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## **THE ENTREPRENEURIAL EXECUTIVE**

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## THE ENTREPRENEURIAL EXECUTIVE

### CONTENTS

LETTER FROM THE EDITOR .....	vi
LETTER FROM THE PUBLISHERS .....	vii
BUSINESS TACTICS FOR CONFRONTING ECONOMIC RECESSION AND PLANNING FOR RECOVERY .....	1
John A. Pearce II, Villanova University	
Richard B. Robinson, Jr., University of South Carolina	
RELATIONSHIPS BETWEEN COMMUNICATION STYLE AND LEADER-MEMBER EXCHANGE: AN ISSUE FOR THE ENTREPRENEUR .....	17
Augusta C. Yrle, University of New Orleans	
Sandra J. Hartman, University of New Orleans	
William P. Galle, Jr., University of New Orleans	
THE MOST IMPORTANT FINANCE SKILLS FOR ENTREPRENEURS: DIFFERING VIEWS AMONG FINANCE PROFESSIONALS .....	35
Greg Roth, University of Portland	
Brooke R. Envick, St. Mary's University	
Robin Anderson, University of Portland	

---

BOON OR BANE? IMPACT OF THE DIGITAL AGE ON SMALL BUSINESS EXPORTING .....	45
B. Elango, Illinois State University	
J. Donald Jones, Baruch College	
ENTREPRENEURIAL LEADERSHIP STYLES: WHAT WORKS AND WHAT DOESN'T .....	63
C. W. Von Bergen, Southeastern Oklahoma State University	
Barlow Soper, Louisiana Tech University	
POSTMODERNISM: STRATEGIC IMPLICATIONS FOR ENTREPRENEURS .....	79
Carl Obermiller, Seattle University	
RISK MANAGEMENT FOR SMALL BUSINESS .....	95
Jack L. Howard, Illinois State University	
I.M. Jawahar, Illinois State University	
THE SUPPLEMENTARY ROLE OF SMALL BUSINESSES IN THE TRAVEL AND TOURISM TRADES .....	115
Myron J. Leonard, Western Carolina University	
Ruth A. Clotey, Barry University	

## LETTER FROM THE EDITOR

Welcome to the *Entrepreneurial Executive*. I am confident that this volume continues our practice of bringing you interesting, insightful and useful articles by entrepreneurs and scholars.

The *EE* is an official journal of the Academy of Entrepreneurship®, a non-profit association of scholars and practitioners whose purpose is to advance the knowledge, understanding, and teaching of entrepreneurship throughout the world. It is my objective to expand the role of the *EE*, and to broaden its outreach. We are interested in publishing articles of practical interest to entrepreneurs and entrepreneurial scholars, alike. Consequently, we solicit manuscripts from both groups.

The *Entrepreneurial Executive* is funded by the proceeds of membership dues and conference registration fees at Academy of Entrepreneurship® and Allied Academies meetings. We do not receive funding support from any university or agency. We encourage readers to become members of the Academy and to attend conference meetings in the spring and the fall. Upcoming conferences are announced on the Allied Academies home page: [www.alliedacademies.org](http://www.alliedacademies.org), as well as information about the organization, its affiliates and its journals. In addition, instructions for submitting manuscripts are displayed on the home page.

I am interested in recruiting Editorial Board members and in soliciting manuscript contributions and conference participation from a broad cross section of people interested in entrepreneurship. If you would like to become a member, contribute a manuscript, come to a conference, or just chat about the *journal*, please feel free to call, fax or e-mail me at any time.

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## LETTER FROM THE PUBLISHERS

We are extremely pleased to present Volume 7 of the *EE*. The Academy of Entrepreneurship® is an affiliate of the Allied Academies, Inc., a non profit association of scholars whose purpose is to encourage and support the advancement and exchange of knowledge, understanding and teaching throughout the world. The *EE* is a principal vehicle for achieving the objectives of the organization. The editorial mission of this journal is to advance the knowledge, understanding, and practice of entrepreneurship throughout the world. To that end, the journal publishes high quality manuscripts, which are of practical value to entrepreneurship researchers and practitioners.

As publishers, we intend to foster a supportive, mentoring effort on the part of the Editor and the referees which will result in encouraging and supporting writers. We welcome different viewpoints because in differences we find learning; in differences we develop understanding; in differences we gain knowledge and in differences we develop the discipline into a more comprehensive, less esoteric, and dynamic metier.

The Editorial Policy, background and history of the organization, and calls for conferences are published on our web site. In addition, we keep the web site updated with the latest activities of the organization. Please visit our site and know that we welcome hearing from you at any time.

JoAnn and Jim Carland  
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## ARTICLES



# **BUSINESS TACTICS FOR CONFRONTING ECONOMIC RECESSION AND PLANNING FOR RECOVERY**

**John A. Pearce II, Villanova University**  
**Richard B. Robinson, Jr., University of South Carolina**

## **ABSTRACT**

*A primary economic indicator declared that the US was in recession as of February 2001. Managers' responses during this downturn should be influenced by the cyclical nature of their industry and by the extent to which the roll of the recession is effecting their competitive environments. Depending on their situation, managers may find value in seven success tactics that benefited adopters during the decline phase of the last recession. They may also wish to take advantages of recovery tactics that can help to position their firms for the end of the recession when new competitive dynamics come into play. This article explores the logic of these tactics and provides prominent examples drawn from corporate successes.*

## **THE UNITED STATES IS IN A MANUFACTURING RECESSION**

Of the three major indicators of a recession, the first to reflect a downturn in the economy is monthly index of the National Association of Purchasing Management. A precursor to the more encompassing measures of the Gross National Product and the Leading Economic Indicators, the index recorded its thirteenth consecutive sub-50 monthly report in September 2001; the NAPM defines as its recessionary threshold as two consecutive sub-50 months.

Because the manufacturing sector constitutes about 20% of the overall economy, the numbers indicate that its weakness is so severe that it can pull the national economy into a downturn. Other economic signs suggest that a severe downturn, if not a nationwide recession, has arrived. US worker productivity, a measure of living standards, fell at an annual rate

of 0.3% in the second quarter of 2001, after showing the biggest drop in eight years in the first quarter. Unit labor costs jumped 6.3% for the quarter, the biggest increase since 1990. Factory orders declined in the first two quarters of 2001, unemployment levels reached a nine-year high, and the overall economy is growing at an anemic rate of only 1.2%. April 2001 also marked three quarters of consecutive declines in corporate profits, the longest stretch since the Asian currency crisis of 1997-1998. With the economy of the US slowed further by the terrorist attack of September 11, 2001, recession seems even more likely.

This article looks at recent recessions in an attempt to identify the tactics that executives have used - often in emerging entrepreneurial companies - to minimize negative impacts on their firms' performances. This topic is important because entrepreneurs have the same needs to forecast the future direction of the economy as do executives of larger firms, but they characteristically lack the resources to undertake extensive monitoring and interpretation of economic trends. Unable to afford specialized in-house economic talent, entrepreneurial executives often need to do their own economic forecasting. The insights presented in this article are intended to provide these entrepreneurs with research and experience based information that can improve their ability to cope with economic downturns.

We begin with an overview of how downturns affect industries, before turning to eight tactics that have reduced the severity of the decline phase of a recessionary period on business profitability. The focus then turns to success tactics that have directed some highly successful company turnarounds during the recovery phase of the economy. The paper concludes with guidelines for entrepreneurial executives to consider in preparing for economic downturns.

### **HOW VULNERABLE IS AN INDUSTRY?**

A recession does not arrive at every location throughout the country at the same time. In fact, some locations often go largely unaffected. Similarly, some industries are hit first; others are hit harder. Therefore, even when national statistics show that a broad-based slowdown is occurring, entrepreneurial executives need to assess the extent to which their own industry is affected. The principal predictor of likely impact is the cyclicity of the industry.

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## Cyclical Industries

The performance of a cyclical industry coincides with the phases of the business cycle. Therefore, in a recession a cyclical industry is characterized by stable or falling prices, a decrease in corporate spending, a decline in real earnings, excess production capabilities, and high unemployment. The economy produces less than its capacity. Examples of cyclical industries include jewelry and precious metals, automakers, apparel and other textile products, red meat, paper and paperboard mills, computer manufacturing, homebuilders, real estate sales, hotels, airlines, media, and electronics.

In the 1990-1991 recession, automobile manufacturers and the suppliers that served them were among the hardest hit. Net income slipped 78% at Ford and 81% at Chrysler. To minimize losses, the carmakers reduced costs by closing plants, squeezing suppliers, and using special discounts to entice buyers.

Another major recession victim was the real estate industry, and as a result, the commercial banking industry. Real estate lending was the biggest single category of business for commercial banks and became the major source of financial weakness for the banking industry during the recession. Comprising approximately 25% of the industry's loans, the commercial real estate market became the largest problem-loan category in banking history.

Major airlines also suffered from the decrease in consumer spending and turned to price wars to maintain passenger volume. In early 1991, American Airlines cut fares on all of its routes, both domestic and foreign, escalating a round of discounts in the industry designed to lure travelers back into the air after months of slow traffic due to the recession and the Persian Gulf War. Delta air followed suit by cutting one-way and round-trip fares for business travelers. United Airlines also began offering coupons good for discounts on designated flights.

Despite a recession, some cyclical firms can increase their sales. These firms entice buyers by using discounts, or offering limited services for a reduced price. For example, although the U.S. hotel industry lost 2.7 billion in 1991, there were many hotel success stories, particularly among limited service hotels, defined as those without restaurants (Faust, 1992).

### **Counter-Cyclical Industries**

An industry that typically does well during a recession is a counter-cyclical industry. It is characterized by an increase in earnings, a rise in employment, an increase in consumer spending, and full utilization of its production facilities. Counter-cyclical industries typically perform well in a recession because they provide the consumer with cost savings on a necessity product. Therefore, generic products and discount warehouses improve their profit performance as consumers seek to save money on necessary purchases.

### **Noncyclical Industries**

A noncyclical industry does not follow any cycle. Its performance is unrelated to the state of the economy. During a recession, consumers will continue their expenditures on necessity products such as food and health care. In fact, health-care and drug companies claimed four of the top 10 spots on the American Stock Exchange at the trough of the 1990-1991 recession (Cowan, 1991). Many health-care products are unaffected by a recession because of consumers' insensitivity to the cost of their care, the aging U.S. population, and consumers' concern for being health conscious.

The farming industry is another prime example of a noncyclical industry. While consumers cut spending, industrial production slid, and jobs disappeared during the 1990-1991 recession, the nation's farmers for the most part remained unharmed. The recession's major impact on farmers was the beneficial lowering of interest rates.

Other noncyclical industries that tend to perform well during a recession include accounting, auditing, and bookkeeping services and soap, cleaners, and toilet goods. Overall, recent experience suggests that consumers are willing to continue spending on services while cutting back on purchases of products. As evidence, GDP for services increased during every quarter of the last recession.

The military defense industry also eased through the recession. Government spending on military defense increased from \$312.7 billion in the second quarter of 1990 to \$332.3 billion in the first quarter of 1991. This

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industry is characterized by long-term contracts that guarantee spending by agencies of the government.

### **Regional Impacts**

Only partially related to the concentration of industries in an area, experience has shown that geographic regions of the country vary in the extent to which they are recession sensitive. For example, a strong regional impact of the last recession was apparent. Nearly 64% of the overall 1990 increase in business failures was attributable to the states along the Eastern Seaboard in the New England, Middle Atlantic and South Atlantic regions. Then, during the first half of 1991, bankruptcies in the Pacific states jumped 75%. Following a 14% increase in California in 1990, failures rose 67% in the first six months of 1991 (Duncan, 1991).

### **Recessions Roll**

Recessions tend to work their way through an economy, from one region to another and from one industry to another. During the first six months of 1991, every major industry group reported increases in business failures, compared with the same period in 1990 - but the industry declines had different starting points, different rates of decline, and different recovery patterns. Bankruptcies of firms drove the surge in retail and service failures across the United States mainly providing services to businesses. In addition, failures in the finance, insurance and real estate sectors soared. The depressed real estate market combined with the impact of the Savings and Loan crisis to sharply increase the failures in these industries throughout the United States. In turn, the depressed real estate and finance industries continued to drag down the construction industry in most regions (Duncan, 1991).

As the 1990-1991 recession progressed, a disproportionately large share of workers were displaced in goods producing sectors, and these layoffs were more widespread across industries than in earlier recessions. The four industries with the highest displacement were goods producing, mining, construction, and manufacturing. In the service industry, retail and wholesale had the highest rate of displacement, while workers in the service industries were least likely to lose their jobs. The greatest increase in

displacement between was among executives and managers, technicians, mechanics and construction trade workers. However, blue-collar occupations still had the highest proportion of displaced employees (Gardner, 1993).

### **SUCCESS TACTICS DURING ECONOMIC DECLINE**

Having roughly determined the extent to which their firm is vulnerable to recessionary impacts, given the cyclical nature of its industry, the economic health of its region, and the vitality of its suppliers and customers, entrepreneurial executives will want to consider eight tactics that improved strategic viability for businesses in the last recession. These success tactics include retrenchment, tightening credit, maintaining budgets, maintaining prices, increasing liquidity, reducing debt, deferring capital expenditures, and pursuing selective growth.

#### **Retrenchment**

The main goal of retrenchment is to stabilize a company's financially during the economic downturn so that it can be in position to recover from the recession. As a companion action, retrenching companies turn to entrepreneurial activities that increase revenues or to efficiency initiatives that reduce operating expenses and increase profit margins. Retrenchment tactics are often the front half of a cut-and-build strategy in which the company cuts certain expenses and invests the savings in new priorities (Pearce & Robbins, 1993).

Retrenchment through cost and asset reduction proved to be a successful tactic that stemmed the decline of many firms in the 1990-1991 recession. Cost reductions included leasing rather than purchasing space, eliminating elaborate promotional activities, laying off employees, and eliminating perks like company cars. A retailer that successfully reduced costs to increased profits was Walgreen, the drug store chain. During the recession, Walgreen's management trimmed selling, general, and administrative expenses from 23.3% of sales in 1990 to 22.2% in 1991, helping to increase net income 10% in 1991 (Byrne, 1991).

The recession-exposed operational weaknesses in the publishing industry provide a second example. Publishing companies used the 1990-1991 recession to trim their operating costs and focus their corporate

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strategies to emerge as stronger businesses. When interest rates dropped in 1992, publishers realigned capital resources by refinancing debt at lower rates or extending debt over a longer time.

Asset reductions can involve selling nonessential outlets and equipment. Dress Barn, a retail women's clothing company, implemented asset reduction by eliminating 22 of its smaller stores at the onset of the recession. The stores were chosen because they could not generate sufficient income to support corporate overhead. As a result of the cutbacks and the reconfiguration of its resources, Dress Barn was able to post a 10% sales increase during the first half of 1992 (Wyatt, 1992).

### **Tightening Credit**

During the recession of 1990-1991, entrepreneurial executives found that an effective tactic to minimize the effects of the downturn was to tightened rather than loosened credit policies. The entrepreneurs believed that loosening credit might boost sales, but they come at the expense of liquidity if the debt sours. They modified their target markets, and increased their segmentation efforts as ways to escape recessionary declines. The more focused the appeal of their product, the less likely the companies thought that general downturns hurt them. Managers also reported altering the marketing budget, using more sales promotion, but not increasing advertising. Labor force reductions occurred, with 50% of managers reporting some layoffs, and 16% experiencing larger reductions (Shama, 1993).

Tightening credit policies is a way to increase a firm's liquidity during a downturn. Increased liquidity, especially in recession, can enable the firm to take advantage of special deals that may occur due to recessionary effects on less prepared competitors or suppliers. Other ways to increase liquidity are to sell excess inventories, and closely examine the productivity of each employee. Labor force reductions reduce costs and expenses, increasing liquidity.

### **Maintaining Advertising Budgets**

When faced with recession, companies are tempted to reduce advertising expenditures. Reduction in such expenses is immediately reflected in an increase in the bottom line of the company. However, other

entrepreneurs have found that recessions are good times to maintain advertising budgets (Mooney, 1991).

A recession study by the Strategic Planning Institute concluded that the companies that fared best in the two years after recessions had either held steady in advertising expenditures, or made moderate cuts during the recession (McLaughlin, 1990). The study found that advertising campaigns may be more effective during recessions because industry competitors are also feeling the pinch of recession, and may attempt to forestall losses by reducing their advertising. Thus, even by maintaining a constant level, a firm can increase its exposure due to the attrition of competing ads. Because competitors are "quieter" during a recession, a company's advertising stands out.

In addition, hungry ad agencies are motivated to turn out a more creative product at a more competitive price (Jacob, 1992). Thus, when many competitors reduced advertising budgets, toiletries maker Alberto-Culver increased its ad spending. Partly as a result, company profits were up more than 35% in 1992.

When advertising budgets must be cut, marketers often shift spending to short-term promotions such as coupons to boost sales of key brands at the expense of marginal products. Mattel stepped back from vigorous product development to concentrate on the its historically big moneymakers, Barbie dolls and Hot Wheels. Fewer new toys were developed and new products survived only when they showed quick success.

Employing the same focus tactic, but reversing the deployment logic, DowBrands stopped advertising its established Glass Cleaner so it could shift funds to help launch its new line of Ziploc freezer bags.

### **Maintaining Prices**

The temptation to cut prices to increase sales is tremendous. Budget conscientious consumers spend with increased reluctance during a recession and price considerations tend to overshadow attention to innovative features. But price-cutting can be shortsighted. Budgets are based on projected revenue. Reduced pricing may help to stabilize the number of units sold but if spending plans are not adjusted, profit margins can quickly turn negative. Failure to update the impacts of sales forecasts on margins is a major factor in business bankruptcy during recession (Garter, 1991). Additionally, when



prices fall during recession, consumers become less willing to return to higher price levels during the economic recovery ("Preparing," 1988). Instead of cutting prices immediately to maintain sales during the last recession, many managers found that prices should be reduced only as a last attempt to maintain cash flow.

### **Increasing Liquidity**

The liquidity and flexibility of a company are increased when inventory levels and accounts receivables are reduced. Liquidity provides staying power in a recession. High cash and cash equivalents can be a source of expansion funds for fixed assets acquisitions as the recovery absorbs excess capacity. Calculating current ratios and comparing them with ratios calculated for other recent periods measures successful implementation of this approach.

### **Reducing Debt**

Lower debt can reduce cash demands through smaller interest payments. Like reducing inventory and accounts receivable, reducing debt increases liquidity and helps provide flexibility and increased staying power. However, lowering debt decreases cash and thus, the company's flexibility. Lines of credit can also be revoked when paid-off, at times because of the bank's portfolio of loans rather than the condition of the company.

### **Deferring Capital Expenditures**

Reducing capital expenditures increases both available cash and the productivity of existing investment. Delaying capital expenditures enables the firm to get more from its existing facilities at a time when consumers may be more concerned with price than technological innovation. However, a potential disadvantage of delaying investment is that suppliers might not be able to furnish new equipment in a timely manner to allow entrepreneurs to take advantage of the recovery. The resulting delays in production can frustrate the company's clients and prompt them to go elsewhere.

### **Pursuing Selective Growth**

The risks associated with activating an aggressive growth strategy during a recession are high if the financial reserves of a firm are limited and its cash flow position is strained. On the other hand, the cost of pursuing selective new opportunities is low since many competitors are "sitting in wait" for an economic recovery. Entrepreneurial executives want to consider taking advantage of opportunities that arise or can be created by a recession:

1.	Exploit competitors' problems. Economic downturns make many opportunities available. Many valuable employees are laid off or become disenchanted during a recession.
2.	Focus on long term goals. Take advantage of favorable interest rates. Refinancing existing debt or take on new low-priced debt when the recession seems to have bottomed out.
3.	Buy inimitable assets when they become available. Recessions can produce once-in-a-career opportunities to buy key property, buildings or patents that would otherwise be unavailable.

### **SUCCESS TACTICS DURING ECONOMIC RECOVERY**

Following a recession, many businesses achieve impressive labor productivity improvements. During the recovery in 1991, increased productivity by firms led to a 75% gain in gross domestic product (GDP). In previous recessions, productivity improvements on average brought a 58% GDP increase in the year following the recession. These productivity gains led the way for corporate profits from U.S. production to increase by a third during the most recent recovery, from \$300 billion in 1992 to \$400 billion in 1993. When demand rebounds, businesses can boost productivity in the short term without hiring new workers. However, unless the rate of innovation accelerates, productivity growth eventually returns to its lower long-term trend. The experiences of a business following the 1990-1991 recession

suggest that entrepreneurial executives can accelerate their firms' recovery by taking steps that improve productivity.

### **Philosophy for Recovery**

The most important idea behind recovery planning is that even when conditions are depressed, a company must make decisions based on the long haul. A recession must be treated as the short-term problem that it is. Recovery will come, sooner or later. Thus, the strategy that entrepreneurs develop or modify during the recession will determine their firm's participation in the nation's recovery.

The best way for a business to prepare for growth following a recession is to maintain a focus on the long-term. In December 1990, Fortune magazine surveyed 200 executives. Of those surveyed, 38% expected to increase their capital spending in 1991, and only 27% expected to cut (May, 1991; 72). When a recovery takes off and exports rise and consumer demand increases, businesses must have the necessary cash flow to finance growth in investments.

