and Mrs. Wilson enter your store to look at insulated windows. They already know that insulated windows reduce heating costs because they have talked with other suppliers. Why should they buy yours instead of theirs? If you said, "Mr. and Mrs. Wilson, these windows have flexible vinyl glazing," their answer would probably be, "So what?", a shrug of the shoulders, or "What is the price?" Flexible vinyl glazing means nothing to the average customer.

As a seller, you must explain the advantages of the flexible vinyl glazing in terms that show Mr. and Mrs. Wilson the benefits that they would realize. If you explain, "Flexible vinyl glazing won't chip and will not require painting," the Wilsons will recognize how this will preserve the appearance of their windows and eliminate the cost and inconvenience of maintenance.

Complicated Products

In today's world, products are becoming increasingly complicated: to prompt a customer to buy, technical features must be explained in terms of the increased satisfaction that they will bring to the owner. If customers do not understand how advanced, sophisticated features provide them with specific benefits, the technology and cost of these features are wasted.

Selling at Premium Prices

If you are selling a product at a premium price, it is particularly important to explain your product in terms of the benefits that it offers the customer. This must hold true in advertising, promotional materials, or selling directly to a customer.

Direct Selling and Your Product Message

Although not all products or services are sold person-to-person, an understanding of the direct selling process is often useful in explaining the key elements of any successful marketing message.

Customizing Your Marketing Message

Direct selling is the ideal marketing situation. When you are face-to-face with a customer, you have an opportunity to find out which specific benefits are most important to the particular customer. Then you can explain how your product or service provides those benefits.

Not all prospects will be interested in all the benefits that your product offers. For example, your product may offer superior styling, quality, and convenience. If you know that a prospect doesn't care about styling, you would stress the quality and convenience features of your product.

Detailed Presentation

A direct selling situation lets you present your product or service in more detail than an advertisement. You have the prospect's attention and the time needed to explain your product thoroughly.

Naturally, direct selling does not apply to many products and services. Perhaps the price is too low to justify the time or the audience is too scattered and too numerous to permit talking with each individual customer. These customers can only be reached through advertising.

The selling principles of a successful direct selling effort are equally valid in shaping a message to larger audiences. Therefore, to understand the basics of the sales message, we will begin by analyzing the direct selling situation. Later we will relate these principles to developing the message for other marketing channels.

MARKETING STRATEGIES V

Media Selection

The principles of direct selling can guide your development of a marketing message. The selection of a suitable channel, or medium, for the message depends upon the nature of your market and the complexity of your message. The table below describes some of the key features of the various marketing channel that could be available for your product or service. Advertising has been broken down into two categories as follows:

- Media advertising such as radio, TV, newspapers, and magazines.
- Direct advertising such as mailings, handbills, and telephone solicitation. The third promotional channel, direct selling, has been included as a basis for comparison.

| | | | | |
|--------------------|-------------------|--------------------|--------------|----------|
| Media Advertising | Large, scattered | Brief, universal | \$2 - \$15 | 1% |
| Direct Advertising | Medium, selective | Intermediate | \$100-\$1000 | 1% - 10% |
| Direct Selling | Small, known | Detailed, specific | ? | 10% - ? |

Audience Comparison

Compare the three approaches briefly. The first column compares the audience. Media advertising, where the audience is scattered, is ordinarily most useful for products and services that are sold to the general public. In direct advertising, the advertiser has relatively limited control over a specific audience. For example, the audience for a radio commercial is limited to the show's listeners. With a direct mail or telephone campaign, the advertiser has greater selectivity. The mailer can be addressed to particular persons whose income, occupation, or special interests indicate a desire for the product or service. Finally, in the case of direct selling, the audience is usually known. The seller's only contact is with parties who have a known need or desire for the product or service.

Message Capability

The second column compares the message capability of each of the three types. Media advertising messages must be brief -- perhaps 30 seconds of broadcast time or a few inches of print. Even if more space and more time are available, there is a limit to how much the audience is willing to hear or read.

In a direct mail or telephone campaign, the selected audience is usually more interested in the particular product or service and has time available to digest a more detailed message.

Finally, in direct selling, the seller has the advantage of being able to make a detailed presentation of the product or service and address it specifically to the needs of a particular customer.

Cost

The third column describes the cost per thousand persons reached, generally referred to as the "CPM." For example, a newspaper advertisement that cost \$50 and reached 10,000 persons would have a CPM as follows:

- $CPM = \text{Cost divided by Thousands of Persons}$
- $CPM = \$50 \text{ divided by } 10$
- $CPM = \$5.00$

A direct mail campaign, with its more selective audience, would have a somewhat higher cost, perhaps \$100 to \$1,000 per thousand, as shown on the table (above). This would include the cost of mailer preparation, envelopes, postage, purchased mailing lists, and so on.