Designing a business strategy for financial recovery is doubly difficult when the marketplace is in a state of turbulence. During a typical recession, retail sales are down, factory orders are low, and consumer psychology is defensive and paranoid (Goodwell & Martin, 1992). Given fewer resources and a tighter budget, entrepreneurs must develop plans to attract customers who are more hesitant to spend. Further, the character of business relationships often changes during recessions. Customers may become disloyal, demand renegotiated contract terms, and alter purchase patterns. Suppliers may vary their delivery schedules; some may improve service time while others reduce it. Internally, anxiety and the threat of job loss, may jeopardize employee morale and lower productivity.

### **Planning for Recovery**

In preparing for economic recovery, a business's first step should be to assess its financial position. If the firm is in a serious financial bind, then it may focus on survival by generating short-term revenues at the lowest cost. Conversely, if the firm's market position and profit structure are strong, it may have the opportunity to increase investment in advertising, new product

introductions and added distribution to increase brand valuation and market share.

Many U.S. manufacturers took to a defensive approach to the economic recovery that began late in 1991. They began by reducing their reducing break-even levels. Many companies found that they could trim costs by 10% of 15% a year through a series of small steps, including reducing the frequency of internal reports and meetings, and eliminating non-productive perquisites. One key to recovery was making cutbacks during recessions in ways that do not adversely affect the quality of the company's products. Firms that can enact only moderate cuts have traditionally survived recessions and realized stronger long-term sales and market share growth than competitors that made severe cuts (McLaughlin, 1990).

A firm's second step should be to revise its market segmentation and targeting to adjust for shifts in customer behavior (Pearce & Michael, 1997). The firm may refine its marketing mix to balance price reductions, advertising and promotions, and value pricing; product introductions and R&D cuts; and renegotiate contracts and sales reductions.

Opportunistic strategies are the result of managing with the next recession in mind. Entrepreneurial firms that have healthy cash flows, a well-defined market niche, ongoing quality programs, and stable or increasing sales volume are well positioned to gain competitive ground during periods of economic decline. Options under this strategy include price reductions to weed out competitors, maintenance of R&D that other companies cannot afford, new products introductions to increase market presence, and hiring new staff who would be unavailable under more munificent conditions.

As damaged companies begin to layoff employees, healthy companies may recruit their competitors' trained personnel. Caution must be exercised when recruiting these people, as the first to be eliminated are usually relatively poor performers. The careful opportunist will wait until the deep cuts have begun to pick up new staff. A final opportunistic measure is horizontal integration - the purchase of competing companies. Again, caution should be exercised to prevent overburdening resources and endangering the long-term viability of the company.

## CONFRONTING RECESSION

Within every industry segment that is hit by a recession, there are companies that perform better than their competitors. The foundation for good performance during a recession seems to be laid well before the recession through an emphasis on diversification. Some strategic components of this diversification that pay off during a recession are utilization of superior technology, a highly efficient cost structure, and recently restructured business processes. Most companies build their strategic plans around ideas about how to take advantage of the growth and expansion of an economy, but find them equally important in preparing for periods of economic stagnation and decline.

While other tactics have advantages, diversity provides the greatest insulation for a firm against the negative effects of recession. Diversity protects a company by mixing the sources of its revenues. The diversity can be created by the number of products that the company produces, the types of services that it offers, or the range of customers that it serves. In all cases, customers differ in their buying patterns, which smoothes out a company's overall revenue fluctuations. For example, since the 1991 recession, each of the major networks has reformed itself through mergers to increase its diversification. They believe that sharp declines in one business segment can be counterbalanced by nearly offsetting increases in another. If television advertising declines, as it has in past recessions, the diversified networks hope to benefit from increased ad revenues in their cable, Internet, and radio businesses.

However, the advantages of diversification are most evident in firms that have developed a broad geographic spread. Because recessions do not appear everywhere at the same time, geographic diversification allows a firm to rebalance its resources among locations in response to the prevailing local economic conditions. Differences in economic cycles can be used by global companies that are active in different markets around the world, to counterbalance the volatility in demand caused by domestic macro-economic changes. Large corporations, like General Electric, rely on recession tactics that stress global diversity to prevent the company from becoming captive to domestic economic cycles. As evidence of the value of this approach, GE pushed its exports up 18% during the first year of the last recession with new orders for power plants, appliances, and medical equipment. Entrepreneurial

executives can adopt similar strategies with appropriate modifications in scale.

The furniture industry suffered greatly in the 1990-1991 recession, especially in the Northwest and Southern California, where tens of thousands of white-collar workers lost their high paying jobs. Bryne Home Furnishings in Burbank relied on diversification and succeeded while its larger competitors failed. While continuing to sell furniture and accessories to upper-middle class customers, Bryne began renting furniture and accessories to movie and television studios. It also cultivated strong business relations with interior designers who placed Bryne's furnishings in their displays. The accessories not only attracted the eye of browsing customers, and served as a new profit center for the company.

Profits in the paper industry also started to slide in 1990 and saw a decline of 59% in 1991. However, during this hyperhostile period, International Paper produced profits. The company had expanded its presence overseas during the late 1980's to make it less vulnerable to the wild cyclical swings of the U.S. industry. The strategy worked. In 1991, \$4.1 billion, or 32 percent, of total sales came from exports or foreign-based units.

### **KEEPING RECESSIONS IN PERSPECTIVE**

Many companies emerge from a recession as more efficient operations. They have laid-off surplus workers, closed inefficient plants, bought productivity enhancing equipment, and become more globally competitive. According to a survey of industry experts and executives, a recession also produces a newly committed workforce, better communications in the office, faster response to the market, opportunities for those who stay, and a premium for talent (Dusky, 1991).

Recessions play a vital role in an economy. From a national perspective, short-term pains of individual industries or companies often result in long-term gains for the economy from increased productivity. Recessions encourage organizations to wring out under-performing resources and to find innovative solutions to competitive demands. Those companies that can weather the period of recessionary turmoil often benefit from lower inflation and interest rates, along with the purging of excess inventory, corporate overhead, and marginal competitors. These changes help underwrite durable, non-inflationary growth for years to come. Therefore,

it is a responsibility of an entrepreneurial executive to ensure that the company both outlasts the recession, and that it emerges stronger and more competitive than before.

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## **RELATIONSHIPS BETWEEN COMMUNICATION STYLE AND LEADER-MEMBER EXCHANGE: AN ISSUE FOR THE ENTREPRENEUR**

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### **ABSTRACT**

*It is almost a truism that the entrepreneur, even more than the manager in a large, established business, is dependent in many ways on the organization's employees. In turn, it is widely recognized throughout the managerial literature that the willingness of employees to put forth their best efforts arises in large part from the quality of the employees' relationship with their manager - here, the entrepreneur. What can the entrepreneur do to influence the quality of the relationship? In this research, our focus is upon communication, and we examine the relationships between findings from two related literature streams: a prescriptive body of theory involving "best practices" in supervisor-subordinate communication, and leader-member exchange (LMX) theory from the management literature. LMX suggests that supervisors may afford differing treatment, and thus possibly use different communications tactics, with subordinates in higher quality exchange relationships than with those in lower quality relationships. This literature, however, leaves unresolved whether the entrepreneur, as supervisor, should treat employees differently. In this research we find evidence that employees perceive differences, especially in level of participation-related communication, depending upon whether they believe they are in a higher or lower quality LMX relationship. Moreover, we find weak evidence for congruence between supervisor and subordinate*

*perceptions of the quality of the exchange and no significant evidence that similarity of the dyad influences its quality. Implications for entrepreneurs are developed.*

## INTRODUCTION

It has been recognized that as soon as the entrepreneurial organization reaches a size where there is a payroll and employees, a series of challenges arise. Specifically, the entrepreneur, even more than the manager in a large, established business, is dependent in many ways on the organization's employees. This dependence occurs for several reasons: these individuals, and there may be relatively few of them, may be representing the firm to its customers and/or producing the firm's "product." Where they perform poorly, their deficiencies may quickly become obvious and irreversible. In turn, it is widely recognized throughout the managerial literature that the willingness of employees to put forth their best efforts arises in large part from the quality of the employees' relationship with their manager - here, the entrepreneur. Yet entrepreneurs are often visionary, driven individuals who may find it difficult to establish the needed relationships. What can the entrepreneur do to influence the quality of the relationship with the organization's employees?

In this study, our focus is upon communication as a potential vehicle for the entrepreneur to use in influencing employees. Specifically, it represents an initial effort to investigate relationships between two distinct literature streams within communication and management which appear to have implications for entrepreneurial communication. We first examine the "best practices" communication literature dealing with perceptual congruence. We then turn to the management leadership literature involving leader-member exchange (LMX). Therefore, we question whether the LMX literature can be used to aid in understanding any variations which may exist in the ways managers communicate with different employee types and whether there are differences between subordinates perceiving that they obtain higher or lower quality exchanges with their supervisors.

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## THE COMMUNICATION LITERATURE

Historically, the communication literature has had a prescriptive orientation and, in the area of superior-subordinate communication, has been concerned with identifying "best" communication styles, tactics, and behaviors. Note, especially Jablin's (1979) literature review which refers to Redding's (1972) findings that "communication-mindedness," empathetic listening, persuasion rather than telling, sensitivity, and openness characterize better supervisors. Moreover, Jablin points to wide support for these ideas throughout the literature. More recently, Pettit, Goris, and Vaught (1997) have shown that the quality of several aspects of communication could be used to predict job satisfaction on the part of employees. Moreover, communication represented a weak moderator of the job performance-satisfaction relationship. (See also Clampitt & Downs (1993); Dansereau & Markham (1987); Pincus (1986) for related discussion of these issues.) Note that the underlying idea is that "best" behaviors can be identified and, if used by the manager, will improve the manager's effectiveness.

If this is the case, how may deviations from the "ideal" be understood? One perspective coming from the literature proposes that perceptual differences between supervisors and subordinates may distort communications, suggesting that perceptual differences held by a subordinate may cause distortions to the supervisor's message. If so, the subordinate may, in effect, receive an ineffective message even when an effective one was sent. Conversely, of course, the distortion may be the supervisor's. This is especially true if the supervisor believes the message was ideally sent, when, in fact, it was not. Of interest are numerous studies (Boyd & Jensen, 1972; Schnake, Dumler, Cochran, & Barnett, 1990; Tompkins, 1989; Wexley, Alexander, Greenwalt, & Couch, 1980; White, 1977) which have indicated that superiors and subordinates have differing perceptions of a variety of factors which affect their relationships. Moreover, supervisor-subordinate expectations regarding many aspects of the communication process may also be vastly dissimilar (McCallister, 1983). Similarities--especially those related to demographics, attitudes, and/or values--have been shown to reduce the potential for distortion (Cheryl, Ravlin, & Meglino, 1996; DiSalvo & Larsen, 1987; McCroskey, Richmond, & Daly, 1975; Schnake et al., 1990).

More broadly within the management/perception literature, a number of comparable findings of perceptual distortions and lack of supervisor-subordinate congruence have been reported (See especially Kolb, 1995; Webber, 1970). Hatfield and Huseman (1982) developed a scale (used in this study) to test for supervisor-subordinate congruence in perceptions of aspects of their communications and found that congruence was directly related to satisfaction.

In general, then, the communication literature has historically taken a "classical" approach to supervisor-subordinate communications and has attempted to identify "best" practices which apply across situations. Distortions, arising from lack of congruence between supervisors and subordinates, have been seen as a primary problem area, moderating the direct relationship between improved communications and satisfaction and/or performance outcomes. From the perspective of the entrepreneurial literature, a potential problem may be that the orientation and perceptual differences between the visionary, driven entrepreneur and the employee, who may be much less of a visionary and less motivated, may be significant enough that congruence becomes difficult to achieve (See Jackson & Venkatapathy, 2001; McNerney, 1994).

On the other hand, a discussion by Dansereau and Markham (1987) suggested that an alternative model, and one perhaps more potentially useful to the entrepreneur, for understanding communication between supervisors and subordinates may arise from the dyad tradition, which examines the supervisor-subordinate relationship as a distinct pairing. The dyad tradition, they point out, represents a contrast to the group tradition, where the supervisor is understood to use the same (and presumably "best") style with all subordinates. Under the dyad tradition, it becomes reasonable to expect that supervisors could use different communication styles with different subordinates, depending upon the nature of the relationship. Moreover, Dansereau and Markham (1987) see the development of these ideas as a potential area for research.

Note, however, that a number of concerns arise when the issue of dyads is considered seriously. A typical conclusion of the perceptual congruence research in the communication literature noted above is that an absence of congruence is evidence of communication problems and suggests that senders should be more sensitive to relationships with their various receivers (Hellweg, 1978). Moreover, the communication literature has been

prescriptive in orientation, suggesting, for example, that empathy in communication represents a preferred approach. If the emphasis is placed upon the dyad, however, the result may easily become descriptive rather than prescriptive. Thus, it may be possible to identify dyads where the communication style is not (and possibly should not be) empathetic. But would such a finding mean that use of empathy is contingent on situational variables? Is it not just as possible that dyads displaying little empathy in descriptive terms are functioning at a less-than-optimal level which could be improved by increasing the level of empathy? In effect, should we expect a driven entrepreneur to become empathetic? To consider questions such as these, we turn to the management leadership literature and an examination of the leader-member exchange (LMX) tradition from which Dansereau and Markham (1987) derived their ideas.

### **THE MANAGEMENT LEADERSHIP LITERATURE: LMX**

Within the management literature, there has been increasing recognition (consistent with Dansereau & Markham, 1987) that understanding leader behavior may require moving beyond the traditional model and incorporating an LMX perspective (Dienesch & Liden, 1986; Liden & Graen, 1980). As traditionally approached, the management literature has assumed that leadership style is uniform and that subordinates' differing perceptions of the leader's behavior reflect measurement error (Katerberg & Hom, 1981). Note, of course, that the traditional approach does not necessarily imply one "best" style. Management contingency theorists have argued for at least 30 years (e.g., Fiedler, 1964, 1967), that any given style may not be effective in all situations. What these theorists have implied is that, within the situation, the leader will use the same style with all subordinates (see Yukl, 1998, for a recent, interesting discussion).

In contrast, the LMX model focuses upon the leader-subordinate dyad and explains the methods by which a leader and a member develop various behavioral interdependencies between their respective roles (Graen & Schiemann, 1978). As Gerstner and Day (1997) maintain in their recent meta-analytic review of LMX, theory development historically has emphasized the discovery of differentiated dyads. During this "vertical dyad linkage" stage, concern was with distinguishing in-group employees from those in the out-group and identifying the degree to which the in-group

received a different level of supervision in terms of freedom from close supervision and negotiating latitude (see especially Graen & Cashman, 1975; Liden & Graen, 1980).

According to Gerstner and Day (1997), the next phase has been an emphasis on the exchange itself, in terms of discovering its quality and consequences. (For interesting, recent work, review especially Engle & Lord, 1997; Klein & Kim, 1998; Settoon, Bennett, & Liden, 1996.) Up to this point, however, development was primarily descriptive rather than prescriptive and mainly paid attention to describing the functioning of the dyad rather than focusing upon how dyads should operate. Potentially troubling findings have surfaced, especially indications that assignment to in-group or out-group status may occur early in the life of the dyad and may be resistant to change (Dienesch & Liden, 1986; Graen & Cashman, 1975). Where this is the case, it is possible that the assignment is made on the basis of factors such as demographic similarity (presumably leading the dyad to feel comfortable or compatible) rather than upon "rational," business-related grounds (see especially discussion of these issues by Liden, Wayne, & Stilwell, 1993; Yukl, 1994, 1998).

## **RELATIONSHIPS BETWEEN COMMUNICATION THEORY AND LMX**

Our focus in this research is upon the possible linkages between communication theory and its implications for communication between supervisors and subordinates and LMX. As noted, both literature streams have dealt with the supervisor-subordinate dyad, and both are concerned with the quality of the relationship which exists between the supervisor and the subordinate. There is a call for the development of a more prescriptive basis within LMX, and communication theory potentially offers a prescriptive body, at least of "best" practices for communication with subordinates. This research represents an initial approach to examining some of the issues raised. Specifically, we consider several research questions which we believe arise when the two literature streams are examined conjointly.

Our review of the literature suggests that there should be a relationship between the practices of the entrepreneur as supervisor and the quality of the leader-member exchange (Deluga, 1998). Specifically, employees in higher quality exchange situations should be expected to

experience higher quality communication by the supervisor. From the standpoint of the entrepreneur, if this is the case, the key then becomes building high quality exchange situations - meaning identifying and hiring employees that they can trust - and then expecting the high-quality communication to follow from the enhanced relationship (Flynn, 1994; Williamson, 2000). Thus, our first research question is:

RQ1: Subordinates who report higher quality LMX will also report better communication quality from their supervisors.

Note, however, that a finding of poorer communication quality associated with lower LMX does not, by any means, indicate that supervisors should change their communication styles with their out-group subordinates. Such a correlation--if obtained--simply relates two perceptions by the subordinate. In addition, as indicated in our earlier discussion of lack of congruence and perceptual distortions, it is important to examine consistencies between supervisory and subordinate perceptions. Accordingly, our second research question is:

RQ2: Supervisors' assessments of communication and LMX will be directly related to subordinates' assessments.

Finally, an issue which we do not directly approach in this study is the contingency question. Supervisors may exhibit different behaviors with different subordinates, but those differences may be grounded in fact. For example, Hersey and Blanchard's (1977) well-known situational theory suggests different leader behaviors at different levels of follower maturity. Thus, leaders should be expected to be more directive with less-mature followers (and perhaps to deviate from "best" communication practices). This study begins what we believe will demonstrate a need for extended examination of this topic. Our discussion of issues surrounding the early development of the exchange relationship suggests that demographic similarities rather than rational business needs may form the basis for this relationship (Cheryl et al.(1996); Deluga (1998). A finding that high LMX dyads are similar in demographics would suggest that differences in

communication and LMX may not be based upon business-related contingencies. Conversely, the absence of such a finding would suggest the possibility that follower maturity or some other factor(s) accounts for the differences (Schriesheim, Neider, & Scandura, 1998). Therefore, and consistent with findings suggesting that the relationship does develop early, our third research question is:

RQ3: Supervisor-subordinate pairs which are similar demographically will experience higher LMX.

## METHOD

### Sample and Survey

Subjects in this research were primarily employees of a large regional medical center in the southern United States. Survey packets were sent directly from the researchers to 170 management employees. Managers were asked to participate, and their anonymity was assured. Eighty-eight (52 percent) elected to do so. Those participating were asked to complete a survey and to select two of their employees to respond as well. The manager then provided an employee survey packet to each employee with instructions to complete it and return it directly to the researchers. Again, anonymity was assured, but a coding system on the surveys was used to associate employees with their supervisors. A total of 164 employee surveys were returned. Thus, our sample consisted of 164 dyads, but the same supervisor could appear in as many as two dyads. Note that while this convenience sample did not consist of entrepreneurs and their subordinates, it was our expectation that the dynamics of communication are general enough that it was not necessary to identify an entrepreneurial sample at this early stage in our research.

The survey instrument asked for demographics including age, gender, and race. Employees were asked what kind of work they did and how familiar their supervisor was with their work, while supervisors were asked how many people they supervised, size of the organization, and their level. The remainder of the survey consisted of 27 items, worded into supervisor



and employee terms (i.e., "I ask my subordinates..." vs. "My supervisor asks me...").

The first 14 questions consisted of the Hatfield and Huseman communication instrument mentioned previously. (For a discussion of validation, see Hatfield & Huseman, 1982; Huseman, Hatfield, Boulton, & Gatewood, 1980; Huseman, Hatfield, & Robinson, 1980.) The instrument was of special interest given the intent of this study. As the authors point out, the instrument was designed to identify areas of congruence and lack of congruence between supervisors and employees on three aspects of communication--the factors found in the scale (labeled by them as coordination, participation, and expression). The final 13 questions consisted of the surviving items from the recently developed LMX scale by Liden and Maslyn (1998).

## RESULTS AND DISCUSSION

Because the Hatfield and Huseman instrument had been validated several years ago and with a very different group of employees (manufacturing as opposed to hospital), we conducted a factor analysis to determine how well the instrument fit this sample. Table 1 below provides demographic information on our sample.

<b>TABLE 1: DEMOGRAPHIC INFORMATION FOR ALL SUBJECTS</b>					
Employee - N = 164*			Supervisors - N= 88**		
Employee - Age			Supervisor - Age		
Category	Frequency	Percent	Category	Frequency	Percent
Less than 30	19	12.9	Less than 30	5	6.7
30-39	42	28.6	30-39	13	17.3
40-49	51	34.7	40-49	26	34.7
50+	35	23.8	50+	31	41.3
Employee - Gender			Supervisor - Gender		
Category	Frequency	Percent	Category	Frequency	Percent
Male	56	37.8	Male	32	43.0
Female	92	62.2	Female	43	57.0

Employee - Race			Supervisor - Race		
Category	Frequency	Percent	Category	Frequency	Percent
Caucasian	63	43.4	Caucasian	37	50.0
Hispanic	2	1.4	Hispanic	2	2.7
African-American	79	54.5	African-American	31	43.2
Asian-American	0	0.0	Asian-American	1	0.7
Other	1	0.7	Other	3	3.4
*Reduced to as low as N = 145 for some analyses					
**Reduced to as low as N = 74 for some analyses					

Table 2 below presents the results of the factor analysis and indicates that the scale's psychometric properties remain reasonably good for our sample. While we obtained a four-factor solution, factors 1 through 3 are virtually the same as those reported by Hatfield and Huseman (1982), and our factor 4 was a one-item factor which appeared to be a breakout of factor 2. We refer to it as "freedom to question." Our factor solution was then used as the basis for the analyses which follow.

TABLE 2: ROTATED COMPONENT MATRIX					
Factor 1			Factor 2		
Coordination			Participation		
E1	0.711	Asks for suggestions	E4	0.747	Questions supervisor's instructions when they are wrong
E11	0.817	Explains changes in work	E6	0.588	Tells supervisor about errors
E12	0.800	Tells of work procedures	E8	0.731	Supervisor reports on prior work
E3	0.665	Informs about company rules			

E5	0.661	Informs about future company plans			
E7	0.586	Praises for good job			
E9	0.731	Explains company problems			
Factor 3			Factor 4		
Expression			Freedom to Question		
E10	0.692	Criticizes employees' work in public	E2	0.948	Questions supervisor's instructions when they are not understood
E13	0.862	Ridicules employee			
E14	0.521	Expresses sympathy about personal life			

Our first research question deals with the relationship between LMX and supervisory communication practices, and we predicted a positive relationship. The "all employees" column in Table 3 below provides our overall findings. Specifically, it indicates that there is a direct relationship between LMX and two of the practices, coordination and participation. This finding suggests that as subordinates perceive they are in higher quality exchange relationships, they also report their supervisors coordinate (in a two-way fashion) their activities and that they have increased ability to participate. From the standpoint of the entrepreneur, what is suggested is that when the entrepreneur feels the comfort level with the employee which is implicit in the high quality exchange, the supervisor is more willing to allow greater freedom to participate and to engage in two-way coordination by the employee.

We continued our analysis to look at how subordinates reporting the highest vs. the lowest quality LMX relationships might differ. As indicated in the final two columns of Table 3, for high-scoring subordinates, both the coordination and the participation factors are significantly related to LMX; while for the low-scoring subordinates, only coordination is significant. This finding may suggest that those in lower quality LMX relationships feel that

the supervisor engages in two-way coordination but does not permit them true participation. It appears to echo the idea of "negotiating latitude" in early LMX research (e.g., Graen & Cashman, 1975), and suggests that entrepreneurs, who have been characterized as unwilling to give up control, may, in fact, do so in the case of a high-quality exchange.

Table 4 presents the results of a discriminant analysis examining differences between the two groups. The function is significant (Wilks Lambda < .001), and an examination of means (see Descriptive Statistics at the bottom of Table 4) suggests that, while there is little difference between the groups in their perception of the supervisor's expression (i.e., of concern and the like) or their ability to ask questions, those in higher LMX exchanges score in positive ranges on coordination and participation, while those in lower exchanges score negatively.

<b>TABLE 4: SUMMARY OF CANONICAL DISCRIMINANT FUNCTIONS</b>				
Eigenvalues				
Function	Eigenvalue	% of Variance	Cumulative %	Canonical Correlation
1	.908 <sup>1</sup>	100	100	0.690
<sup>1</sup> First 1 canonical discriminate functions were used in the analysis				
Wilks' Lambda				
Test of Function(s)	Wilks' Lambda	chi-square	df	Sig.
1	0.524	52.024	5	0.000**
Standardized Canonical Discriminant Function Coefficients				
		Function	Sig. Probability of	
Factor 1	Coordination	0.800	0.000**	
Factor 2	Participation	0.571	0.000**	
Factor 3	Expression	0.110	0.886	

Factor 4	Freedom to Question	0.167	0.249		
	Supervisory LMX	0.299	0.004*		
* <.05    ** <.01					
DESCRIPTIVE STATISTICS HIGHS VS LOWS					
		High LMX N = 42		Low LMX N = 43	
		Mean	Std. Deviation	Mean	Std Deviation
Factor 1	Coordination	0.5995	0.9296	-0.5335	0.5736
Factor 2	Participation	0.3471	1.2848	-0.4233	0.3479
Factor 3	Expression	0.0000	1.1287	0.0000	1.0618
Factor 4	Freedom to Question	0.2109	1.2346	0.0000	0.8406
	Supervisory LMX	24.9523	7.1258	20.6744	6.1903

Our second research question asked whether there would be a relationship between LMX as reported by employees and by supervisors. In this study, we did find a positive relationship [ $r = .243$ ,  $p < .01$  (see Table 3)]. Moreover, when entered into our discriminant analysis (Table 4), the coefficient was .299 ( $p < .01$ ). However, several cautions are in order when interpreting these findings. First, while the coefficient is significant, it is low in terms of variance accounted for, probably reflecting to some degree, the lack of congruence between supervisory and subordinate ratings historically found throughout the literature. Moreover, we note Gerstner and Day's (1997) recent comment, "LMX can be measured from both leader and member perspectives, but is it the same construct when measured from different perspectives?" (p. 828). For example, as we examined the survey items from the leader's perspective, we were concerned that they could be

influenced by social desirability, in that they may believe that they should treat all subordinates similarly and demonstrate behaviors such as participation. In general, while we found what we consider a weak positive relationship between supervisory and subordinate LMX in this study, we echo Gerstner and Day's (1997) concerns about measurement issues and believe that considerable additional study is needed in this area. Moreover, because the issue of congruence seems to be a central one in the case of entrepreneur-subordinate dyads, future research should probably focus specifically on these dyads.

Our final research question represents an initial attempt to examine whether supervisors dealing with subordinates using lower quality exchanges may be doing so for objectively oriented reasons: lower subordinate skill or training, for example. We approached this issue by looking for obvious signs of similarity bias and specifically asked whether subordinates in dyads of similar gender and race would report higher quality exchanges. We identified 31 dyads which were similar in gender and race and computed employee LMX as well as scores for the four communication factors (coordination, participation, expression, and freedom to question). We could find no significant differences between this group and the sample as a whole (although, in terms of directionality, LMX was higher) and conclude that no obvious signs of bias are apparent in this very limited examination. Obviously, far more work remains to be done in this area.

### **SUMMARY, CONCLUSIONS, AND IMPLICATIONS FOR ENTREPRENEURS**

In this research, we have considered linkages between LMX quality and supervisory communication practices and have found evidence that subordinates report a direct relationship between increasing quality of LMX and communication styles such as coordination and participation. We found some evidence of a relationship between supervisors' and subordinates' reports of LMX quality, suggesting that we may be capturing something beyond the subordinates' perceptions. We do not find evidence, at this point, that demographic similarities influence the quality of the supervisor-subordinate exchange. From the perspective of the entrepreneur, what is suggested, especially if our findings continue to be supported in future research, is that emphasis needs to be placed upon the early stages of

the boss-subordinate relationship. Specifically, the entrepreneur's primary concern should be with identifying employees whom the entrepreneur trusts (Flynn, 1994; Williamson, 2000). This research suggests that once relationships are established between trusted employees and the entrepreneur, they will be able to engage in participation, two-way coordination, and enhanced communication. Additionally, high-quality superior/subordinate relationships can be vital to entrepreneurs who want to overcome poor communication skills.

However, more study is needed. Specifically, we remain concerned about potential measurement issues in this area and see both measurement and direct application to entrepreneurial samples to be critical directions for future research. Finally, another necessary research direction focuses on a need to evaluate contingency issues and to examine the impact and appropriateness of using differing supervisory styles across employees.

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# **THE MOST IMPORTANT FINANCE SKILLS FOR ENTREPRENEURS: DIFFERING VIEWS AMONG FINANCE PROFESSIONALS**

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## **ABSTRACT**

*Finance is commonly viewed as one of the most important topics for entrepreneurs to understand to ensure their survival and success. This study addresses 10 finance topics commonly taught in university courses. Each topic was evaluated by financial advisors on its level of importance for inclusion in entrepreneurial finance courses. The financial advisors include accountants/CPAs, bankers (lenders), investment bankers, venture capitalists, angels, personal financial advisors, and "others." The financial advisors considered all 10 topics to be at least "very important." However, some important differences did emerge among the various types of financial advisors on the topics of financing sources and methods, the relationship between outside investors and the entrepreneur, and the time value of money.*

## **INTRODUCTION**

Entrepreneurial finance is a relatively new subdivision within the discipline of finance and researchers have only begun surveying finance professionals as to which finance skills are most important for entrepreneurs. In this study, we compare the perceptions of different groups of finance professionals who advise entrepreneurs. These groups include venture capitalists, bankers, investment bankers, angels, accountants/CPAs, personal financial advisors, and others. Each group was asked to comment on the

importance of ten finance skills for entrepreneurial success (see Table 2 for a list of these topics). Our results suggest that there is reasonable agreement among finance professionals, although some significant differences are observed. In general, these differences support the view that finance professionals place a higher value on the skills most closely related to their specific professions within the larger field of finance.

## **LITERATURE REVIEW**

Several prior studies have surveyed financial professors to learn what topics are most important to cover in finance courses. For example, Cooley and Heck (1996) surveyed finance professors to investigate the perceived importance of various topics that might be covered in an introductory finance course. These researchers asked respondents to rank topics on the degree of importance and course coverage. Cooley and Heck found that time value of money, capital budgeting, risk and return, security valuation, and cost of capital were the introductory finance course topics viewed as most important by academics. Mergers and bankruptcy, leasing, inventory management, international finance, and receivables management were viewed as least important by finance professors. Other researchers have surveyed finance professors to identify what topics are most important to cover in specialized finance courses. Gardner and Mills (1990) and Granger and Aby (1977) gathered data on the financial institutions and the investments subdivisions, respectively.

An alternative approach taken by some researchers is to gather data on the perceptions of finance practitioners, or of finance practitioners and academics (see Graham & Krueger, 1996; Gup, 1994; DeMong, Pettit & Campsey, 1979). McWilliams and Pantalone (1994) surveyed top financial executives (mostly vice presidents of finance, chief financial officers, treasurers, or controllers) of large corporations to identify what skills these professionals believed were most important for finance majors. Respondents were asked to rank specialized finance courses in the major subdivisions according to their importance. McWilliams and Pantalone found that a majority of large-firm financial executives believed that working capital management, capital budgeting, and financial institutions should be required courses for finance majors. At a time when courses in entrepreneurial

finance were becoming much more popular, these respondents placed a very low priority on the specialized course "small business finance." Perhaps this is not surprising, given that the respondents all had successful careers in large corporations.

Only recently have researchers begun to consider the importance of various topics in the entrepreneurial finance subdivision. Anderson, Envick, and Roth (2001) surveyed entrepreneurs and financial advisors to examine the perceived importance of different finance skills for entrepreneurial success. Their evidence suggests that entrepreneurs and financial advisors are in general agreement regarding the seven most important skills; however, entrepreneurs placed a higher value on the "behavioral" topics in finance. Anderson, Envick, and Roth argued that entrepreneurs likely experience challenges in their relations with other firm stakeholders, e.g., outside investors. Such challenges could cause entrepreneurs to rank behavioral or human-relation topics more highly.

Although some initial research has investigated the perceived importance of different entrepreneurial finance topics, we are aware of no study that compares the views of different types of finance professionals. Venture capitalists, bankers, investment bankers, business angels, accountants, and personal financial planners provide distinctly different functions. Because different professions within finance contract with and relate to entrepreneurs in very different ways, these professional groups could have different views on which finance topics are most important for entrepreneurial success.

## **METHODOLOGY**

A nonprofit business organization, which primarily focuses upon promoting entrepreneurial activities, was utilized as the target pool for participants. This organization consists not only of financial advisors, but entrepreneurs, management and marketing consultants, among other types of members. We targeted 186 participants, which is the entire listing of members we believed to be financial advisors. Ninety-two surveys were returned, resulting in an outstanding 49.5% return rate. See Table 1 for demographic information regarding the participants.

<b>TABLE 1</b> Demographic Information on Participant Financial Advisors			
<b>By type:</b>		<b>By financial advisor education:</b>	
Accountants/CPAs	24	High school	3
Bankers (lenders)	26	Trade school	0
Investment bankers	7	Bachelors	37
Venture capitalists	10	Masters	42
Angels	8	Doctorate	7
Personal Financial Advisors	9	Other	1
Other	8	Unknown	2
	92		
<b>By business age:</b>		<b>By financial advisor age:</b>	
Infant (< 3 years)	15	Twenty-six to thirty-five	13
Young ( 3 to 7 years)	15	Thirty-six to forty-five	33
Mature ( >7 years)	60	Forty-six to fifty-five	29
Unknown	2	Fifty-six to sixty-five	13
		Sixty-six and over	3
		Unknown	1
<b>By business size:</b>		<b>By gender:</b>	
Small ( < 50 employees)	50	Female	10
Medium (50-250 employees)	13	Male	74
Large (> 250 employees)	25	Unknown	8
Unknown	4		

The topics included were chosen from a previous study conducted by Anderson, Envick, and Roth (2001), which asked both entrepreneurs and financial advisors to rank thirty finance topics according to their importance for entrepreneurs. The current study focuses on the ten topics deemed most important in the aforementioned study. The survey asked participants to rate the importance of each finance topic on a 7-point Likert scale (1 = not important at all; 2 = slightly important; 3 = fairly important; 4 = moderately important; 5 = very important; 6 = extremely important; 7 = absolutely essential). Mean scores were used to rank the finance topics from most important to least important according to each group. The data were also analyzed using ANOVAs to determine if significant differences exist among the seven groups.

## RESULTS

The means and standard deviations of all ten topics according to the seven groups of financial advisors are reported in Table 2. All topics received mean scores higher than five, which implies all topics are considered at least "very important." This high level of importance is due to the fact that the ten topics selected were ones previously identified as "very important" (see Anderson, Envick & Roth, 2001).

As one can see by reviewing Table 2, the opinions of the different financial advisors are similar. However, there are some significant differences that deserve mention. Table 3 summarizes significant statistical differences found between the mean scores of the financial advisors. Only those three topics where significant differences were found are reported. These topics include the "overview of major finance sources and methods," "the relationship between outside investors and the entrepreneur," and "the time value of money."

**TABLE 2**  
Means and Standard Deviations of Finance Topics  
According to Financial Advisor Groups

Finance Topic	VC Mean (SD)	Bankers Mean (SD)	IB Mean (SD)	Angels Mean (SD)	Acct. Mean (SD)	PFA Mean (SD)	Other Mean (SD)
Forecasting and financial statements	6.500 (0.707)	6.538 (0.706)	6.571 (0.787)	6.250 (0.707)	6.625 (0.711)	6.333 (1.118)	6.375 (0.913)
Cash Management and projecting cash flows	6.300 (0.823)	6.269 (0.827)	6.571 (0.787)	6.625 (0.518)	6.583 (0.654)	6.667 (0.707)	6.750 (0.707)
Financial statement and financial ratio analysis	6.200 (0.919)	6.269 (0.827)	6.286 (0.756)	6.250 (0.463)	6.500 (0.590)	5.667 (1.732)	6.250 (0.707)
<i>Overview of major business financing sources and methods</i>	5.900 (0.994)	5.522 (1.275)	6.333 (0.816)	6.250 (0.463)	4.957 (1.147)	5.778 (1.202)	5.875 (0.991)
Receivables management	5.600 (1.174)	5.692 (1.123)	5.571 (1.397)	5.000 (0.756)	5.583 (1.018)	5.778 (1.394)	5.750 (1.389)
<i>The relationship between outside investors and the entrepreneur</i>	5.900 (0.876)	5.696 (1.146)	5.333 (0.816)	6.125 (1.356)	5.000 (1.348)	6.444 (0.726)	5.125 (1.458)
<i>Time value of money</i>	6.200 (1.033)	5.154 (1.461)	5.143 (1.464)	5.500 (0.926)	5.417 (1.176)	6.444 (0.882)	4.750 (1.982)
Inventory management	5.200 (1.229)	5.462 (1.240)	5.571 (1.397)	4.750 (1.389)	5.478 (1.310)	5.667 (1.225)	5.375 (1.408)
Project evaluation approaches	5.500 (1.650)	5.423 (0.945)	5.571 (1.618)	5.375 (1.598)	5.261 (1.137)	5.556 (1.333)	5.000 (1.309)
Capital structure theory and liability management	5.100 (1.287)	5.435 (1.376)	5.000 (1.414)	5.500 (0.926)	5.478 (1.275)	4.889 (1.764)	5.750 (0.707)

*Note: Italicized topics indicate significant differences exist. Refer to Table 3.*



<b>TABLE 3</b> Information Regarding Significant Differences Among Financial Advisors				
<i>Overview of the major business financing sources and methods:</i> <b>p = .0295      F = 2.486</b>				
Accountants/CPAs with:	VC	IB	Angels	Other
Means: 4.957	5.900*	6.333**	6.250*	5.875*
<i>The relationship between outside investors and the entrepreneur:</i> <b>p = 0.333      F =- 2.423</b>				
Accountants/CPAs with:	VC	B-L	Angels	PFA
Means: 5.000	5.900*	6.696*	6.125*	6.444* *
Personal Financial Advisors with:	Other			
Means: 6.444	5.125*			
<i>Time Value of Money</i> <b>P = 0.665      F = 2.060</b>				
Venture Capitalists with:	B-L	Other		
Mean: 6.200	5.154*	4.750*		
Personal Financial Advisors with:	B-L	Acct/C PA	Other	
Mean: 6.444	5.154*	5.417*	4.750**	
* = Significant @ .05 ** = Significant @ .01				

## CONCLUSIONS

The evidence from this study suggests that financial advisors generally agree on the importance of different finance skills for entrepreneurs, but the advisors do disagree on the importance of three skills.

The significant differences observed suggest that financial advisors place a higher value on the skills that relate more closely to their own professions.

First, venture capitalists, investment bankers, and angels valued the topic "overview of major business financing sources and methods" more highly than did accountants. Obviously, venture capitalists, investment bankers, and angels provide financing to entrepreneurs and accountants do not. No doubt, these financiers often deal with "naïve" entrepreneurs who do not understand what types of new ventures are best suited for the different sources of finance. Many new entrepreneurs do not understand that angels primarily finance extremely young, very risky ventures; investment bankers finance much more established ventures with proven track records; and venture capitalists finance large new ventures in between these two extremes. Many entrepreneurs also do not understand the nature of the contracts used by these three different providers of equity finance or the level of managerial involvement that the different types of financiers require. The authors have had conversations with venture capitalists that support this assertion. Venture capitalists report that often entrepreneurs, with good business plans, seek venture capital when another form of financing would be much more appropriate.

The second topic where significant differences were found is "the relationship between outside investors and the entrepreneur." In this case, three types of outside investors-venture capitalists, bankers, and angels-all ranked the topic more highly than did accountants. This finding likely reflects that these investors have dealt with entrepreneurs who did not understand the nature of the relationship between outside investors and the entrepreneur. Venture capitalists and bankers have reported in conversations with the authors that entrepreneurs are often surprised by the due diligence requirements or the managerial control requirements imposed by outside investors. Entrepreneurs often view contractual terms regarding these requirements as harsh or unfair. Personal financial advisors also viewed "the relationship between outside investors and the entrepreneur" as more important than did accountants. Personal financial advisors include financial consultants who advise entrepreneurs on the achievement of personal, financial goals. In contrast, accountants focus on accurately reporting the historical accounting income and the book value of assets. It seems natural that in their transactions with entrepreneurs, personal financial advisors

would have more opportunity to consider the impact that outside investors (with managerial control rights) can have on the entrepreneur's goals.

The third topic where significant differences were found is "time value of money." Venture capitalists ranked this topic more highly than did bankers or professionals in the "other" category. Personal financial advisors ranked it more highly than did bankers, accountants, or professionals in the "other" category. Again, these differences can be explained by reference to the professional activities of these groups. The time value of money topic is concerned with the discounting process to find present value and the compounding process to find future value. Venture capitalists often discount a new venture's expected cash flows, using very high required rates of return, to estimate the firm's value (see Smith & Smith, 2000). Given this business valuation, the venture capitalist then can determine the amount she/he is willing to pay for a certain percentage of the new venture's equity. Venture capitalists describe their assumptions underlying this discounting process as a way of justifying the share price offered during negotiations with entrepreneurs. These negotiations are often critical to the success of a new venture, are much more likely to go smoothly, and are much more likely to benefit the entrepreneur when the entrepreneur is familiar with the time value of money.

Personal financial advisors assist entrepreneurs in planning for long-term financial goals, e.g. selling the business and retirement. The time value of money concepts, present value and future value, are essential to this planning process. In contrast, accountants emphasize the accurate reporting of historical income and book value, while bankers concentrate on determining the credit worthiness of potential borrowers. These activities do not rely as heavily on the time value of money as do the activities of venture capitalists and personal financial planners.

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# **BOON OR BANE? IMPACT OF THE DIGITAL AGE ON SMALL BUSINESS EXPORTING**

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## **ABSTRACT**

*The Internet can be used by small firms to enhance their operations internationally. This paper reviews the opportunities presented by the Internet in cross-border trade by small business and the challenge of using the Internet properly. While it is evident that ample opportunities exist for small business firms in the international arena, small firms can benefit from pitfalls experienced by earlier users of the Web. Suggestions are given for entrepreneurs to help them in their development of international e-Commerce strategies.*

## **INTRODUCTION**

Much has been said and written about the phenomenal growth of the Internet and the spread of e-Commerce. Both the Internet and e-Commerce have become an important part of society and an integral part of the international business world. Forrester Research predicts that e-Commerce transactions worth \$6.8 trillion are likely to take place worldwide in 2004. According to IDC, e-Commerce activity outside the U.S., currently 26% of the worldwide total, will increase to 46% by 2004 ("Cross-border regulations," 2000).