In direct selling, costs can vary widely. In fact, the sky is the limit! Perhaps a delivery driver is the salesperson. At each delivery point, the driver makes a quick sales presentation. The cost is virtually nothing. At the opposite extreme, when selling a high priced service or product to industrial or commercial accounts, transportation costs, living expenses, commissions, and salaries must all be considered. For a salesperson in New York to make a single call in Los Angeles, the cost could be \$500-\$600 or more.

Sales Return

The final column shows the expected sales return. For media advertising, less than 1% of the entire audience can be expected to buy. Frequently, even a small fraction of 1% will more than justify the cost of the advertisement. In a direct mail or telephone solicitation, a somewhat higher return is expected, perhaps 1-10%. In direct selling, where the cost of each call is higher, a somewhat higher rate of return must be expected, usually 10% or more.

Advertising Media

A wide variety of advertising media is available. Each has specific applications to various businesses. We will examine some and see how they apply to small businesses.

Television. The biggest and most expensive. A single network television spot can cost tens or even hundreds of thousands of dollars. Yet brief (10-30 seconds) spots on local television channels can often be a wise buy for certain small businesses.

Magazines. While the national news magazines are usually far outside the budget of small businesses, local magazines, regional editions of national magazines, and special interest magazines with relatively small circulations often fall within the budget capability of small businesses.

Evaluating Advertising Media

In evaluating any individual advertising medium, you will normally want to know three factors, as follows:

- Cost
- Audience size
- Audience quality

Each of these factors is closely interrelated. Let's take a closer look at what is meant by audience quality.

Audience Quality

To a seller, a quality audience consists of those people who are most likely to buy the product. It does not mean rich versus poor or educated versus uneducated. To the seller of janitorial supplies, a magazine with a high percentage of janitors among its readers is a quality magazine. Why bother with magazines that reach polo players, yachtspersons, or gourmets? Conversely, the furrier would have little interest in advertising in a janitors' magazine.

The question to ask in evaluating the quality of a particular medium is whether or not its audience is representative of your market. The local suburban weekly may have a higher cost per thousand readers than the metropolitan daily, yet offer a higher quality audience for the local retailer. The suburb, not the entire metropolitan area, is the retailer's primary market.

To the seller of blue jeans, the local rock station offers a higher quality audience than the adult-oriented radio news show, regardless of relative audience size or audience income.

Audience Demographics

In selecting an advertising medium, it is frequently wise to examine the demographics of the audience. The demographics are an analysis of the audience according to social and economic factors. For example, the table below shows the demographics for two radio stations serving the same geographic area.

| DEMOGRAPHIC TABLE | | |
|--------------------------|-----------|-----------|
| | Station A | Station B |
| Age | | |
| Under 18 | 43% | 6% |
| 18-25 | 27% | 7% |
| 26-35 | 13% | 23% |
| 36-50 | 8% | 42% |
| Over 50 | 9% | 22% |
| Income | | |
| \$0 - \$5,000 | 64% | 5% |
| \$5,001 - \$10,000 | 16% | 8% |
| \$10,001 - \$20,000 | 11% | 27% |
| Over \$20,000 | 9% | 60% |
| Education | | |
| High School Graduate | 42% | 12% |
| College Graduate | 12% | 65% |
| Graduate School | 3% | 23% |
| Occupation | | |
| Student | 15% | 5% |
| Unemployed (non—student) | 10% | 1% |
| Clerical | 7% | 8% |
| Skilled | 8% | 7% |
| Unskilled | 6% | 7% |
| Technical | 7% | 27% |
| Managerial | 6% | 26% |
| Professional | 5% | 19% |
| Sex | | |
| Male | 46% | 73% |
| Female | 54% | 27% |

The audience of station A is considerably younger, has a lower income, less education, and fewer job skills than audience B. Nevertheless, the more youthful audience A might be a higher quality audience for certain products such as records, contemporary clothing, or fast foods.

To the seller of higher priced items such as expensive automobiles, home furnishings, or real estate, audience B would be far more interesting.

Effective CPM

In measuring the cost per thousand of a particular advertising medium, you are usually better advised to determine an effective CPM--in other words, the cost per thousand people reached who are representative of your target population.

The Direct Mail Message

The direct mail message may be brief or somewhat detailed. In the simplest case, with a mailer similar to a handbill, preparation costs may be no more than a few cents each. The piece could be self-sealing so that there is no need for an envelope. Addressing costs could be three or four cents each and postage, using lower mail classes, can be reduced to pennies.