It is important to recognize that currently a greater part of Internet-registered households and of international e-Commerce is located in a few areas of the world. The main areas of Internet commerce are North America, the European Community, and Japan. Hence, large segments of the international trade world do not use the Internet. This is certain to change. For example, the emerging markets (e.g., India, China, and Brazil) though relatively small today, are expected to grow substantially over the next

decade. According to Access Media International estimates, there will be 200 million Internet users in Asia by 2004 ("The tiger," 2000). This will be as large as the total number of users in the U.S. in 2004. Even using a conservative estimate that 15% of total market in e-Commerce will be cross-border, there will be a \$1 trillion opportunity for businesses involved in international trade. Small businesses have much to gain by using the Internet, including the possibility of participating internationally even with meager resources.

The significance of the trend is illustrated by two facts: the volume of international trade currently conducted through the Internet (US\$80 billion); and the amount of time senior managers are devoting to needs of their firms to compete successfully in international e-Commerce. For instance, Amazon.com<sup>TM</sup> gains 25% of its revenue overseas and Mr. Jeffrey Bezos, Amazon's CEO, hopes to gain more than half its sales from overseas markets in the near future ("Amazon.com sets," 2000). A top executive of Yahoo<sup>TM</sup> (whose site is ranked No.1 in terms of visitors traffic in Europe) reports that managers devote 50% of their time to planning for the future needs of the international aspects of their business (Auerbach, Wysocki, and Boudette, 2000).

Unfortunately, little has been written about the impact of Internet on international trade and how the Internet can benefit small businesses. According to a survey by Forrester Research, 85% of the online business firms (including large firms) are incapable of shipping overseas ("Cross-border regulations," 2000). This paper looks at the benefits and barriers facing a small business conducting international trade through the Internet. We believe this paper will be useful for small firms, which make products that can be sold globally and are planning to enter overseas markets. The paper addresses the benefits and pitfalls a business may face in international operations. In particular, we will examine the effect of consumer-directed (Business-to-Consumer) and business-directed (Business-to-Business) Internet enterprises on international trade and offer suggestions for small businesses to benefit from these trends. These Internet business segments will be addressed separately in the following sections, as will the benefits of e-Commerce and the impediments to e-Commerce inherent to the segment of e-Commerce being discussed.

## **IMPACT OF THE INTERNET ON INTERNATIONAL TRADE**

Companies planning international operations have two options. One option is to set up operations in various countries. This is an expensive option that is not available to many small firms. The second option is to set up a web site to enable export. This option is affordable to many small firms; hence, this paper concentrates on this second option.

The worldwide character of the Internet makes it an ideal vehicle for exporting by small business. Any Internet user can conduct business with any other user in the world via the Internet. The convenience provided by the Internet is rapidly making it the communications vehicle of choice for conducting business. In calendar year 1999, the total of international trade was \$56 trillion ("World development," 2000). Of this amount, \$80 billion was directly traceable to the use of the Internet.

In general, Internet sites can be classified into two types of e-Commerce: B2C and B2B. B2C e-Commerce refers to businesses selling products directly to consumers for their own use. B2B e-Commerce refers to Internet transactions, which involve businesses selling products directly to other businesses, usually as inputs to the purchaser's value chain. The following sections will expand on the potential benefits and pitfalls involved with B2C and B2B cross-border operations.

### **B2C AND ITS IMPACT ON INTERNATIONAL TRADE**

B2C is the electronic equivalent of the neighborhood store. A business offers goods or services through a web site that is open for business all the time. Visitors to that web site can browse through the store offerings and, finding an item desired, purchase that item at the offering price. This means that individuals can shop for desired goods or services at their convenience, carefully evaluate the various web sites offerings, and purchase those best fitting their needs. The Internet, thus, expands the available places at which consumers can shop (encompassing all businesses in the world that have web sites) and enables consumers to buy from any seller in the world.

There is a special case of B2C business - B2C e-Markets. Perhaps the best-known B2C e-Market is eBay.com, although a number of similar sites have been created. eBay™ lists items which individuals wish to sell. eBay

then conducts an auction for the items on offer, and matches the successful bidder with the seller so they can complete the transaction.

### **BENEFITS OF B2C E-COMMERCE**

The benefits of Internet e-Commerce have been widely trumpeted. Among the most significant of these benefits is the extended reach that it gives to B2C businesses. Many products are marketable across a wide range of nations and cultures around the world. The businesses selling these products are limited in the number of customers they could reach without some additional means of access to customers. The Internet provides the vehicle for global reach by businesses even with a modest website.

Illycaffe is an excellent example of the opportunity offered by the Internet to small businesses (Barrett, 2000). Illycaffe ([www.illy.com](http://www.illy.com)) is an Italy-based company specializing in coffee and espresso machines. This family-owned business has long had an outstanding reputation for sales and service to restaurants. Using the Internet as a marketing tool, Illycaffe is looking to increase its revenues through direct sales to individuals. In addition, Illycaffe uses Customer Relationship Management (CRM) tools to sell more product (up-selling) and additional, related products (cross-selling) to their customers. By using the Internet, Illycaffe is expanding, through internal growth, from a boutique European company to a respected, world-renown marketer.

Illycaffe's experience with Internet expansion clearly indicates the new ability that small firms have to participate in international trade. Similar success stories about international e-Commerce have also been reported by other small business. BackWood Grocery, an outdoor specialty retailer, reports that international orders have higher unit sales compared to a typical domestic order (Campanelli, 2000). Internet operations can be a cost-effective way for niche firms to conduct international business.

Beater Wear of Bellevue, WA is a firm, which plans to use the international potential of the Internet to its advantage ("Small outdoorswear," 1998). Beater Wear sells ski accessories, hence, sales are very seasonal. Beater Wear plans to market to countries in the Southern Hemisphere where the seasons are reversed, thereby reducing the seasonal effect of its sales. Another example is Vellus Products Inc., a manufacturer of pet-grooming products whose foreign sales account for more half of its revenues (Maynard,



1997). According to Sharon Doherty, Vellus Products' president, Vellus has had a positive experience with the extent of international sales leads from its web site.

Another example in this regard is the experience of small Australian wineries. These wineries face a domestic market with no growth in demand and high local taxes (29% consumption tax) forcing them to look for overseas markets. However, these wineries were shut out of international markets because distributors were not interested in promoting unknown wines from small wineries. Occasionally when the distributors picked up these wines they wanted to get rid of the wine as soon as possible using low prices as an inducement. Needless to say, this is a predicament faced by small businesses in many industries where distributors tend to treat small business products as a nuisance. These wineries have now signed up with on-line exchanges wherein many of these firms' wines are sold over the Internet giving them recognition and access to markets worldwide (Greenberg, 2001).

### **BARRIERS INHERENT TO B2C E-COMMERCE**

This section focuses on specific barriers a business faces due to operations in international markets. Needless to say, managerial issues (e.g., ease of shopping, etc.) that are relevant to operating a website also need to be considered along with the factors discussed below.

#### **Credit Card Population.**

It is common to assume that an Internet user will own a credit card that can be used to make purchases through the Internet. This assumption may be erroneous as credit card usage and penetration is far less outside the U.S. Even among the limited credit card users there is a preference to pay cash for purchases. The Japanese, for example, prefer to pay for items by cash (Kunii, 2000). They average only \$2,000 per annum credit card purchases compared to \$6,500 in the US. In such cases, a convenient, alternate means of payment is needed in order for e-Commerce to grow (Landers, 1999).

**Cost of Telecommunications.**

In the United States the telephone infrastructure and tariff structure has been a major contribution to the explosive growth of Internet usage. The availability of telephone tariffs that permit local calls without time charges has made possible extended access times. Outside the US, many telephone companies charge users of the Internet for each minute of use regardless of distance (this is rapidly changing). Even in countries such as Germany the cost for telephone services could be about three to four times higher than in the US ("First America," 2000). This has been a major barrier to the internationalization of e-Commerce. It is expected that, as telephone systems are privatized and upgraded, the tariff structure will change so that it will benefit Internet users.

**Security Issues.**

Another risk a business faces in International operations is the possibility of fraud. The possibility for fraud exists for operations within the United States also, but internationally the problem is aggravated due to distance and time involved in detecting fraud. For instance, a firm will lose money if it is defrauded by a customer using stolen credit cards whether it ships to Dallas, Texas or Beijing, China but the system will take longer time to catch up in the latter case.

**Regulatory Environment.**

Uncertainty and complexity regarding laws regulating Internet based business is a restraining influence on the growth of international e-Commerce. For instance, China has altered its stance on e-Commerce by foreign firms' many times in the last year (McCarthy, 2000). Tariffs and customs duties which must be paid by buyers when buying wares from overseas sellers further complicates the sales/purchase process. Some countries also have imposed restrictions on the type of product (e.g., cigarettes) which can be imported.

Privacy is another issue a business needs to contend with when operating in overseas markets. The European Union, for example, has

stringent rules on privacy protection; rules that are stricter than the laws of the U.S.

Idiosyncratic trade laws are a barrier that businesses face when operating across borders. For instance, discounting of books and other copyrighted material is illegal in Japan (Hirao, 1998). Germany also has similar laws restricting discounting. Understanding and overcoming these barriers can be expensive. Dell Computers<sup>TM</sup>, which has significant operations in many countries, has invested many millions just to understand local laws and taxation issues (Doebele, 1998).

### **Language of Trade.**

Many B2C web sites have alienated potential customers by using a language that is not well understood by all consumers (Micklethwait and Wooldridge, 2000). Non-native English speakers usually must communicate in English, the most common language of the Internet. According to the OCED about 78.3% of web sites are in English ("Le cyber challenge," 2000). An e-business desiring to be truly international needs to provide language support to reach all potential customers; that is, everyone who might have the funds to pay for goods ordered from the company through the Internet. There is a natural inclination to want to use translation software to solve the language problem. However, the state of the art in such software has not yet reached the level where a business would want to rely on a software translation. The burden of providing translation services may limit the countries (or languages) from which they accept orders. Dell, for example, currently offers a menu of languages of 39 different countries in which to conduct business (Doebele, 1998).

### **Currency of Trade.**

Related to the issue of language translation is the need to quote prices in local currencies, or at least to offer a menu of currencies for selection by the customer. Some authors assert that US Internet firms have alienated consumers by pricing everything in US dollars (Micklethwait & Wooldridge, 2000). Pricing wares in local currency may well attract additional customers. However, acceptance of payment in more than a single currency introduces a new risk factor to the e-business - currency risk. Thus, e-businesses that

are truly global must address the challenge of managing the currency exchange rate in pricing goods. This offers the possibility for profitable financial operations as well as the possibility of losses when the market exchange rate changes too quickly.

### **Cost of Purchases.**

Ease of shopping from one's home is one of the main reasons that consumers use the Internet for shopping. Another important reason consumers purchase items using the Internet is that prices are lower compared to conventional stores. While this may appear to be the case with international e-Commerce, the buyers generally have other experiences to report. Purchasers are forced to contend with taxes, shipping, tariffs, and other customs regulations. Many buyers are unaware of all of these when making an initial purchase. However, by the time the customer takes delivery of the product, the time invested and money spent may make the purchase uneconomic, unless the product is the only option available.

### **Shipping Time/Return.**

Overseas customers must also wait longer for delivery when making purchases over the Internet. This issue is compounded if the customer needs to return the product. Overseas shipping is very expensive. This makes returns uneconomic for low value goods. The process of reclaiming duties paid for the buyer when importing is another important issue that needs to be dealt with.

### **Site User-friendliness.**

Earlier in the development of the Internet, customers accepted sites that were not intuitive and customer friendly. With increased experience, improved understanding, and more competition for their attention, customers have begun to demand ease of use and better distribution systems. These, of course, result from good management skills and process, rather than brilliant flights of imagination. There appears to be a misconception that management style should be different away from the home country than at home, but "good national management is usually good global management".

Notwithstanding the impediments to e-Commerce, there is great potential for small business in international trade. Small businesses, however, need to adapt to customers with a variety of social, cultural, economic, and personal needs. For instance, Japanese customers have less of a preference to pay over the Internet and accept delivery at their residences. Recognizing this situation in Japan, Lawson Inc., a Japanese convenience store chain, has arranged with Internet retailers to place Lawson's icon on their web pages (Landers, 1999). By clicking on the icon, a consumer ordering wares from an Internet retailer can arrange to pay for and take delivery (after a suitable interval to allow for shipping) at the local Lawson store. This system works well in Japan because there is a high density of convenience stores (for example, there are over 8,000 7-Eleven stores in Japan) (Kunii, 2000). The Japanese frequent those stores for small items and other services, including using ATMs, using the Internet, and, now, taking delivery of items ordered on the Internet. Hence, what is needed is some degree of creative adaptation in dealing with overseas customers. Overseas customers are more likely to be loyal to a selling firm and less price sensitive. This can provide the firm steady revenue for the long run.

### **SUGGESTIONS FOR SMALL BUSINESSES.**

We offer the following suggestions for small businesses planning/trying to operate internationally as B2C firms:

- |    |   |
|----|---|
| 1. | International markets are a great opportunity, but it takes greater time and effort to cultivate the market. Experience suggests that international operations need twice the amount of effort to get started, but, once established, profits are proportionally larger.  |
| 2. | Initially start with a simple web site. Provide the information needed by international customers. Do not use graphics (or animation) on the web page unless it plays a role in the promotion of the product/service. Many international users do not have the fast telephone lines needed to download complex graphics. Kris Olson, owner of Beater's Wear ( <a href="http://www.beater.com">www.beater.com</a> ), adds that "a small company need not start with a fancy web site". |

3.	A small firm may want to approach international markets sequentially. A firm with minimal international experience may start with Canada (or the country from which most sales leads come). After a settling in period, expand operations to Western Europe, then to Japan, and so on.
4.	For the particular products your firm sells on the Web, verify whether there are any applicable restrictions/regulations by the US government or the destination country. Many entrepreneurs have expressed surprise when they found that their products couldn't be exported to some other countries. Some free sources of helpful information include the US Postal Service and the US Government Small Business Administration (SBA). Box 1 provides a list of useful web-sites where information on international business opportunities can be gathered. For those who do not want to use the web, telephone support is available through the Trade Information Center (TIC) at 1-800-USA-Trade.
5.	Consider using logistics services companies for international shipping. These companies act as an intermediary between a firm and international customers. By using an intermediary, a firm conducting business internationally engages the services of a specialized partner, thereby reducing some of the potential pitfalls. However, using a logistics service will increase the cost of purchase for the customer.
6.	Attempt to provide, as accurately as possible, the total cost of the product (including all taxes, handling charges, shipping, and any other cost) for customers. Provide a separate section for international shoppers. While this may seem obvious, most web sites do not provide this information for international shoppers. Insist on payment in dollars until your company has determined how it will hedge currency risks and reduce transaction costs with banks. The organization that issued the credit card used by the buyer will charge the customer at the appropriate conversion rate.
7.	Start with a one-language web site, even though that may reduce the reach of your web site initially. Once your content is perfected, move to other languages depending on where your markets are. Forrester Research reports that customers are likely to spend twice the amount of time at sites in their native language.
	Many language conversion programs exist which do an effective job, but machine translation can create difficulties through cultural error. Use a recognized host-country marketing expert to verify that the web site reads well. While the effective conversion of the customer-side (front end) to local language is critical, it is also imperative to check that your databases and systems (back-end) can handle information in several languages. When you offer a foreign language at the your web site make sure you at least have a part time person who is able to answer questions in that language.

8. Develop policies on how your company will handle international returns, warranties, sales and service support, and other legal disputes. Even if these policies are less customer friendly than your domestic company policies, it is critical they be communicated clearly to the customer. Your traditional customers may be confused when trading across countries. You should educate your sales staff on these differences and how to communicate them when necessary.

**Table 1**

## Web-Sites with Information on International Trade

Web-site address	Description and highlights
<a href="http://www.stat-usa.gov">www.stat-usa.gov</a>	The Globus and NTDB section in this web page provides up to date information of exchange rates, trade statistics, and market and country research.
<a href="http://www.tradenet.gov">www.tradenet.gov</a>	Extensive information on the process of exporting.
<a href="http://www.sba.gov">www.sba.gov</a>	Small Business Administration page provides a lot of useful information related to small businesses.
<a href="http://www.fedworld.gov">www.fedworld.gov</a>	Quick search of federal government information on the web.
<a href="http://www.ita.doc.gov">www.ita.doc.gov</a>	This site provides information on various sources for assistance in trade.
<a href="http://www.usatrade.gov">www.usatrade.gov</a>	This sites provides consulting and advocacy for U.S. exporters
<a href="http://www.sbea.org">www.sbea.org</a>	Small business exporters association
<a href="http://www.usps.com">www.usps.com</a>	The international mail manual in this site provides the regulations related to mailing goods to overseas countries.
<a href="http://ciber.bus.msu.edu/busres/static/other-indexes-international.htm">ciber.bus.msu.edu/busres/static/other-indexes-international.htm</a>	28 CIBERs were established by the U.S. Congress to facilitate international trade. To find a CIBER near you, use the link at the left. Many CIBER's offer hands-on advice for entrepreneurs.
<a href="http://www.fita.org/useful.html">www.fita.org/useful.html</a>	Federation of international trade association's list of useful web-sites for international trade.

All these suggestions are also appropriate to B2B trade, but there are additional considerations that will be discussed in the next section.

### **B2B AND ITS IMPACT ON INTERNATIONAL TRADE**

There are two common types of Internet B2B web sites. The most common B2B site is operated by one business offering its wares to selected other businesses. The second type (called B2B e-Market) acts as a central connection point between buying companies and selling companies. In many respects, B2B e-Commerce is similar to B2C. The web site operators can be buyers or sellers of goods or services. However, the firm operating the web site (the controlling e-business) chooses the firms with which it wishes to do business. The partner firms need not be true e-businesses, that is, operate a major portion of their business through an Internet web site. The partner firms need only be willing to receive orders from, or transmit orders to, the controlling e-business via the Internet. Jupiter Communications forecasts non-service B2B e-Commerce to grow to \$6.3 trillion by 2005. They also forecast that this component of B2B e-Commerce will be 42% of the market, suggesting that B2B e-Commerce will grow to nearly \$15 trillion worldwide.

A B2B e-Market is the electronic equivalent of the traditional wholesaler. The e-Market accumulates the buying needs of one set of businesses, solicits bids for all or part of the amount being purchased, and negotiates favorable terms for the member buyers using cumulated buying power. The e-Market then selects the sellers offering the best price and terms, and connects buyers and seller(s) to complete the transactions. The advantages of this structure are clear. Lower buying prices are obtainable by a single buyer with large buying power. Lower total transaction costs to the buyers involved in the purchases are possible through economies of scale. The advantages of e-Markets are so substantial that General Motors, Ford, and Daimler-Chrysler have created a joint B2B e-Market (called Covisint) for acquisition of components for their automobile units (Hicks, 2000). Their announced plan is to establish Covisint as an independent firm that will open the market to every automobile manufacturer and supplier. Similar markets have been created by partnerships for the exchange of poultry and meat (unnamed so far), and for the buying and selling of steel (MetalSite). The Gartner Group projects that the number of e-Markets will grow to 7,500-10,000 e-Markets by 2002 ("B2B marketplaces," 2000).



## **BENEFITS OF B2B E-COMMERCE**

Perhaps the most significant benefit B2B e-Commerce offers is the potential for participation by small firms from anywhere in the world and a significant reduction in transaction costs. Use of the Internet for e-Commerce has a number of advantages to businesses over the earlier standard (EDI protocol) where business transactions took place over communications facilities, but outside the Internet. EDI is a rigorously defined protocol. The Internet provides a vehicle that is flexible and can be adapted to new uses. EDI allowed only a few firms that were established suppliers (with a particular firm) to participate. The Internet, in contrast, allows for a larger number of potential suppliers to compete for an order. This is true even for firms without an established EDI. Previously, when a buyer was interested in seeking suppliers for particular goods/services, the buyer had to post a tender seeking suppliers. As most small business orders are of lesser relative value than orders from larger firms, such orders were not highly publicized. Firms that had an on-going business relationship with the buyer or were local firms were the prime bidders for such contracts. Using Internet B2B, potential suppliers around the world can be aware of orders that are open. Sellers and buyers both benefit from lower costs and an enlarged base of potential customers/suppliers. The sellers benefit by marketing worldwide, thereby allowing for greater sales volumes and efficient production cycles. Buyers benefit from a reduction in their supply chain costs that come from efficient sourcing and spot buying through auctions and bid-quote systems.

The second major benefit of B2B for small firms is the reduction in transaction costs. Firms can join B2B marketplaces at a nominal price and nearly zero operating costs. This is compared with the time and cost of collecting information through international phone calls, faxes, and couriers for each bid placed. A B2B marketplace can also facilitate the collection of bills for goods/services provided by small businesses. For instance, businesses using the Internet for completing business transactions can also benefit from lowered payment/collection costs by using an electronic clearinghouse for settlement of accounts.

In conclusion, B2B marketplaces have lowered many entry barriers by eliminating information costs and reducing transaction costs, thereby opening opportunities for small firms. B2B, however, also may increase

international competition for small firms who have established privileged connections with customers.

### **BARRIERS INHERENT TO B2B E-COMMERCE**

There is one issue that is insufficiently addressed in most discussions of international e-Commerce. Many of the industries dominated by small businesses are transportation intensive, but deal in goods with low market value. Examples might be steel and wood products, where the transportation charges (and, incidentally, other taxes and customs duties) may escalate the breakeven point beyond the market price of those goods produced locally. In cases where such goods have been transported over great distances, considerations other than local market price have instigated the sales. Hence, B2B marketplaces, for many practical reasons, may not enhance the entry of small firms into international trade.

A factor that is frequently ignored is the continuing need for face-to-face dealing with customers in international markets. This is the traditional, and continuing, way that businesses build and maintain relationships with their customers and, thereby, hold current business and build revenues through increased business. Thus, small business entering B2B transactions should develop plans for regular contacts with customers that produce revenues above a certain level, or which are opportunities for significant increases in revenue produced.

### **SUGGESTIONS FOR SMALL BUSINESSES**

We offer the following suggestions for small businesses trying to operate internationally through B2B marketplaces:

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|----|--|
| 1. | Join as many B2B marketplaces as appropriate to your business strategy. While this can be a significant investment for a small business firm, there are payoffs through increased knowledge about market trends and intelligence normally unavailable to small business. |
|----|--|

2.	A B2B marketplace need not be seen as just another marketing outlet. B2B marketplaces may allow you to plan production and scheduling. Output can be managed better than previously possible.
3.	International firms (both small and large) can participate in local markets through B2B marketplaces. It is, therefore, critical that small local firms strengthen their ties to current customers while competing for orders internationally through B2B marketplaces.
4.	Small firms can reduce the cost of supplies by using B2B marketplaces. Large firms, like General Electric, claim to have saved as much as 30% through B2B marketplaces. Hence, small firms should use B2B marketplaces to find alternative low cost suppliers.
5.	Do not rely on a B2B marketplace alone for information. Conduct active research via the web and occasionally visit both powerful buyers and suppliers for information. There is no substitute for first hand knowledge.

### CONCLUDING COMMENTS

The digital age offers significant opportunities to both consumers and businesses. The Internet provides access to a worldwide market for companies of all sizes. The struggle for dominance over global e-Commerce, according to Doebele, has not yet been won, but significant strides are being made. Nonetheless, Jonas Rahm, Chief of International Operations for the Swedish web site developer Icon MediaLab, holds that "It is a totally open market, but is closing quickly." The Internet has changed, and will change more dramatically still, the way that business is conducted.

The Internet is a boon for small business exporters if their Internet operations facilitate cross-border operations, as illustrated by the examples in this paper. However, the Internet can quickly become a bane if small businesses do a poor job in setting up Internet operations. More things can go wrong with international sales than with local sales. International operations take more time and effort, draining the resources of a small firm. While many of the issues raised by this paper are relevant to both large and small businesses, this paper looks at e-Commerce from the perspective of small business. We believe this paper can help small businesses avoid some of the pitfalls.

To paraphrase a well-known saying: big firms are not like small firms; they have more money. Big size alone offers some protection against the effects of bad decisions that are not available to small firms. Small firms must take advantage of their ability to move quickly and firmly establish their presence in an international e-Commerce business before larger firms close this window of opportunity.

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# **ENTREPRENEURIAL LEADERSHIP STYLES: WHAT WORKS AND WHAT DOESN'T**

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## **ABSTRACT**

*Many entrepreneurs claim to use common sense as their management philosophy. An example is the Golden Rule as a managerial guide for personnel decisions. Since this adage was never meant as a management philosophy, but as a statement of respect and concern for others, it may be inappropriate. Employees want to be understood as unique individuals and as such, they respond to different supervisory methods than entrepreneurs might assume. Entrepreneurs must realize that what works to motivate one employee may not work well with other employees. Examples of effective methods and the principles on which they are based are provided.*

## **INTRODUCTION**

Entrepreneurs have many options when deciding how to provide leadership. Some leadership styles are more successful than others and which is which is well documented though not always well understood, disseminated, or utilized. Common sense is sometimes claimed to be the leadership style of choice. Unfortunately, common sense does not always provide the best direction. An oriental fable dramatizes the negative consequences of following common sense, i.e treating others as we would like to be treated.

Once upon a time, there was a great flood; and involved in this flood were two creatures, a monkey and a fish. The monkey, being agile and experienced, was lucky enough to scramble up a tree and escape the raging waters. As he looked down from his safe perch, he saw the poor fish struggling against the swift current. With the very best of intentions, he

reached down and lifted the fish from the water. The result was inevitable (Adams, 1969, p. 22).

Just as the monkey assumed that the fish's needs were similar to its own and behaved accordingly, so do many entrepreneurs assume that their employees think, feel, and want to be treated as they do. Such well-intentioned behavior frequently results in similarly unfortunate circumstances. Let us move from an old tale to a current scenario:

An owner of a small e-commerce business was being interviewed by a local newspaper official. The reporter asked him about his philosophy of management. The owner responded, "I just trust my gut and go by the Golden Rule, treating others the way I would want them to treat me."

The intent of people like this owner is admirable yet "the trick is not to learn to trust... gut feelings, but rather to discipline yourself to ignore them" (Lynch, 1997, p. 419). In this case the Golden Rule is touted as a rationale for relying on common sense. The Golden Rule is used in a way not intended, i.e. as a management philosophy. Many entrepreneurs believe the Golden Rule is the ideal principle for guiding management practice (e.g. Manz, 1998; Schonfeld, 1994). However, difficulties arise when we use ourselves as the measure of how to treat others (Perreault, 1996), assuming we understand their perspectives, rather than assessing those perspectives.

Treating others as we wish to be treated is based on one's own wants, needs, and perceptions, which does not take into account others' perspectives and preferences. Such an approach implies that entrepreneurs use themselves as models for understanding how to manage people. A corollary is that entrepreneurs treat employees the way they themselves want to be treated. "Our tendency is to project out of our own autobiographies what we think other people want or need. We project our intentions on the behavior of others" (Covey, 1989, p. 192). Often, however, employees do not want to be treated as their employer would like, but respond to different methods (Hill, 1992). Hence, using the Golden Rule is not an appropriate model for entrepreneurs. Given these considerations, the management philosophy of the e-commerce business owner discussed above may be problematic.

### **WHAT CAN GO WRONG**

How can such an ingrained, common sense adage, one of the oldest ethical maxims (Matthew 7:12, 1979), not be the best way to manage people?



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The reality is that what one employee appreciates, another may despise. This is because most of our preferences in life are learned and are highly individualized (Zimbardo & Weber, 1994), including how we like to be treated by the boss.

The tendency to assume that others share our opinions, feelings, and behavior is called the false consensus effect by social psychologists and is considered a fundamental bias in our thinking about other people (Dawes, 1989). We commonly think that others hold similar political opinions, find the same movies amusing, or believe that everyone feels baseball or football is the distinctive American game. Individuals tend to overestimate the proportion of other people who agree with their attitudes about drugs, abortion, seat belt use, university policies, politics, and even Ritz crackers (Nisbett & Ross, 1991; Suls, Wan, & Sanders, 1988). In other words, we assume that people agree with us to a greater extent than they actually do across a wide variety of issues. The adage, "The thief thinks everyone else is a thief," aptly applies.

The bias of assuming that others behave, think, or feel as we do is an error in perceiving that arises because most people want to believe that others agree with them (Mullen, Atkins, Champion, Edwards, Hardy, Story, & Vanderklok, 1985). This way of viewing the world tends to enhance people's confidence that their own judgments, actions, and lifestyles are normal or appropriate which serves as an affirmation of the correctness of their own views (Marks & Miller, 1987; Sherman, Presson, & Chassin, 1984). However, overestimating the trustworthiness of our ideas can be a significant hindrance to rational thinking. We can always believe there is plenty of support "out there" for our opinions, no matter how egocentric they may be. Hence, people may operate under the false assumption that their beliefs are widely held. Thus, false consensus bias can serve as justification for imposing one's beliefs on others. Surely they think, feel, and act as we do, anyway (Fiske & Taylor, 1991)!

The deleterious effects of false consensus may likewise operate in groups and lead to obstacles in their decisions. Cohesive groups of highly qualified, experienced individuals often share the false belief that everyone in the group agrees with the group's judgments (Janis, 1982). Such an illusion of unanimity is a key symptom of faulty decision-making called groupthink that has been cited in a number of poor decisions. Notable examples include: the ill-fated Bay of Pigs invasion of Cuba in 1962 by President Kennedy and

his advisors, decisions made by President Johnson and his counselors between 1964 and 1967 to escalate the Vietnam War, the decision made by President Nixon and his top team to cover up the Watergate break-in in 1972, and the 1986 decision made by NASA and Morton Thiokol to launch the tragic Challenger space shuttle.

### THE PROBLEM OF ASSUMING SIMILAR PERSPECTIVES

The following six key areas denote where doing to others as we would like may not be an effective strategy and where tailoring our approach to others based on their needs and perceptions is generally more appropriate.

Table 1	
Problem Areas Using the Golden Rule	
◆	Rewards
◆	Diversity
◆	Differences in Perceptions of Harassment
◆	Differences in Ethical Perceptions of Business Practices
◆	Cultural Differences
◆	Leadership

#### Rewards

The range of potential differences between ourselves and the people we manage can be great. For example, consider rewards that we might provide employees. Entrepreneurs often assume that what rewards them likewise will reward employees. An entrepreneur may reward a worker with higher pay when the worker really wants prestige, recognition, or more vacation time. Many plant managers have taken a top performer and spouse to an extravagant dinner when that was the farthest thing from that particular couple's desire. They may well have preferred beer and pizza or dinner alone! Of course, the opposite mistake is also made when we assume that because of certain background factors a couple would prefer beer and pizza

when in fact they want to go to a fancy restaurant. Similarly, many of us have heard someone say, "Everybody likes public recognition." The fact is that in research Daniels (1994) has done, most employees say they do not like it. They give various reasons, but most center on concern about what peers might think about them. The effective entrepreneur knows which people like public recognition and which do not and decides on a plan of action accordingly.

Kovach (1987) demonstrated that managers frequently do not understand what motivates their employees. Supervisors were asked to rank-order ten motivational items according to what they believed their employees wanted from their jobs. There were significant differences between these rankings and those of employees. For example, employees rated interesting work as their most important job reward. However, supervisors claimed that their workers' highest preference was for good wages (supervisors ranked interesting work fifth). Additionally, employees rated "full appreciation of work done" and the "feeling of being in on things" as their second and third priorities, respectively; supervisors indicated appreciation as eighth and being in on things tenth. Overall, supervisors had surprisingly inaccurate perceptions of what motivated their employees. It is significant that these different perceptions were obtained from a number of surveys over a 50 year period.

With respect to benefits, some organizations have realized that they may have erroneous ideas of the needs of their employees and have attempted to remedy this situation by implementing cafeteria style or flexible benefit systems (Barringer & Mitchell, 1994). The idea is to allow employees to put together their own benefits package by picking and choosing from available options. Thus, a young parent might opt for the company's life and dental insurance plans, while an older employee may choose an improved pension plan. Flexible benefits have grown in popularity.

## **Diversity**

Diversity is a second issue that brings the Golden Rule into question. Demographic changes have created a more varied society. In the U. S. workforce these shifts and the impact of the civil-rights and follow-on movements have generated more and more workers with differing value

systems and backgrounds. Companies are initiating numerous programs geared toward enhancing appreciation of diversity. Valuing diversity means being responsive to a wide range of people unlike oneself. Included is any number of distinctions such as: race, gender, class, native language, national origin, physical ability, age, sexual orientation, religion, professional experience, personal preferences, and work styles. Valuing diversity involves going beyond the Golden Rule (Carnevale & Stone, 1994). It requires one being receiver-centered rather than self-centered with regard to one's actions. Valuing diversity involves treating others as they wish to be treated. The implications of this shift in perspective are profound. It requires setting aside one's own perspectives or personal perceptual filters and preferences in order to perceive others for who they are. It means recognizing that other peoples' standards and values are as valid as one's own. This may sound simplistic. However, in a culture that has long been accustomed to being relatively monolithic, dominated by white, male, European values the shift is often difficult and painful.

Once entrepreneurs understand and accept basic sources of uniqueness in their workers and errors in their own thinking, they become better equipped to meet each worker on his or her own turf, as it were. Then, they can more effectively explore what particular interactions and methods will maximize each person's contribution to the firm's goals.

### **Differences in Perceptions of Harassment**

The appropriate legal standard for determining behaviors that constitute a sexually "hostile working environment" has not been clearly established (Li-Ping Tang & McCollum, 1996). The problem is the behaviors that typically constitute a hostile working environment are subject to individual perceptions, definitions, and interpretations; in other words, behaviors like sexual jokes or comments, or touching and patting may hold entirely different meanings for various individuals.

There is virtually no doubt about the fact that certain behaviors constitute sexual harassment. For example, "quid pro quo" behaviors (e.g. a supervisor telling a subordinate that the person either performs a sexual favor or will be terminated) is clearly sexual harassment. Nevertheless, where the behaviors are not so blatant and may still constitute a sexually

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hostile environment, the question of defining how a reasonable person would interpret behavior becomes much more important.

One problem is gender-based differences in the way men and women view various behaviors (Baugh, 1997). Based on the literature, for instance, females are much more likely than males to report that they experienced some form of unwelcome sexual attention and to define more social-sexual behaviors as sexual harassment than do males (Gutek, 1989). Similarly, males are less likely to attribute responsibility for sexual harassment to the alleged harasser than are females, and men are more likely to place blame on the female target than are females. Conversely, females assign responsibility for sexual harassment to the harasser. There are likewise differences in how men and women perceive jokes. What may be funny to most males may be insulting or demeaning to many females and failure to account for these differences may lead to strained working relationships, decreased morale and job satisfaction, and possibly charges of harassment.

Entrepreneurs must understand that it is the perceptions of the allegedly harassed individual that will be meaningful in a courtroom. A comment that a male supervisor may perceive as merely complimentary might be perceived by a female as uncomfortable or insulting and create the basis for a sexual harassment charge. Therefore, it is essential to keep in mind the fact that it is the perceptions of the person on the receiving end, not merely the intentions of the sender, which ultimately will determine whether the behavior is unwelcome. Again, it can be seen that failure to take into account the orientation of others may have an unfortunate impact and that doing to others as we would have them do to us is an improper managerial model.

### **Differences in Ethical Perceptions of Business Practices**

Ethical decision-making has emerged as an important entrepreneurial concern in both academic literature and the business press (Labich, 1992; Paine, 1994). Franke, Crown, and Spake (1997) performed a meta-analysis of research on gender differences (20,000 respondents in 66 samples) in perceptions of ethical decision-making and found that women are more likely than men to perceive specific hypothetical business practices as unethical. Research shows that these differences may carry over to men and women's underlying moral structures, value systems, and ethical frameworks. For

example, Gilligan (1977, 1982) demonstrated that women and men possess different underlying moral orientations. She argues that women operate from a framework of caring rather than one of justice, as Kohlberg (1981) suggests is universally held.

Other differences exist, as well. Konovsky and Jaster (1989) reported that men and women differed in the justifications used to support unethical behavior, and Betz, O'Connell, and Shepard (1989) found that men were more willing to participate in a wide variety of unethical behavior including padding travel expenses, using inside information to buy stock, engaging in computer-based theft, and shortcutting paperwork procedures. Tyson (1990) found that in order to save their jobs, men were more likely than women to conceal negative performance from superiors, maximize short-run performance even at the expense of long-run company welfare, bend labor rules to cut costs, and authorize release of a profitable-but potentially unsafe-product. In examining ethical behavior among marketing research professionals, Ferrell and Skinner (1988) found that women in data subcontracting and marketing research firms reported higher ethical standards than men.

A problem with the Golden Rule is that as seen above, people's ethical values differ, and they may mistakenly assume that their preferences coincide with others. Given differences in ethical perceptions, it is understandable how such variance may create problems at work because each gender tends to see ethical situations from their own (often contradictory) perspectives. Additionally, it is sometimes hard to apply the Golden Rule in corporations where the interests of individuals are subordinated to the needs of the firm and where competitive activities demand selfish behavior. Marketing strategies, for example, do not treat competitors with kindness, but are based on self-interest (Steiner & Steiner, 1994).

### **Cultural Differences**

Just as individuals have distinct personalities, different cultures possess unique characteristics that must be understood. Managers who have failed to recognize these differences have committed a number of mistakes. Ricks (1993) documented numerous blunders that result from individuals being insensitive to other cultures. For example, Arabs typically dislike deadlines. An Arab faced with a deadline tends to feel threatened and backed

into a corner. Many Americans, on the other hand, try to expedite matters by setting deadlines. As a result, American-owned electronic devices may set untouched in Middle Eastern repair shops because the American owners made the mistake of requesting that the work be completed by a certain time.

In a related example, the acquisition of the Firestone tire company by Japan's Bridgestone did not proceed as smoothly as hoped. In fact, John Nevin, the crusty former chairman of Firestone, admitted that his style appeared abrupt and abrasive at times to the Japanese whose manner is much more subtle. He needed to be less direct and forceful with them, and they had to become more aware and tolerant of American directness.

Cultural norms also affect entrepreneurial leadership style regarding what subordinates come to expect. For example, a manipulative or autocratic style is acceptable in Arab, Far Eastern, and Latin countries, whereas, a more participative or involving style is required in other countries like Austria, Sweden, and Denmark (Hofstede, 1980). In Sweden, specifically, it is traditional for employees at all levels to be involved in the decisions affecting them. However, in India where autocratic decision-making is the norm, it would be considered a sign of weakness for managers to consult subordinates about decisions (Greenberg & Baron, 1997). Therefore, an American entrepreneur, accustomed to participative decision-making, may undermine his or her efforts in India by treating employees in a way that he or she would like to be treated, and not how local customs dictate.

## **Leadership**

A final area in which the assumed similarity is inappropriate relates to the use of contingency leadership. Contingency leadership calls for using management techniques in a selective, situationally appropriate manner, instead of relying on one best way at all times. The contingency approach does two things: (a) it encourages entrepreneurs to view organizational behavior within a situational context and (b) it encourages leaders to adopt the style that will have the greatest positive effect on performance and achievement of organizational objectives. Entrepreneurs must adjust their style to fit their employees and situations.

According to contingency leadership, evolving situations, not fixed rules (such as, do unto others as you would have others do unto to you) determine when and where various management techniques are appropriate.

Research supporting the contingency approach is voluminous (e.g. Hughes, Ginnett, & Curphy, 1996; Quinn, Faerman, Thompson, & McGrath, 1996). Samples include the following.

<i>Supportive Leaders.</i>	<p>Leaders who emphasize concern for the welfare of subordinates are more effective:</p> <ul style="list-style-type: none"> <li>(a) with individuals who have high needs for affiliation,</li> <li>(b) with individuals having high social needs,</li> <li>(c) with individuals who have highly perceived abilities to do the work,</li> <li>(d) for boring or simple tasks, and</li> <li>(e) when jobs involve stressful or frustrating tasks.</li> </ul>
<i>Directive Leaders.</i>	<p>Leaders who articulate guidelines and performance standards are more effective:</p> <ul style="list-style-type: none"> <li>(a) with individuals who have high needs for security,</li> <li>(b) with individuals who have low degrees of self-confidence and who believe outcomes are a function of chance or luck,</li> <li>(c) with individuals who have lowly perceived abilities to do the work, and</li> <li>(d) for unstructured or ambiguous tasks.</li> </ul>
<i>Participative Leaders.</i>	<p>Leaders who stress information sharing and consultation are more effective:</p> <ul style="list-style-type: none"> <li>(a) with individuals who have high degrees of self-confidence and who believe outcomes are a function of their own behaviors, and</li> <li>(b) when jobs involve complex tasks.</li> </ul>
<i>Achievement-oriented Leaders.</i>	<p>Leaders who accentuate excellence and challenging goals are more effective:</p> <ul style="list-style-type: none"> <li>(a) with individuals who have high needs for achievement and</li> <li>(b) when jobs involve complex tasks.</li> </ul>

Employee performance and satisfaction are likely to be maximized when entrepreneurs compensate for things lacking in employees and/or work settings. However, entrepreneurs who spend time explaining tasks when they are already clear or when employees have the ability and experience to



handle the tasks, will find their input likely to be ineffective because employees will see such directive behavior as redundant and/or insulting (Wofford & Liska, 1993).

## CONCLUSIONS AND SUGGESTIONS

Productive management strategy is not a matter of being aware of our own needs and responding to employees based on them, simply because we assume that others want to be treated like us. Instead, productivity is encouraged by being sensitive to others' perceptions, wants, and priorities, then treating them in accordance with these outlooks. Generally, entrepreneurs will be most effective when they take into account the perspectives and preferences of their subordinates and not use themselves as models in managing others.

The following suggestions may be helpful:

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|-----|--|
| (a) | Be continuously aware of your assumptions about people and your interactions with them. This is a lifelong process, not an end to be achieved, then forgotten about. Do you assume the best about people, or the worst? People will perform up or down to our expectations. Do you assume people share your values, perspectives, and preferences?                                 |
| (b) | Be aware that your views, preferences, and needs are not necessarily shared by others. This seems obvious, but people forget. The cliché, "What you see depends upon where you stand," is appropriate since everyone sees the world from their own unique point of view. Remember, everyone takes a different path to get to their particular vantage points.                      |
| (c) | Learn as much as you can about individual differences and preferences. These include race, culture, personality, family background, gender, religion, and nationality. The more you know about differences the better you will be able to see beyond your own vantage point. Accumulating knowledge in this area is the first step, appreciating and valuing differences the next. |

- (d) Engage in dialogue. Decisions about the welfare of others ought to take into account their perspectives. When unsure, ask! It is amazing what people will tell you, especially if they understand that you genuinely want to know. For example, a policy-making process that includes consultation with employees could disclose others' unknown needs and preferences regarding the issue. Pay attention to non-verbal cues. Due to the inequity of power in owner-subordinate relationships, it is common for subordinates to avoid verbally sharing their beliefs or feelings. Learning to understand the possible meanings of non-verbal behavior can provide cues to others' true feelings. White knuckles clasp the arms of a chair do not signify comfort or agreement, no matter what the person says.