MARKETING STRATEGIES VI

Three Major Steps

A direct selling situation usually consists of three major steps as follows:

Qualifying the prospect. Determining the prospect's needs and wants so that you can then explain your product or service in terms that will show how its features provide those benefits.

Presenting the product. Describing your product and its features in terms of the benefits that the prospect seeks.

Closing the sale. Securing the prospect's commitment to buy your product or service.

Qualifying

In the first step, qualifying the prospect, you want to learn why the prospect needs or wants your product or service.

Perhaps you sell sewing machines. A prospect has seen your ad for a low-priced model and has arrived at your shop. Naturally, you have a variety of models and you want to find out which model is best suited to the customer's needs. By simply taking the order for the lowest priced model, you might be doing a disservice to both yourself and the customer. If the customer simply wants a machine to hem dresses or patch jeans, perhaps the lowest priced model is entirely adequate. If the customer plans to make clothing for a family, a higher priced machine might be better suited to the customer and more profitable for you.

Asking Questions

How can you find out which machine is best suited to the customer's needs? By asking questions such as:

- "How do you plan to use the machine?"
- "How often do you sew?"
- "What types of sewing do you do?"

These questions help you learn more about the customer's needs and wants.

Indirect Questions

Qualifying questions should be indirect questions, usually beginning with words such as *Why*, *What*, *When*, and *How*. These questions usually cannot be answered with a simple "Yes" or "No." They require more complete answers that reveal buying motives.

You can learn about your customer by asking about competition. This is particularly helpful when selling high-ticket consumer goods or when selling to commercial and industrial customers.

If a person is buying a replacement for something he already owns, you can ask questions about the product he now owns. "What kind of refrigerator do you now own, Mr. Baker?" When Mr. Baker tells you that he now owns an Electromat X99, you might ask other questions such as:

- "Is that the 12 cubic foot or 15 cubic foot model?"
- "Is it equipped with automatic defrost?"
- "Does it have automatic ice-making?"

The answers to these questions will help you lead into such features of your more expensive refrigerators as larger capacity, automatic defrost, and an automatic ice-maker.

Presentation

The second step in direct selling is presenting the product. An effective presentation often depends upon the information received in the first stage, qualifying the prospect. This permits you to explain the features of your product, and its advantages, so that your prospect clearly understands its benefits. Qualifying information lets you direct your explanation to those specific benefits in which the particular prospect has expressed an interest.

Transition to the Close

The presentation is followed by the primary objective--closing the sale. This is most effective if introduced as a smooth transition from the presentation. Sometimes it's easy. The prospect, absolutely convinced of the advantages of the product and the benefits that it offers, will come right out and buy it. More frequently, it's up to the salesperson to bring up the closing question.

Trial Closes

An easy way to do this is through trial closes. A trial close is a question that is asked to determine the prospect's readiness to buy. The following is an example of such a question:

- "Are you satisfied that our product will help you reduce your maintenance costs?"

If the answer is negative, you can reemphasize how your product reduces maintenance costs or you can ask the prospect to be more specific about the cause of his or her doubt.

Seeking Agreement

If the prospect agrees with the salesperson on a series of points, it becomes difficult to say no when the salesperson asks for the order. However, the prospect who disagrees on a number of points will probably defend this position by also saying no when the salesperson asks for the order.

The salesperson should seek agreement on a number of points such as:

- "Don't you think the self-defrosting feature of this refrigerator is a real convenience, Mr. Baker?"
- "You probably need a larger refrigerator than your present one, don't you?"

The salesperson probably knows the points to which the prospect will agree. The idea is to summarize them and ask them consecutively to establish a pattern of agreement, one that will make it difficult for the prospect to say no when the salesperson asks for the order.

Benefit Summary

Another effective transition is a statement that summarizes product benefits, such as the following:

Ms. Perkins, I think you'll find that the Brand X washer has everything you're looking for. A partial load cycle saves you water, energy, and money. Temperature controls protect your fabrics. And Brand X's reputation for quality assures you that this machine will operate dependably for a long time with little or no maintenance."

Closing the Sale

Now let us look at the most vital factor in the selling process--closing the sale. All previous steps have been taken with one purpose in mind--to close the sale, to get the prospect to buy.

Unfortunately, many salespeople fall apart at this stage. The salesperson is afraid that a negative response will end communication with the prospect forever. Having maintained a sociable communications level up to this point, the salesperson resists the possibility of rejection. This is a perfectly natural reaction for many people.