Finally, it is easy to judge others if we assume they are similar to us. This "like me" effect results in an individual's perception of others being influenced more by what the observer is or wants than by what the other person actually is or prefers. Indeed, it can be said that assumed similarity thinking is a "lazy" way of managing others (Robbins, 1997). People who assume that others are like them will be right some of the time, but only when they judge someone who actually is the same. The rest of the time, they will be wrong, leading to inaccurate perceptions and invalid data for making predictions, decisions, and guiding behavior. This is like the proverbial broken clock; it is right twice a day.

Use common sense adages like the Golden Rule cautiously to check whether you might be rationalizing when it comes to your own decisions. Accept the fact that the other person is as much an individual as you and insists on being treated as such (Drucker, 1999). You may want to ask yourself periodically, "How would I feel in this situation if I were my complete opposite?"

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# POSTMODERNISM: STRATEGIC IMPLICATIONS FOR ENTREPRENEURS

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## ABSTRACT

*The concept of postmodernism has been applied to art, architecture, and philosophy to account for changes in contemporary society. This paper discusses the essential meaning of the term and relates it to emerging and evident trends in the marketplace. The key dimensions are changes in our concepts of truth, reality, unity (of self), and value. After a discussion of these essentials of postmodernism, the paper concludes with a set of ten implications for entrepreneurs.*

## INTRODUCTION

It's not your father's Oldsmobile. It's no longer your father's world. So, it's no surprise that you and your father (or mother<sup>1</sup>) should differ in approaches to entrepreneurial enterprise. The brave new world has been characterized by a new perspective on life-*postmodernism*. In this article I will briefly describe postmodernism and suggest a number of significant changes that it implies for the challenges of business startups.

## POSTMODERNISM

Most philosophers identify the postmodern perspective on life as beginning in the 1960's and centered in Western Europe and North America, the result of many factors, but chiefly economic and technological developments. Like any attempt to generalize about a vast cultural perspective on life, it is not subject to simple explanation. Postmodernism has been discussed in hundreds of books and articles, and I make no claim to

present a complete or necessarily representative description here. More complete discussions of postmodernism may be found in Baudrillard (1983), Brown (1995), Featherstone (1988) Firat and Venkatesh (1993), Jameson (1983), and Lyotard (1984).

Different authors emphasize different aspects of postmodernism, but several interrelated factors are commonly noted. These factors are also the aspects of postmodernism that are most relevant to business. I have summarized these factors with the following terms: *truth*, *reality*, *unity*, and *value*.

*Truth* refers to a central change from modernism to postmodernism, regarding beliefs in an underlying purpose and a knowable process. Central to modernism is the scientific method, which assumes a universe that is subject to an ultimate theoretic. Hypotheses about this grand model can be devised and tested against empirical measures, which are assumed to represent reality. Postmodern scholars refer to such unified expressions of truth as "metanarratives"-stories that characterize the human condition, the universe, or reality. Postmodernism recognizes them as "stories," per se-fictions. Heisenberg's "uncertainty principle" (not even measures of physical reality can be taken without disrupting what is being measured) is central to the underlying belief that no certain knowledge about reality is attainable. Therefore, postmodernism rejects the notion of any single theory and accepts as equally valid various ideologies and philosophies.

*Reality* refers to a loss of distinctions made by modernists between real objects and their signifiers, real activity versus ersatz experience, and, ultimately, subject and object. Modernists attach importance and significance to "real" objects. For them, signifiers, symbols, and images may be associated with things, but it is the things that are truly important. For postmodernists, the distinction is blurred to irrelevancy. Two processes are significant. First, images and symbols become detached from their objects.

These "free-floating signifiers" can then become meaningful in their own right and used independently from their original objects. For example, the Christian cross symbol is used in contexts other than its original one, many of which are not even religious. Second, the image and symbolism take on context-relevant weight and meaning. That is, they do not merely represent something meaningful, they become meaningful themselves. Brand names provide apt examples. The image of Tommy Hilfiger, conveyed so effectively through promotion, becomes truth in a postmodern world. The



clothes don't make the person; the image of the clothes, as conveyed by the brand name, becomes the person.

The lack of a sense of underlying truth and an indifference to distinctions between real objects and their signifiers underlie another significant dimension of postmodernism—a lack of *unity*. Modernists assume that all things are part of a whole and that that whole is constant and continuous. The scientific method assumes a continual, incremental movement toward understanding of a unified world. In fact, scientists either explicitly or implicitly work toward a single grand theory that could explain everything. Postmodernists accept fragmentation and inconstancy. The MTV generation, with its rapid-fire changes in images and shortened attention span, reflects the postmodern themes of irreverence, non-conformity, noncommitment, detachment, indifference, and fragmentation (Venkatesh, 1989). Diversity is not just politically correct, it is the nature of the worldview. Further, this sensed lack of unity applies both to the world and to the observer. Postmodern individuals have separate selves or compartmentalized self images, which are equally valued and variously appropriate, depending on the situation.

The final dimension, *value*, refers to the sensed process of value creation. Modernists locate value in production and mean by that the act of producing goods or services. The prevailing notion is that value is created when the product is formed and destroyed when the product is consumed. Postmodernists argue that value is created during consumption. It is during consumption that the experience is created and during consumption that the images attached to the product are transferred to the consumer. Thus, consumption has changed from a destructive, self-serving activity to a constructive, meaningful one.

### **RELEVANCE OF POSTMODERNISM FOR ENTREPRENEURSHIP**

Each dimension of postmodernism discussed above has relevance specific to entrepreneurs. More detailed discussion of each dimension is presented below, with implications for entrepreneurial strategy following.

## Truth

Perhaps the most fundamental change, the decline in belief in a fixed, knowable reality has pervasive effects on entrepreneurship, but following are two phenomena that align most closely with it.

*No single business strategy.* The business model has in a sense come full circle. Long ago, products were made by individual craftspeople or small shops. The means of production and marketing varied widely from shop to shop. That economy was replaced when technology made mass production possible, and markets came to be characterized by a few, nearly indistinguishable competitors. Now, technology has opened the world electronically and has vastly expanded the possibilities for competition. Small firms can sell worldwide over the web. Consumers can compare thousands of offerings at the click of a mouse. One consequence of the vast array of choices is the decline in the importance of source. Brand names are still important, more important, in fact (more about this below), but the meaning of the brands has changed. Brands are no longer important mostly because they represent the solid, dependable "institutionalized" companies of yesteryear.

The multiplicity of strategies is most evident in the dot com arena. Traditional standards of advertising and product lines have blurred. Of the most successful dot com ventures, Amazon.com may soon sell everything, and EBay sells nothing. Companies thrive and expand while they grow deeper in debt. Business schools are racing to develop courses to explain the new strategies. At the University of Michigan, one MBA course, "Competing in the New Economy," is called an "anti-course" and is premised on the idea that the old theories don't apply. The goal of the course is not for the professor to teach the students the necessary tools; rather it is for them to interact to create new tools (Silverman, 2000).

Finally, entrepreneurs no longer start businesses with a sense of commitment, an internalized faith that they are in for the long haul. Postmodern entrepreneurs do not believe in a single best way of doing business. One of the most important aspects of the new venture business plan has become the "exit strategy"-what to do when it becomes clear that the venture has failed<sup>2</sup>. Postmodern entrepreneurs expect their ventures, at least as initially proposed, to be temporary. A crucial decision now is the balance between sufficient commitment and effort to achieve a difficult success

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versus the flexibility to "cut bait" on an idea and move on to something better with as many resources intact as possible. Postmodern entrepreneurs recognize that the first round of investment money often serves to establish that the concept doesn't work. Accepting that, they change the business, create a new name, and find investment support for the new direction.

*People rather than things.* In an ephemeral world where technology changes at warp speed, both consumers and firms recognize that relationships with people, however changeable they may be, are more stable than relationships with things. For firms, things are a burden that holds one in the present, soon to be the past. Product life cycles are being slashed (Smith & Reinersten, 1995); firms hesitate to make capital commitments to production techniques. Electronic data interchange technology and just-in-time inventory techniques make it unnecessary to keep stock on hand. Production has increasingly become a backroom activity. Automobiles can be made to order. In the postmodern world, production increasingly becomes a backroom activity for "virtual" firms whose principal assets are marketing; everything else is outsourced. Manufacturers don't make anything; retailers don't touch the products they sell. Firms succeed not because of their tangible assets, but because of their relationships-relationships with their suppliers and, increasingly important, lifetime relationships with their customers.

A striking change in postmodernism, elaborated by Rifkin in *The Age of Access* (2000), is a shift among people from family/friends/religion/ethnicity-centered social organization to a market-centered social organization. Increasingly, people define themselves in terms of their consumption relationships. Consumers turn to the market for food, clothing, shelter, recreation, amusement, security, and family care. Malls have become today's town meeting halls, and the internet continues to supplant face-to-face and even telephone conversation. People may have richer communication with their suppliers, sometimes strangers that they have never seen, than they have with their family members. Certainly, electronic data collection and "data mining" have made it possible for firms to "know" consumers better than most of their friends do.

Rifkin notes that the increasing reliance on relationships corresponds with a shift in the market from discrete exchanges of products to enduring relationships that emphasize the attached services and de-emphasize the actual products. Services, on average, return nearly twice the gross margin

of goods (Deutsch, 1997). With the rate of technological change reducing the value of the products, firms are switching to a form of "give away the razor and sell the blades" strategy. Products are sold at or below cost in order to gain entry into a relationship with a customer that the firm hopes will have a high lifetime value. As examples, Lego sells a robot toy at cost, but consumers pay when they download software commands; emWare, Inc. sells a sprinkling system at cost with service charges for web-supported controls; many firms now provide essentially throw-away telephones in return for service contracts. Postmodern exchanges are for auxiliary products, but more importantly, service, including training, maintenance, upgrading, and logistics management.

### **Reality**

Whether a cause or an effect of the disavowed attainability of "truth," postmoderns do not recognize a "reality." Or, if they do, they exhibit no preference for the "real" over the "hyperreal." Two fundamental manifestations of this dimension for business are branding and simulated reality.

*Branding* is not peculiar to postmodernism, but its importance is. For moderns, brands were distinguishing characteristics that facilitated communication and selection, but the communication and selection were usually in reference to objective product features. For postmoderns, the key to branding is product image. The business process has become inverted; marketing has become the end, not the means of the exchange. Spokespeople do not serve merely to attract attention to a message or to authenticate it, they, and their images, become part of the benefit that is purchased. Designer labels, the Nike swoosh, the Coca Cola name, all allow consumers to partake of cultural experiences. For example, international marketing manager, Frazer Thompson says of his new promotion campaign, "Heineken will always be a brewer, but we are definitely also in the business of enjoyment. We want people to drink beer for enjoyment. I want consumers to say, 'Only Heineken can give me this memorable experience.'" (Dorsey, 2000). Or, consider Cannon, whose camera advertising creates association with independence, non-conformity, and distinctiveness of style (all characteristics of the user, not the camera). When a consumer purchases and

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uses the Cannon Rebel, the simulated reality is part of the experience-he becomes and is perceived as a stylish non-conformist.

An important aspect of brand image is the emotional or experiential meaning of the brand. Because postmoderns regard the core attributes of most brands as similar, the differentiating aspects are connections to the brand that have little to do with functional attributes. Many recent new product successes owe much of their appeal to design aspects that heighten or facilitate positive emotional reactions or product use experience. Examples are the Prowler, Cruiser, and Beetle-all retro-styled automobiles; the Apple I-Mac and Sony Vaio; and, a variety of newly stylized versions of former commodity items-waste cans, toothbrushes, 35mm cameras, and hand tools (Givney & Luscombe, 2000).

An interesting development in branding is the simultaneous increase in the importance of spokesperson, as a key brand association, and the decline in importance of being famous. Modernists respond to well-known sports and entertainment celebrities; but, postmodernists regard unknowns and imitators as equally valid. Postmodernism is the age of the instant celebrity. "Survivors" was one of the biggest entertainment hits in history. The winner, Richard Hatch, has become, overnight, as much in demand as anybody, especially for startup companies, who identify with his spectacular rise from obscurity and his open aggressiveness. In Germany, the hottest advertising campaign features Stephen Kappers, previously a complete unknown. The ads not only feature him, they play up his lack of reputation. "'Nothingness has a name,' says German magazine *Spiegel Reporter* in an article analyzing the Stefan Kappers phenomenon that cites French philosopher Jean-Paul Sartre." (Aalund, 2000)

The symbolic associations often have more value than the objectively real ones. "The image does not represent the product ... the product represents the image" (Firat & Venkatesh, 1993, 244). The ultimate in this effect can be seen in the brand communities of Harley Davidson, Saturn, Burger King Kids Club, Holiday Inn's Priority Club, etc., which not only help to define their customers, but bring them together for an ongoing social experience with similar and likable people like themselves.

*Simulated reality* may be based in technology (virtual reality) or merely in design. In either case, it capitalizes on the postmodern indifference to the "real" versus the simulation. Virtual reality technology permits us to play games in which they fight, kill, fly, race, etc. without the costs of

developing the necessary skills or accepting the risks. It allows us to shop in thousands of stores without the hassles or expense of driving or parking. Simulations designed without computer assistance enable us to go river rafting, on safari, or mountain climb. The IMAX in Flagstaff, Arizona, invites tourists to "really experience the Grand Canyon" (Firat & Venkatesh, 1993). Other notable simulations offer consumers homogenized versions of foreign cuisines or travel (for example, tours of Asia with stays in 4-star English speaking hotels or cross-country biking with catered meals and vans for luggage and laggards). Consumers aren't being fooled; they know the simulation is not the "real" thing; but, it is the preferred thing.

## **Unity**

A characteristic of modernism is a movement toward consistency and integration. The postmodern analogs are temporality and fragmentation. The unity dimension is evident both in the importance to business strategy of focus and flexibility and in the further fragmentation of the marketplace.

*Focus and flexibility* are key strategic guidelines in a postmodern world. Postmoderns have no longing for unity; they do not need to be in charge or to do it all. Technological change has made it difficult for a single firm to be either more effective or more efficient in any sub-area of business than potential suppliers. (Excepting, of course, the firm's focal specialization.) More and more activities are being "farmed out." A single firm can be a world leader and still outsource the following: maintenance and repair of computer equipment, training, applications development, consulting, mailroom functions, printing and reprographics, records management, supply and inventory, administrative systems, telephone customer support, payroll processing, taxes, purchasing, general accounting, recruiting, staffing, facilities maintenance, food services, fleet maintenance and operations, advertising, sales promotion, production, fulfillment, and personal selling. Nike may use the slogan "Just do it;" but they don't, in fact, do much of it themselves. If firms do make commitments, they hold them to stringent criteria; Liber reports the expected payback for tangible assets such as buildings, which a decade ago might have been 10 years or longer, is now 18-24 months (Liber, 2000)

The rates of technological and social change also pressure firms toward strategic flexibility. In the modern world, people worked in the same

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business for a lifetime, and firms were created and passed down within families. Postmodern workers don't plan beyond a few years and certainly don't expect to stay with the same firm for a lifetime. Nor do the firms, themselves, expect to remain the same. New technologies too quickly supplant old ones. Even firms that remain in a single product-market must have the flexibility to alter strategies drastically—from research and design with no application limits, to focused segmentation with expansive customer service, to broad-based standardized marketing with very limited service, and back to a narrow focus (Moore, 1995).

*Market fragmentation* goes beyond the segmentation of the modern age. Widespread segmentation was driven by technological and economic improvements that made it possible for supply to exceed demand. Competitive pressure forced firms to focus on specific desires of fractions of the market. Segmentation divides the market along differences across consumers. Fragmentation is not only a finer degree of segmentation (more and smaller fractions), but a cross-cutting of differences across consumers with differences across situations. Among modern consumers, some preferred slacks and others preferred jeans. Postmodern consumers want different types of slacks and different types of jeans, depending on more and more narrowly defined situations. The postmodern consumer no longer has a self image; he has multiple self images, some as ephemeral as moods. He is a dedicated, self-motivated employee, loving husband, devoted father; but, he is also a weekend Goth or heavy metal fan, a risk-loving mountain climber, an amateur digital movie maker, a lover of 19th century Russian novels, and an avid squash player. The modern consumer had "sneakers" for sport; the postmodern has thirteen different pairs of specialty athletic shoes.

In addition to product-situation specialization, postmoderns appear to have information processing specialization; particularly shorter attention spans. The vast multitude of images that compete for attention, the transmission speed of visual data, and the vividness of scenes and sounds encourage a constant shifting of focus that is consistent with the underlying detachment and lack of commitment. Postmoderns don't stay with one thing for long because the next thing is equally attractive. All forms of entertainment have short scenes and quick cuts. Advertising messages have shrunk from 60 seconds, to 30 seconds, to 10 seconds. In response to the constant shifting of focus, advertising media have proportionately increased. A behavioral analog to the reduced attention span is the decreased brand

loyalty of postmoderns (Keller, 1998). Whereas the meaning of brands has increased dramatically, loyalty to brands has decreased, a further push toward market fragmentation.

### **Value**

The change in the conceptualization of value creation from production to consumption parallels the transition to a service economy and the increased importance of brand images. We live in a *service economy*-74% of the GDP in 1993 (Henkoff, 1994). The shift from goods to services is consistent with the new sense of value. A distinguishing characteristic of services is the blurring of production and consumption. For example, a night's stay in a hotel is produced only when one stays the night in a hotel. It is easier to conceptualize the value of a cook-at-home dinner that has been fabricated from scratch and sits on a store shelf than a service, such as a therapy session, which doesn't even exist until it has been consumed and has value only to the extent that the consumption improves, even becomes part of, the consumer.

But, even the cook-at-home dinner may have an associated brand image, the value of which may not be realized until it is purchased and consumed. Among the possible symbolic "realities" associated are "sophisticate" (international cuisine), "nurturing parent" (kid favorite), "wise parent" (organic/nutritious), "successful" (high priced), "stylish" (targeted to the smart set), and so on. To the extent that promotion has succeeded in establishing these associations, they exist as potential meaning. Whereas the product itself will be destroyed in consumption (value cancelled), the expansion of sense of self occurs only in the consumption. For moderns, value is created when the people make the clothes; for postmoderns, value is created when the clothes make the people. Thus, the relative importance of production operations and marketing activities shifts markedly toward the latter in the postmodern world.

## **CONCLUSIONS**

Before presenting implications, a brief disclaimer. These suggestions will not apply to all entrepreneurs nor to any one entrepreneur at all times.



In a modern world, there is sufficient heterogeneity that a variety of strategies can succeed. In a postmodern world, the heterogeneity is far greater. Moreover, as the careful reader may have noted, references to modernism have been made in both past and present tense. Postmodernism may be upon us, but it is not a dominant worldview. Many people, particularly adults who developed their philosophies as modernists, will remain so throughout their lifetimes.

Further, the strategic implications that emerge need not differ dramatically from those that have been derived from other perspectives. The chief value of a consideration of postmodernism lies in providing a richer understanding of the factors that necessitate these strategies. One always hopes that sound strategy springs, not from a list, but from a better understanding of the world.

## STRATEGIC IMPLICATIONS

<i>Maintain lateral flexibility. Be able to change rapidly the way you conduct your business.</i>	
◆	Lease; don't buy.
◆	Consider outsourcing every aspect of your operation that you cannot do better than suppliers and that you don't consider your focal expertise. (That means that even if you love doing the advertising yourself, you should outsource it, if an agency can save you money. And, even if you can deliver more cheaply than a shipper, you should outsource it, if it takes your energy and resources away from your focus.)
◆	Design contractual arrangements with options.
◆	Limit your dependencies upon individual suppliers and customers.
<i>Maintain temporal flexibility. Don't commit for the long term. Don't expect your team to do so.</i>	
◆	Avoid ventures that have payoffs beyond two years.
◆	Recognize that potential investors share this insight. They are investing in you; sell yourself more than your venture.

<i>Develop contingency plans. New ventures are uncertain; don't overplan the proposed venture and underplan responses to the unexpected.</i>	
◆	Focus on big uncertainties (e.g., significant changes in technology or competitors), not small ones (e.g., poor response to proposed advertising vehicles).
<i>Focus on the meaning of your offering, from the perspective of the consumer.</i>	
◆	Do not content yourself with traditional tools, such as conjoint analysis or attribute analysis. Support them with indirect techniques and user image studies.
◆	Capitalize on the semiotics of brand elements (name, logo, spokespeople, etc.) and the non-functional design aspects of your product. Use their meaning to your advantage. (Bryan Nesbitt (2000), Senior Manager of Design at Daimler-Chrysler, on a recent episode of "Talk of the Nation," NPR stated that all new cars provide roughly equal quality; what distinguishes the successes is their names and designs and the emotional powers they create.)
◆	Go one step beyond the traditional "marketing myopia" warning. You're not selling drills, but you're not selling mere holes either. You're selling all the meaning associated with holes and the making of holes. Understand your offering in the broadest sense of the benefits and meaning that consumers take from it.
<i>Get a postmodern perspective. Include young people on your team. They're more likely to have it.</i>	
◆	Immerse yourself in leading edge technologies and popular culture, especially those unrelated to your venture. (You're likely to know most of what is relevant to your focus.)
<i>Narrow your focus, but broaden your search.</i>	
◆	If you are a niche enterprise, expect to serve increasingly smaller segments, but
◆	Recognize that segments other than your target may borrow the meaning you create. Be ready to capitalize. (For example, consider Doc Martens, now de rigueur footwear among youth and style conscious worldwide, its original target was construction workers. See their website, drmartens.com.)
<i>Develop "people skills." No matter if you get started as an inventor, a scientist, or an engineer; you must be effective at developing and maintaining relationships.</i>	
◆	Train yourself in personal selling-professional selling, not the A-B-C method.
◆	Develop (or hire) strength in customer service and negotiating.

<i>Think "anti." For postmoderns, there is no failure like success.</i>	
◆	Don't use the most popular spokespeople; create your own.
◆	You may not need tried and true advertising appeals or vehicles. (Examples: Benetton, Nike, "Got Milk," Absolut Vodka)
◆	Create new designs.
◆	If you can't be creative, be imitative; but, do it consciously.
<i>Embrace technology. This goes without saying.</i>	
◆	Use the internet to communicate with your customers and suppliers.
◆	Have a web page that is not merely a billboard. It should be part of the experience your customers get. Which means, you need to invest in it, maintain it, update it, play with it.
<i>Get away from your product. It's not all that your consumers want, and it's likely too easy for competitors to copy.</i>	
◆	Consider leasing rather than selling. (Why isn't there a consumer market for leased computers, audio/video equipment, sports equipment, even clothing, with continual updates, training, and maintenance?)
◆	Compete on the basis of related services and auxiliary products, not the core product.

## ENDNOTES

<sup>1</sup> All uses of masculine references are made for stylistic purpose and are intended to be gender neutral, unless specifically indicated otherwise by context.

<sup>2</sup> To be fair, exit strategies should also identify options for the possibility that the firm succeeds beyond the management skills of its founders.

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# RISK MANAGEMENT FOR SMALL BUSINESS

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## ABSTRACT

*Every organization is exposed to risks associated with employment practices and must develop strategies to avoid and/or minimize risks. Risk management is particularly crucial for a small business because a single poorly managed risk could threaten survival. In this paper, a framework that small business owner/managers could use to systematically analyze risks is described, and various options to manage risks are identified. Next, a risk transfer device is discussed in detail. This discussion focuses on protections, coverage, cost, and benefits of obtaining employment practices liability insurance (EPLI). Finally, risk reduction tools and techniques to complement EPLI are discussed.*

## INTRODUCTION

Small businesses employ almost 58% of the workforce and represent 99% of the organizations in United States (<http://www.sba.gov/advo/stats/sbafaq.pdf>). Every organization including small businesses is exposed to risks and must develop strategies to avoid and/or minimize risks and also to mitigate the effects of risks. In contrast to large organizations, small businesses do not have the resources to employ risk managers or risk management consultants to deal with risks. Yet, managing risks is, at least as much, if not more important, for smaller organizations than for larger organizations because a single poorly managed risk could drive a smaller organization to bankruptcy.

An organization engages in several operations or activities. Almost all of these activities, including technical activities (e.g., production,

manufacture), commercial activities (e.g., buying supplies, selling products/services), financial activities (e.g., finding sources of capital, managing capital flows), accounting activities (e.g., recording and analyzing financial information), and human resource activities (e.g., hiring employees, disciplining employees) involve exposure to risks. The focus of this paper is on the risks posed to small businesses by human resource activities.

In large organizations human resource professionals and risk management specialists guide and help the organization manage the risks associated with human resources. In contrast, in small organizations, the owner or a manager directs all activities including those related to the management of human resources. The owner or manager must engage in several human resource/employee relations activities, such as hiring employees, promoting employees, resolving conflict among co-workers, disciplining employees, and terminating employees. Mistakes made in performing any of these activities will expose organizations to severe risks and consequences. For instance, disciplining employees in an inappropriate manner or terminating employees in an insensitive manner could lead to a discrimination lawsuit or charges of wrongful termination against the employer.

The primary purpose of this paper is to educate owners and/or managers of small businesses to better manage risks. First, an overview of the risk management process is presented to help managers/owners think about risk management issues in a systematic manner. Second, options available to managers/owners to manage risks are described. Third, a comprehensive discussion of EPLI is provided. Finally, tools and techniques that small businesses could use to complement EPLI are described.

## **OVERVIEW OF RISK MANAGEMENT**

Knowledge of the risk management process will help small business owners and managers to think about risk management in a systematic matter. The risk management process consists of the following 6 basic steps (Vaughan, 1997).

Determining objectives
Identifying risks



Evaluating the risks
Considering alternatives and selecting the risk treatment device
Implementing the decision
Evaluating and reviewing the effectiveness of the decision

A brief description of each step is presented. The focus as each step is described is on the risks associated with employment practices that organizations face in an everyday manner.

**DETERMINATION OF OBJECTIVES.** Employees in the United States receive numerous protections based on federal, state and local laws and statutes. As such, employment practices can come under the scrutiny of various enforcement agencies, as well as the court system. How employees are treated in an organization can lead to situations where employment practices can be questioned. An employer must decide which risks associated with employment practices he or she wants to address, as well as how to address these practices. As such, one or more objectives need to be set. One objective could be to protect the organization's financial position. Another objective could be to ensure that all employees are treated fairly. A third objective could be to prevent (if possible) or minimize the number of potential employment discrimination lawsuits, or the number of lawsuits associated with employment practices. Although the actual objectives may vary from one organization to the next, every organization must explicitly set objectives.

Setting objectives has two benefits. First, it forces the manager or owner to foresee potential risks. Second, it will serve as a control device to help ensure objectives are met. Setting objectives that are realistic is likely to be a challenging task for a small business because the owner and/or manager is forced to consider the large number of negative possibilities that could result from employment practices.

**IDENTIFYING RISKS.** The second step involves identifying the major actual or potential risks posed by employment practices of the small business. This is a daunting task. Small businesses that employ 15 or more employees must take this task seriously because organizations of this size have to comply with several federal and state laws and regulations. As such, identifying the pertinent laws to comply with at both the federal and state levels is a must for all small business owners and managers. It is important

to have at least a basic understanding of these laws (Ledvinka & Scarpello, 1992; Sovereign, 1994).

The essence of most laws is to prohibit discrimination in all terms and conditions of employment on the basis of race, color, religion, sex, and national origin (Ledvinka & Scarpello, 1992; Sovereign, 1994). It is important to understand that every employment decision (e.g., recruiting, selecting/hiring, deciding who to promote, allocating pay increases) should be free from bias or prohibited discrimination. In essence, what this means is that any type of decision that deals with employees (e.g., hiring, promoting) can be legally challenged. The best way to ensure compliance is to always make decisions based on job-related qualifications (e.g., hiring the best applicant, promoting the best performer or the most senior employee). Additionally, employers are obligated to provide a harassment-free work environment. Employers including small business owners must take this seriously because sexual harassment lawsuits could significantly influence survival of an organization.

While the risks seem unending, a first step would be to become familiar with the various employment laws at both the national and state level (Ledvinka & Scarpello, 1992; Sovereign, 1994). The purpose is to identify employment practices that may not be in compliance (e.g., has been challenged in the past) or the practices that could be easily questioned. Practices that have led to litigation should be considered as known risks. Those that have not, but could, should also be considered as risks.

A second step is to examine the organization's written policies and procedures that shape employment practices. Certain policies may help one decide not so much whether a risk exists, but more precisely, how much of a risk exists (Gavin & Jawahar, 2002).

**EVALUATING THE RISKS.** Once a small business owner has identified the risks associated with specific employment practices, the next step is to evaluate those risks. The most effective approach for evaluating risks is to classify them into one of three categories (Vaughan, 1997).

"Critical risks: all exposures to loss in which possible losses are of a magnitude that will result in bankruptcy.
Important risks: those exposures in which possible losses will not result in bankruptcy, but will require the firm to borrow in order to continue to operations.

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Unimportant risks: those exposures in which possible losses can be met out of the firm's existing assets or current income without imposing undue financial strain."

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The key to using these categories is to understand the potential costs of employment litigation, along with a complete awareness of the organization's assets. This will help the business owner to identify if they can financially withstand the potential \$100,000 discrimination lawsuit. For a small business that is barely making ends meet and has no employment policy manual, this could be viewed as a critical risk. For a small business with an employment policy manual and some financial assets (\$10,000 - 50,000), then this might be evaluated as an important risk. Each business must carefully and honestly evaluate risks that could result from poor human resource decisions in the context of its financial resources tied to human resource management decision (Cascio, 1987).

**CONSIDERING ALTERNATIVES AND SELECTING THE RISK TRANSFER DEVICE.** There are four basic techniques that can be used to address risk in the workplace. Risk can be avoided, reduced, retained or transferred. Risk avoidance is when an organization refuses to accept a risk. An example of this type of action could be the small business owner who has employees, determines that the risks associated with having employees is higher than he or she is willing to accept, and then chooses to be a one-person business. This could be the case when small contractor chooses to remain small.

Risk reduction involves taking steps to prevent or control the effects of risk. One way to accomplish this in a small business is to establish an employment policy and procedures manual. If a small business educates its managers and employees on its policies and procedures, and then follows and enforces these same policies and procedures, risks associated with employment practices can be reduced.

Risk retention is pursued when a business owner understands that a risk exists, but that alternatives to retaining the risk are unattractive. For example, inherent risks exist when a business owner employs individuals to perform work for an organization. This risk might be retained since the net result for the business owner is better than if he or she were working alone.

Risk transfer is when the business owner transfers the risk to another party. The best illustration of risk transfer is insurance. The business owner

can transfer risks associated with certain employment practices by obtaining insurance.

To determine which of these tools is appropriate, one must first consider the severity and frequency of the risk being addressed. Risks can be classified by their level of severity (high or low) and by the frequency (high or low) with which they occur. As such, risks can be placed into any one of the four cells as illustrated in Table 1.

Table 1		
	High Frequency	Low Frequency
High Severity	Risk avoidance Risk reduction	Risk transfer/insurance
Low Severity	Risk retention Risk reduction	Risk retention

Once a risk has been classified, then the following methods for addressing the risks can be taken. The key is to attempt to take action to alter or reshape the risk so that the risk is moved from its current position in the matrix to another position that reduces either its frequency and/or severity from high to low.

For risks that are classified as being high in both severity and frequency, risk avoidance and risk reduction are appropriate courses of action. In terms of dealing with employees, a certain level of risk always appears to be present, so on the surface, the only avoidance option appears to be not having employees. Risk reduction can also be pursued, and the attempt is to reduce the severity or frequency of a risk to a manageable level. If it cannot be reduced to a manageable level, the risk should be avoided.

Risks that occur often (high frequency), but have a low severity, can be effectively addressed through retention and reduction. The risk can be retained as it is, or actions can be taken by the organization to reduce the frequency of the risk in the workplace. Risks that have high severity, but low frequency, can be transferred through insurance. The idea is to prevent that one catastrophic event from causing a business failure.

Finally, risks that are low in both frequency and severity are best handled through retention. Certain risks associated with having employees are implicitly retained. For example, a small business owner cannot control

every action taken or statement made by his or her employees, but these actions can be shaped by employment policies, thus resulting in a situation where low frequency and severity do exist.

**IMPLEMENTING THE DECISION.** Once the alternatives have been considered and a risk treatment device is selected, then the next step is to effectively implement the decision. Depending on the issue and specific situation, this could mean implementing policies, selecting insurers, or providing training to employees and managers. For example, an employer may decide that in order to reduce the risks associated with employment practices of his or her managers employment practices need to be standardized. Accordingly, the employer may publish standard employment policies and procedures in an attempt to reduce the variability of actions, decreasing the likelihood that one employee is treated differently than another employee in a similar situation. This action could be aimed at reducing the chances of a discrimination claim.

**EVALUATING AND REVIEWING.** Once the programs are in place, it is imperative that organizations evaluate the effectiveness of their program. Employers may have to adapt their policies and practices to fit the changing legal environment. For example, employment laws are constantly changing and being updated. Prior to 1991, many discrimination claims against employers had maximum limits on how much a plaintiff could be awarded. Today, depending on which laws a case is being heard under, punitive damages could total millions of dollars (Sovereign, 1994). Continual evaluation and review is key to effectively managing the risks associated with employment practices.

Once an employment policy and procedure has been implemented, it is imperative to check whether or not the policy and procedure achieved its objective. Implementing a policy and procedure and then assuming that it was effective is a common mistake that should be avoided. One way to evaluate and review the effectiveness of this type of action would be to see if the number of complaints, both formal and informal, increased, decreased or remained the same. If the number of complaints increased, then the policy and procedure did not correct the problem. That does not necessarily mean that the policy and procedure was an incorrect one, but that perhaps another course of action is necessary. If the number remains the same, again the issue could be that additional actions need to be taken in conjunction with the policy and procedure, such as formal training. If the number of complaints

decreased, then the objective appears to have been met. The key is to evaluate and determine if the course action chosen made progress towards its intended objective.

### **THE USE OF INSURANCE TO ADDRESS THE LIABILITY ASSOCIATED WITH EMPLOYMENT PRACTICES**

Purchasing insurance has long been one way of transferring the risks associated with conducting business (Hagglund, Weimer, Speidel, & Whitman, 1998). Most, if not all businesses understand the importance of purchasing general liability insurance to protect employers from property damage and bodily injury. Put quite simply, this is a basic insurance that for the most part does not cover employment practices. Employment benefits liability insurance can be added as an endorsement with general liability, but it only protects employers from failing to offer benefits to an employee and from failing to offer COBRA coverage to former employees. Intentional acts of non-coverage are not covered in this type of insurance.

A second type of insurance required by law is workers compensation (Hagglund et al., 1998; Ledvinka & Scarpello, 1992; Sovereign, 1994). This is an insurance that covers injuries and illnesses arising from work or working conditions. As such, it only covers very specific instances for very specific amounts of damages. Again, this type of insurance does not protect an employer from charges of discrimination or harassment.

Directors and officers' insurance policies protect members of the board of directors and/or officers of the company, should they be specifically named in a lawsuit (Hagglund et al., 1998). This type of insurance does not protect the company or corporation as a whole, just the specific directors and officers. Additionally, this type of insurance is generally not appropriate for small businesses that do not have a board of directors.

As evidenced by the foregoing discussion, the coverage provided by these types of insurance fails to cover most of the concerns that arise out of employment practices. Additionally, coverage by these types of policies is provided when the act or situation occurred. As such, if a business were to somehow operate without workers compensation insurance and an accident occurs, coverage would not be provided even if a business added this type of insurance prior to a claim being made. While some specific endorsements

might be added, liabilities resulting from employment practices are largely uncovered.

### **EMPLOYMENT PRACTICES LIABILITY INSURANCE**

In an attempt to address growing employment discrimination and harassment litigation, employment practices liability insurance (EPLI) has been developed by some insurance providers. This type of insurance is designed to fill in the many areas not covered by other types of insurance coverage. Generally, this type of insurance covers the broad category of employment practices that lead to allegations and claims of employment discrimination and harassment in the workplace (Hagglund et al., 1998). These claims are largely the result of the lack of knowledge of the various employment laws and the protections they afford employees and/or lack of knowledge about how to enact employment practices so that they are in compliance with the various laws and regulations.

**EMPLOYMENT PROTECTIONS.** Employees in the United States receive considerable protections against discrimination and harassment (Ledvinka & Scarpello, 1992; Sovereign, 1994). This protection covers most aspects of employment, from recruitment and selection practices prior to an individual being an actual employee, to the processes associated with ending the employment relationship. As one can imagine, this encompasses many different employment actions associated with managing employees. The intent of the protections is to not only provide employees from different backgrounds equal access to employment opportunities, but to encourage business to make sound business decisions, based on the merits of the employee, rather than issues associated with age, race, sex, and so forth.

**WHAT DOES EPLI COVER?** In the United States, employees can seemingly sue an employer for almost any reason. Given the wide range of federal and state protections that employees have in the United States, employees can allege discrimination in virtually any employment decision, such as hiring, promoting, disciplining, and terminating employees. EPLI is a type of insurance that employers can purchase to transfer the risks associated with employment practices should such practices be legally challenged. The problem is that most businesses, including small businesses, do not know what EPLI covers, what it does not cover, and how this type of

insurance fills in the gaps not addressed by other insurance policies that the business might already have.

Generally speaking, EPLI is designed to provide protection against claims that an employer's practices and decisions are discriminatory in nature (Hagglund et al., 1998). Insurance policies will vary from insurer to insurer. Therefore, it is important to carefully study the policy to understand what the policy covers (or does not cover) before purchasing one from an insurance provider.

Generally, employment discrimination, whether it is based on color, race, religion, sex, national origin, age or disability, will be covered by EPLI if the discriminatory act is found to be unintentional. Intentional acts may be covered by some companies, but may not be covered by all companies. Additionally, these allegations of discrimination may be related or connected to demotion decisions, promotion decisions, disciplinary decisions, evaluation decisions, training decisions and termination decisions. It is important to understand that when making decisions that affect employees, decisions can be perceived to be discriminatory in nature, especially if the decisions are not or do not appear to be based on factual, job-related information.

Most EPLI policies provide protection for employers against wrongful discharge of employees. Typically, the employment relationship between an employer and employee is an "at-will" relationship. At-will employment relationship means that the employment relationship between an employer and an employee can be broken for any reason other than those prohibited by various employment laws (Hagglund et al., 1998; Ledvinka & Scarpello, 1992; Sovereign, 1994). For example, a woman cannot be terminated from a position because she is a woman. However, she can be terminated if an employer can demonstrate that she did not perform her job to a specified standard.

There are several exceptions that make it more difficult to discharge employees (Hagglund et al., 1998; Sovereign, 1994). One of these exceptions is when a specific contract exists between the employer and the employee. It is difficult for an employer to break a written contract with an employee unless the employer can demonstrate "just cause". Just cause means that the contract was violated in some way, or that the employee was not performing to standard.



A second exception is that an employer cannot legally discharge an employee for disobeying an order that violates public policy. For example, ordering an employee to discriminate against an individual or individuals or harass any member of a protected group is an order that violates public policy. An employee cannot be legally discharged for refusing to take part in such an activity.

A third exception is an implied employment contract. This has long been a concern of many employers, and is a reason why many employers do not have an employee handbook. However, if worded carefully, an employee handbook is not considered an implied employment contract. Rather, it can be designed to clearly address many of the concerns addressed by EPLI itself. More often, statements to employees to the effect that "as long as I am here, you will always have a job here" are considered to be implied employment contracts.

Additional reasons that employees cannot be discharged include complaining about wage-related matters, union membership or union activities, filing health or safety complaints or asserting benefit rights associated with retirement. Taking unpaid leave as authorized by the Family and Medical Leave Act, reporting unethical and illegal acts by employers (i.e., whistle-blowing) and filing workers compensation claims cannot be used as the basis for discharge decisions. EPLI can help provide coverage against some of these claims, depending on the language of the insurance policy.

Workplace harassment is also an area of risk for businesses. With the past publicity associated with several sexual harassment cases, it has become clear that harassment in the workplace can be very costly to businesses. Even if an organization takes all the correct steps (e.g., having a written policy, educating employees about harassment), misconduct by just one person is all that is necessary to be faced with a sexual harassment lawsuit. EPLI can help to address this potential risk, by protecting the financial assets of a small business through coverage of sexual harassment.

While coverage of specific acts will vary among insurers, in general, discrimination and harassment claims resulting from employment practices are likely to be covered. Many policies explicitly state the specific acts that are covered such as demotion, wrongful discharge, failure to promote, retaliation, and wrongful discipline.

Some insurers will cover intentional acts, while others will not. Also, the norm on this type of insurance is that coverage is provided based on when the claim is made, not when the incident occurred. This is generally different from other types of insurance coverage that businesses purchase.

### **PRIME CANDIDATES FOR EPLI**

Every business is exposed to risks. However, some businesses are exposed to more risk than others. Discussions with insurance professionals and anecdotal evidence associated with employment litigation indicate that two factors enhance exposure to risks associated with employment practices. The first factor is the wage rate of the positions within an organization. The higher the wage rate, the more likely it is that someone might contest employment decisions, claiming discrimination. The reason is if someone earning a high wage is discharged, it is more difficult to find a job at an equivalent wage than someone who earns a low wage, such as minimum wage. As such, a person who earns a high wage might be more willing to contest the legality of the decision in order to protect their earnings than someone who makes minimum wage. The ability to replace the minimum wage is much easier than the ability to replace a \$15 - \$20 per hour job.

A second factor that has been supported by anecdotal evidence is high turnover. Organizations with high levels of turnover might be more likely to experience claims of discrimination or have their employment practices questioned. There are many possible causes of high turnover. One could be that the jobs in the organization are low paying jobs and that the employees find higher paying jobs. This situation is not troublesome from a risk perspective. The troublesome situation is one in which jobs in the organization pay reasonably well, but turnover remains high. It is important to understand why this occurs. If it is occurring due to negligent management or indiscriminant terminations, then a problem might exist.

Ultimately, the combination of the two factors could be a larger problem. When pay and turnover are both high, exposure to employment practices related risks is enhanced. Such organizations should seriously consider purchasing an EPLI.

## **REQUIREMENT FOR QUALIFYING FOR EPLI**

To obtain EPLI coverage an organization must meet some basic requirements. For EPLI the requirements are very specific. A business, or the business's insurance agent, must complete a very specific and detailed application. Applications typically inquire about a business's history. Specifically, closing of facilities and staff reductions are examined from the organization's recent history (i.e., 2 - 4 years), as well as any anticipated facility closings or staff reductions. The size of the organization, salary ranges and turnover rates are also required, as these may indicate the level of potential risks associated with employment practices. Finally, many human resource management practices are examined in detail (Hagglund et al., 1998). Information must be provided on affirmative action plans, employment applications, employee handbook and the policies contained within the employee handbook.