Various Techniques

A variety of techniques can be used to close the sale. The best approach often depends upon the salesperson's individual selling style, the prospect, the product or service that is offered, and the salesperson's earlier success in convincing the prospect of the advantages of the product and the benefits that it offers.

Direct Close

The direct close assumes that the prospect is ready to buy. In closing, the salesperson asks a direct question such as the following:

- "We can deliver your sofa next week. What is the address that we should ship to?"
- "You want this in green, don't you?"
- "Will this be cash or a charge?"
- "Would you like to put this on a budget plan?"

Assumptive Close

The assumptive close is a modification of the direct close. The salesperson assumes that the prospect is ready to buy, but asks less direct questions, such as:

- "Which color do you prefer, red or green?"
- "Which model do you prefer, the standard or the deluxe?"
- "Have you decided where you would like the machine installed?"
- "Shall I call an electrician to arrange the installation?"

Dealing with Delay

Not all closing attempts are immediately successful. The prospect may delay, unable to make a decision. If so, the salesperson should ask the reason for the delay. The reason will often help the salesperson plan the next course of action in reestablishing the presentation of the product or service.

For example, the prospect might say: "I think I'll stick with my present machine a while longer." If you properly qualified the prospect earlier, you might respond: "But didn't you say that repair costs were running awfully high? Isn't it worth a few dollars to know that you will save on maintenance costs, and not have to worry about a breakdown at a critical time?"

Dealing with Objections

A prospect may express some objection, real or imaginary, to your product. An objection should never be considered a barrier to a sale. Once you know about it, it is no longer a barrier, simply a hurdle that must be cleared.

A prospect may say, "Your price is too high." First of all, try to find out how much too high. Perhaps it can be reduced. Or, the objection might be a signal to reemphasize more features of the product that offset any apparent price disadvantage.

Open-ended Close

In the open-ended close, the salesperson asks open-ended questions that imply readiness to buy, such as:

- "How soon will you need the sofa?"
- "When should I arrange for installation?"

The prospect's answer to these questions leads to an easy close. If the prospect needs the sofa in three weeks, the salesperson can respond, "Then I'll need an order right away, to assure you of delivery on time."

Action Close

The salesperson takes some positive step toward clinching the order, such as:

- "I'll write up the order right now and as soon as you sign it, we can deliver."
- "I'll call the warehouse and see if they can ship immediately."

Urgency Close

The salesperson advises the prospect of some compelling reason for ordering immediately.

- "That's a pretty tight schedule. I'll have to get an answer from you very quickly if we are going to be able to meet it."
- "That item has been very popular and right now our inventory is running pretty low."
- "Our special price on this product ends the 15th of the month."

Choosing the Closing Technique

The choice of closing techniques will depend upon you, your selling style, your customer, and the facts. Regardless of the technique that you choose for your business, the most important thing to remember is that you pursue some closing technique and don't avoid this critical step.

Developing Selling Skills

Some people seem to be born with natural powers of persuasion. At an early age, they can easily convince a person of the value of some product or service. However, not all people have these inherent skills.

These skills must be developed, and the way to develop them is through the use of a logical, well-considered, planned selling system of qualifying, presenting, and closing.

These skills can be learned. With planning, practice, and diligent pursuit, almost anyone can sell.

The ability to sell is particularly critical in small businesses where the owner is often called upon to conduct the entire selling effort personally. Even if the owner does not sell personally, the sales force must be trained, supervised, and directed.

Selling Skills and Other Marketing Techniques

Any marketing technique that you use must incorporate many of the same selling concepts that were explained in the direct selling situation.

Consider how the basic principles of qualifying and product presentation apply to the development of an advertising message. You cannot qualify the prospect directly by asking questions--unless you can afford a costly marketing research effort. Instead, you must make certain qualifying assumptions about your prospects. What are their needs and wants? What benefits do they seek?

These answers then determine the benefits that you will stress in your product message. The message must explain your product in terms of these benefits.

- "Our insulation will save you money."
- "Won-Kote latex paint is easy to apply and lasts longer."
- "Our trained technicians will repair your television set and back it up with a 12-month warranty to put an end to your maintenance worries."

Closing

An advertising message seldom has a specific "close," but it should have an objective. This objective should be expressed in terms that incorporate the concepts of the closing techniques of a direct selling situation.

- "Don't you owe it to yourself to look at our new line of washers before your present one fails?"
- "Buy now while the special price offer lasts."
- "Call today for a free estimate, before winter sets in. Our estimator will show you how much you can save with all-weather insulation protection."