In addition to asking about the employment policies and procedures, copies of these procedures typically must accompany the application form. Having in place written policies required by the insurer may not guarantee EPLI coverage. In many cases, the insurer requires that policies be worded in specific ways. On the surface, this may appear to be a situation that many businesses may not want to pursue. However, the insurer typically bases the wordings on its knowledge of the legal environment, that is, based on how various policies have withstood legal scrutiny in the court system. Thus, they are using their collective experience to help provide as much legal protection and risk reduction as they possibly can.

## **HOW MUCH DOES EPLI COST?**

There are several factors that influence the cost of an EPLI policy. Premiums are based largely on the number of employees, geographic location of the business, and the industrial classification of the business. Additionally, the employer's history will further influence the premium. As an example, a small business located in Illinois employing 25 employees (prior to accounting for the industrial classification) may pay an annual premium of about \$4300. Depending on the industry code of the business, the premium could range from slightly less than \$3700 annually to slightly more

than \$6500 annually. As with any type of insurance, the deductibles vary but typically begin at \$2500.

While the premiums might seem expensive, it is important to consider the potential costs of an employment related lawsuit. If an employer loses an employment related lawsuit, it is not uncommon to have awards in the neighborhood of \$100,000 or greater. The size of the award depends on which law is being used to pursue the claim. In this case, an annual premium of \$5000 with a deductible of \$5000 only represents 10% of the award. The awards typically do not include "other" fees that accompany a lawsuit, but depending on the coverage of the EPLI policy, those fees may be covered as well. It is at this point that one carefully examines how losses and damages are defined to determine which specific damages are covered. The specific damages to inquire about from a human resource management and small business perspective are: compensatory; punitive/exemplary damages; defense; pre/post judgment interest; back pay; non-monetary; and liquidated damages. Policies may vary in terms of which of these types of damages are covered. Additionally, they may also vary in terms of coverage limits. Examining and understanding these limits is necessary to make informed decisions.

### **RISK REDUCTION TECHNIQUES TO COMPLEMENT EPLI**

It is important to understand that EPLI is just one of the many ways to address the risks associated with running a business and having employees (Hagglund et al., 1998). Again, EPLI is a way of transferring risk (Vaughan, 1997). However, several alternatives to EPLI do exist, and the risks associated with employment can be reduced through a variety of ways. Among the ways to reduce these risks are to establish a comprehensive employee handbook that includes various company policies and procedures, communication programs to communicate policies and procedures, objective and job-related selection and evaluation procedures, and the use of formal training to ensure that all employees understand the business' policies and procedures.

**ESTABLISH AN EMPLOYEE HANDBOOK.** Even if a business decides not to purchase EPLI, examining an EPLI application provides information on how to begin to reduce risks associated with employment.

For instance, an application for EPLI will ask for specific information on a number of employment practices most likely to expose the organization to risks. A small business could use this information to shape its policies and procedures so that they are in compliance with the most common types of allegations of discrimination and charges of wrongful termination (Gavin & Jawahar, 2002; Hagglund et al., 1998). For instance, having an employee handbook with specific employment policies, such as harassment and discrimination policies, can go a long way toward reducing the risks associated with employment practices. Specifically, businesses should consider including the following in an employee handbook:

An employment-at-will statement
An equal opportunity statement
An affirmative action plan (if conducting business with the government)
A discrimination policy
A sexual harassment policy
A complaint procedure for reporting discrimination and harassment
A disciplinary policy
An attendance policy

This list of policies represents an essential, minimum baseline in terms of what should be contained in an employee handbook. Each business must examine itself and the environment in which it operates to determine what additional policies should be included.

One apprehension that many businesses have toward establishing an employee handbook with specific policies is that the handbook could send a signal that there is an employment contract. While that could represent one risk, that risk can be addressed and avoided. A statement can be provided in the employee handbook specifically pointing out that the employee handbook is not a contract, implied or otherwise. Additionally, without a handbook, managers and supervisors have a much greater likelihood to take actions involving employment matters in an inconsistent manner. This can lead to numerous problems with a business' employment practices. Standardizing and following employment policies and procedures can reduce the ability for

an employee to demonstrate that he or she was treated inconsistently - a very common form of discrimination. Thus, the benefits of establishing a comprehensive employee handbook far outweigh the potential costs.

Before implementing and disseminating the employee handbook, an important step for a business to take is to consult with an attorney or law firm that specializes in employment law. This person or firm will ensure that the wording of the handbook or the policies is consistent with employment law, further reducing the risks associated with employment. These individuals are familiar with not only the federal discrimination and harassment laws, but are also familiar with the state's discrimination and harassment laws, as well as the case law in the business' area of operations. Finally, they can further assist the business in ensuring that its specific HR practices are legally sound.

**COMMUNICATION PROGRAMS.** Establishing a comprehensive employee handbook is an important step to take in reducing the risks associated with employment practices. However, it is equally important to communicate and follow the policies and procedures once they have been established. One area that the courts consider when hearing cases on employment practices is whether or not employees were made aware of the policies, as well as whether or not the business followed the stated policies and procedures. This means that once an employee handbook is established for use, employees should be made aware of its existence and its contents.

Increasing employee awareness of the various employment policies can be accomplished in a number of ways (Gavin & Jawahar, 2002). One approach is to provide all employees with a copy of the employee handbook. This should be done with all incumbent employees, as well as when any new employees enter the organization. Additionally, to ensure that employees are aware of what the handbook addresses, conduct orientation sessions to make employees aware of policies and practices and document employees' attendance. This can be done until all employees have been exposed to the policies and procedures contained in the employee handbook. This also should be conducted as new employees enter the organization, during new employee orientation. Documenting that all employees have been made aware of employment policies and practices reduces an employee's ability to say they did not know about a practice if they challenge an employment practice. It will also make it easier for the business to defend its actions if those actions are challenged in court.

A number of other communication steps should be taken by businesses as well. First, any updates or changes to the policies should be given to all current employees, so that their employee handbook remains current (Gavin & Jawahar, 2002). Second, policies and procedures should be publicly displayed in numerous areas so that employees have the opportunity to view the policies. Third, for businesses with a web site or intranet, posting the policies and procedures on this web site or intranet could allow employees access to this information as well. Finally, changes can also be communicated electronically. The key is that all employees need to have this information communicated to them if a business is to benefit from having an employee handbook.

**SELECTION AND EVALUATION PROCEDURES.** Selection and evaluation procedures of the business also need to be evaluated to ensure that they do not lend themselves to situations that can be considered discriminatory or harassing. In many instances, selection and evaluation procedures can create questions in the minds of candidates as to the legitimacy of the questions asked. Employment selection devices including application blanks, tests and employment interviews should be based on objective, job-related information (Gatewood & Field, 2001). Questions and information should be focused on job qualifications and working conditions, not on whether or not someone's spouse will like the idea of the candidate traveling as part of a job, for example. Also, employment applications should contain an employment-at-will statement, indicate that references provided and criminal convictions listed can and will be checked, contain an equal employment opportunity statement, and require the employee to sign the application, verifying that all information provided is correct (Howard, 2001; Katz, 2000). As such, not only will the employment application be improved, each of the devices used in the selection process should be standardized, to ensure that only job-related information is collected.

Performance evaluation devices should also be reviewed to ensure that the devices are measuring job performance in an objective manner. The focus should be on outcomes, such as projects completed or amount produced or sold, rather than on substitutes for performance, such as putting forth effort to complete a job. By focusing on outcomes and objective performance measures, the evaluations can be verified (Hagglund et al., 1998). This should make it easier for an organization to defend its actions,

provided that the ratings are consistent with the objective performance measures.

**FORMAL TRAINING.** A final way to reduce the risks associated with employment practices is to train your workforce (Bensimon, 1994). First, training should be provided to all employees at some point to make them aware of a company's policies and procedures. Additionally, as new policies and procedures are developed, or policies are changed, additional training should be provided to all employees. This training should be documented, indicating the date and time of the training, the topic, the trainer and the attendees. This information can be used to verify that all employees were made aware of the company's policies and procedures, and should be kept in the company's training records. Some training, such as sexual harassment, should be conducted annually, to stress that the policy does exist and that sexual harassment will not be tolerated.

Second, all employees involved in employment decisions, such as hiring, promotion and performance evaluation decisions, should receive formal training on a number of topics. First, the employees should be trained on how to make such decisions. Second, the employees should receive training on how to use the various devices and document information. For example, employees interviewing applicants for positions should be trained not only on what questions to ask, but also on taking notes about the response and how to evaluate or score the responses in an objective manner. Again, documentation on when this type of training was given as well as who has received this training should be done. A business might go so far as to require this type of training prior to making these types of decisions. This can keep managers and supervisors focused on the job-relatedness of the task at hand, as well as make the business better in the long run.

## **CONCLUSION**

Employment practices of any business can be called into question at any time. If a business has employees, it is virtually impossible to eliminate all risks associated having employees. It is possible, however, to effectively manage the risks associated with employment practices. One option is to transfer the risk by purchasing EPLI. By purchasing EPLI, businesses are paying a price to ensure that if their practices are questioned, they would not



necessarily have the same financial crisis that businesses without EPLI might face. EPLI cannot, and should not, be pursued without considering a variety of risk reduction techniques.

To obtain an EPLI policy, several risk management practices largely human resource management practices must exist or must be developed. This represents a set of actions that not only must be taken to obtain EPLI coverage, but also represents a set of actions that should be taken to reduce the risks associated with employment practices even if EPLI is not pursued by the business. Developing a comprehensive employee handbook can substantially reduce the risks associated with employment practices. Additionally, contents (i.e., policies and procedures) of the employee handbook should be communicated to employees. Selection and evaluation procedures need to be evaluated, to ensure that they are clearly job-related and objective. Finally, employees should receive regular training on employment practices. Some training should be provided to all employees, while other training should be provided to those employees who make employment decisions, such as hiring, promotion and performance evaluation decisions.

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# THE SUPPLEMENTARY ROLE OF SMALL BUSINESSES IN THE TRAVEL AND TOURISM TRADES

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## ABSTRACT

*This study determines how big retail firms dealing primarily in serving the travel and tourism trades select and utilize small business firms to send their overflow business to, with major emphasis on referrals. In addition, the research examined how small business firms make contact with and maintain their services with big business firms. The researchers felt that the study could provide a basis for expanded efforts on regional, national, and international levels.*

## INTRODUCTION

"Vulnerability" refers to the degree to which a firm is dependent on other firms, groups, or individuals" (Jacobs, 1974). Although there has been a growing recognition of the "dependence" issue in the management literature, marketing experts have paid little attention to the management of a firm's vulnerability to its markets and customers; i.e., to the development of action plans and structures for reducing a firm's market-related dependencies (Boag & Dastmalchian, 1988). This is surprising, because the success with which a firm manages such dependencies is considered a critical measure of its overall success.

Competitive strategy has been in the forefront of discussion in the business literature since the mid-1970s. Porter (1985) states that competitive advantage is at the heart of any strategy, and achieving it requires a firm to make a choice about the type of competitive advantage it seeks to attain. The partnership is a major competitive strategy used by small businesses to

reduce their vulnerability and "failure rate of about 70 percent" (Steiner & Solem, 1988). Partnerships are cooperative, interactive entities that require a good deal of commitment on all sides. One reason for the inadequate performance of partnerships is the failure to understand this fact. A characteristic of a good partnership is that it has the potential to benefit each of the partners; however, the potential benefit may not be the same for each partner. Sometimes a significant amount of education about these benefits or potential benefits is necessary. Large firms should learn to "speak the language" of smaller firms. Since partnership is inherently more complicated than autonomy, a critical factor is that partners be unable to address a problem on their own. They must have a sense that, through interaction with the other partners, a solution may be achieved. Sometimes this interdependence is described as "value added." If there is no value added, it is difficult to sustain partners' interest over time.

A basic reality of modern economic life is the interdependence of all business. No modern business is an entity in itself. It must buy from other firms and sell either to different business owners or to consumers in competition with a great many other businesses. This means there is a place for everyone if he or she has something worthwhile to offer in an effective, efficient way. Furthermore, numerous small enterprises are essential to enable a few large ones to concentrate on those activities where their efforts are more effective (Baumback, 1988).

## **OBJECTIVES**

This study was undertaken to determine how big business firms dealing primarily in the travel and tourism trade select and utilize small business firms to send their overflow business to, with primary emphasis on referrals. In addition, the research examined how small business firms make contact with and maintain their services with big business firms.

## **RESEARCH PROCEDURE**

Twelve interviews were conducted with executives of large and small travel-serving businesses located in Asheville, North Carolina. With a population of 60,000, Asheville is the largest city in the western portion of the state. Because of the beautiful natural habitat and pleasant summer

climate, thousands of tourists and conventioners are attracted to the area annually. To accommodate them, Asheville has developed a variety of tourist-related business firms. In order to provide information in depth, the interviews were unstructured and designed to probe the working relationships between travel-serving firms and the ways in which these relationships were initiated.

Basically, small businesses complement big business activities in the downtown tourism center. The large businesses provide the primary facilities which attract travelers and tourists to the urban downtown centers. The small businesses usually can provide facilities in a cooperative role better than they can compete with the large businesses. Ordinarily, it is the large hotel or restaurant which is more prominent in the minds of distant customers when they are planning touring, convention attendance, or business travel to a city. The smaller businesses mainly take care of additional needs.

This study will, for the most part, examine referrals as a means whereby small businesses in the travel and tourism trades can supplement big businesses. Some provide the same or related types of services, relying in part on referrals to tap the market primarily attracted by the large businesses. This occurs when the large businesses have an excess of customers or when they are asked for recommendations about places to eat, drink, get gasoline and so on.

### **REFERRAL BUSINESS AMONG LARGE AND SMALL TRAVEL AND TOURISM FIRMS**

To begin with, a large hotel indicated a priority listing of other hotels used to allocate overflow business. These hotels were similar in size, rates, and status. The managers maintained a telephone communication network which effectively dealt with the overflow problem. However, there appeared to be a great amount of cooperation between the large hotel and a variety of non-related small businesses such as restaurants, furniture stores, automobile repair services, etc. Many small business firms donate merchandise to the large hotel to be given as prizes to guests. Large business firms also donate merchandise. For example, a large supermarket chain contributed a frozen turkey. In exchange, the contributors are mentioned as sponsors of the give-away promotion in which their products are awarded. In addition, they are recommended by the hotel through word-of-mouth whenever appropriate.

Small business firms view this as a very effective form of low-cost promotion.

So that hotels will become more familiar with, and be able to recommend a restaurant's food and service, it is not uncommon for the Director of Guest Services and even the bell captain to be invited for a meal. A night club that serves a buffet luncheon sometimes invites certain hotel employees for a free meal. Aside from quality and service as criteria for recommendation, the ability of the restaurant to serve a large number of guests without much advance notice is also a consideration. A group of guests will often make a spur of the moment decision to eat out. They may also ask the Director of Guest Services to hurriedly put together a tour package which includes shopping and entertainment as well as dining. While the hotel did not push other restaurants over its own, a book containing the menus of many local restaurants was provided to guests who wanted to go out to eat. While the hotel did not allow food catering on its premises, one restaurant reported that catering could be provided guests who met in the Civic Center, school auditoriums, and other gathering points away from the hotel.

The manager of a restaurant specializing in Chinese food indicated that hotel guests, in general, were very resourceful in using the telephone directory to contact his establishment. They would call to ask about the food or to ask directions, and arrive shortly thereafter. In addition, the manager stated that he placed brochures and other promotional material in motels located in the vicinity of his restaurant. The researchers observed that restaurants could not be used as a source for hotel referrals since it is customary to first seek lodging before dining. At one time the restaurant was included in a highly successful room directory service (a listing of tourist-related business firms placed above the telephone) utilized by most of the large hotels. However, the company offering the service went out of business without refunding what appeared to be sizeable financial contributions provided by the manager and many other participating firms.

It was frequently emphasized that small tourist-related firms should take the initiative in contacting large hotels to invite them to observe their operations. Once a hotel becomes familiar with a firm and is satisfied with the services provided, it will continue to recommend and even provide transportation to and from that firm. Automotive repair centers were encouraged to contact large hotels concerning their rates, quality of

workmanship and dependability, or to work with towing services used by the hotel. The researchers interviewed an automotive repair service that reported having close ties with towing services used by the hotel. The researchers interviewed an automotive repair service that reported having close ties with towing services used by the hotel. The researchers interviewed an automotive repair service that reported having close ties with three towing services located in the vicinity of its operation.

The researchers observed that in some instances small motels actually refer customers to large hotels. One large hotel sends brochures to nearby small motels. Small motels are very popular with many tourists since they are less expensive than their counterparts. In addition, many conventioners will stay at small motels close to the convention site. A small motel manager indicated that many appear to be economy-minded even though their expenses are being paid. This manager frequently drives around town checking who is filled up and who is not.

Parking lot attendants refer patrons to other lots after reaching capacity. Friendships have developed between managers of different lots, and it is on this basis that referrals are made. Although the parking lot managers had never contacted the large hotels, they did express an interest in serving their guests, especially on weekends when more parking space is available. The researchers observed that parking lots, in general, did not have identifying features other than "park" signs. This, of course, would create difficulty for hotels attempting to help their guests locate the lot.

A complaint made against large hotels by a furniture supplier was that they were reluctant to carry brochures and other promotional material. The hotel managers indicated that they preferred to promote by word-of-mouth. As a result, the supplier decided to achieve exposure by placing frequent advertisements in the local newspaper and in a tourist publication. Even small advertisements were perceived as being beneficial since many tourists and conventioners often scan the print media for information about shopping, dining, and entertainment.

Concerning support services, the researchers observed an interesting example of cooperation between competitors to better serve the needs of large hotels. A bakery supplying large hotels called on a competitor to help by providing items not produced but required to complete a line.

## RECOMMENDATIONS

From the findings, the following recommendations were drawn:

Small business firms that serve large business firms, especially hotels, must make the initial contact and show them what they have to offer in the way of quality and dependability. Small business firms must have the ability and willingness to provide their service without much advance notice.

Small business firms, including motels, restaurants, theaters, etc., should also take advantage of existing opportunities in the vicinity of their operations. The possibility of cooperation and reciprocity should not be overlooked.. Methods for attracting customers could include brochures and other promotional material placed in appropriate establishments, in addition to encouraging referrals by word-of-mouth.

Small business firms should periodically invite certain hotel officials to observe their operation and, if possible, provide them with a sample of their product or service offering. By doing this, the small business firms can reassure the hotel officials that the quality provided is consistently maintained. In addition, a small proportion of product or service offerings should be donated for drawings, contests, or other promotional activities involving guests. This appears to have the same impact as advertising and is probably less expensive.

To achieve a greater share of the tourist and convention markets, restaurants could add a catering service. Since large hotels with restaurants do not invite outside catering, smaller hotels/motels and other tourist-related businesses should be encouraged to promote the service through word-of-mouth. Catering service has been frequently utilized by groups at the Civic Center and various auditoriums and meeting halls throughout the Asheville area.

During the tourist season, small business firms should frequently advertise in the local newspaper and tourist publication to keep their name and product or service visible to potential users. Promoting the product or service in the yellow pages of the telephone directory would also be beneficial.

Parking garages and lots, especially those in the vicinity of large meeting facilities, need to do a better job of communicating what they have to offer large hotels. If conventioners or tourists are planning to attend an event at one of these facilities, advance parking arrangements provided by hotel management would be a welcomed convenience. To enhance such a cooperative venture, a prominently displayed name and street number would greatly increase visibility, reduce confusion, and make promotion of the lot easier.

If an automobile repair center is interested in obtaining business from a large hotel, it should first send a list of services and rates to the hotel. Then, appropriate hotel officials should be invited to observe the center's operation. If the officials approve the service, they should be encouraged to provide favorable word-of-mouth; a very effective method for promoting auto repair. Close ties should also be established with nearby towing



services that are used by large hotels.

Since large hotels sometime arrange tour packages for guests, small business firms could develop a system's approach to more efficiently meet the needs of their target markets. Each should view the complementary nature of its contribution to the gamut of activities enjoyed by tourists. A combination of complementary business firms, perhaps conveniently located in close proximity to each other, could be presented to large hotels as a package (including group discount rates) to be offered to guests. This combining of complementary resources could improve traffic flow for all businesses involved. The researchers feel that the concept could be equally successful if applied to small business firms providing support services.

Since inexpensive lodging appears to be attractive to many economy minded tourists and conventioners, they are seeking out the smaller, less elaborate hotels and motels. Brochures and other promotional material, including rates, could be given by large hotels to nearby small hotels and motels if an overflow situation should occur. In these situations, favorable word-of-mouth is also very effective. If possible, the large hotel could reciprocate at a later time.

Small tourist-related firms should make an attempt to establish a hotel room directory. Research should be undertaken to find a reputable and efficient company to provide this important service.

## FUTURE RESEARCH

Clearly, additional research must be carried out using larger samples before the suggestions presented here can be confirmed. In particular, future research should focus on providing greater in-depth insights into the nature of specific market dependencies and the ways in which vulnerable firms can reduce associated risks. The importance of tourism to the Asheville area, to other parts of the United States, and to the overall economies of many countries justifies further investigation of these issues.

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