chapter 3

Entrepreneurship, New Ventures, and Business Ownership

Martin E. Klimek/ZUMA Press, Inc./Alamy

What makes entrepreneurs tick? What drives

them to succeed even if they first fail?

The lessons they

offer pave the road to business victory.

learning objectives

After reading this chapter, you should be able to:

3-1 **Define** *small business*, discuss its importance to the U.S. economy, and explain popular areas of small business.

3-2 **Explain** entrepreneurship and describe some key characteristics of entrepreneurial personalities and activities.

3-3 **Describe** distinctive competence, the business plan, and the start-up decisions made by small businesses and identify sources of financial aid available to such enterprises.

3-4 **Discuss** the trends in small business start-ups and identify the main reasons for success and failure among small businesses.

3-5 **Explain** sole proprietorships, partnerships, and cooperatives and discuss the advantages and disadvantages of each.

3-6 **Describe** corporations, discuss their advantages and disadvantages, and identify different kinds of corporations; explain the basic issues involved in managing a corporation and discuss special issues related to corporate ownership.

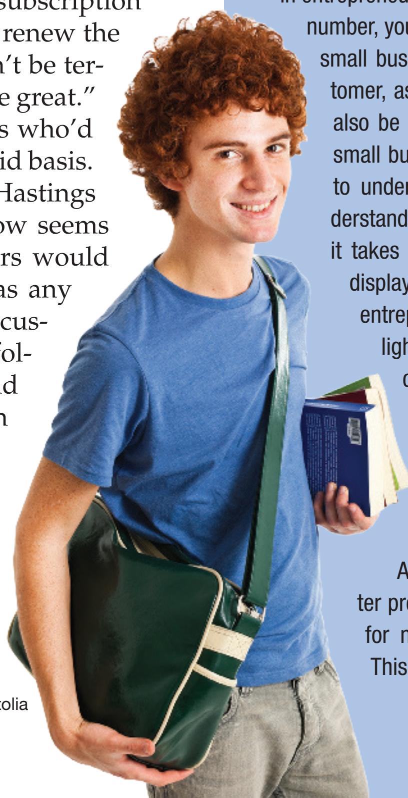
It All Started
With a Late Fee

In the 1980s and 1990s, consumers who wanted to watch movies at home headed to their neighborhood movie rental store. Blockbuster was the clear leader in the market. Consumers were able to rent a movie for a flat fee of several dollars, but late fees were steep. In 1997, California entrepreneur Reed Hastings incurred a $40 late fee at Blockbuster. “It was six weeks late,” he admits. “I had misplaced the cassette [and] I didn’t want to tell my wife.... I was embarrassed about it.” After locating the *Apollo* 13 movie that he had rented several weeks before, he dropped off the VHS cassette and paid the late fee on his way to the gym. As it turns out, his itinerary for the day was quite opportune: In the middle of his workout, he recalls, “I realized [the gym] had a much better business model. You could pay $30 or $40 a month and work out as little or as much as you wanted.”

Thus, the idea for Netflix was born. But Hastings knew he needed to start slowly. So, when Netflix was launched in 1997, its only innovations involved the convenience of ordering movies over the Internet and receiving and returning them by mail; Netflix merely rented movies for $4 apiece plus $2 for postage (and, yes, it charged late fees). Basically, the customer base consisted of people who wanted to watch movies without having to leave the house. But Hastings and co-founder Marc Randolph quickly decided to test a subscription-based model, unlimited rentals by mail for a flat fee and, perhaps most important, no due dates (and thus no late fees). Current customers were first offered the opportunity to shift from their pay-per-rental plans to subscription plans on a free-trial basis and then given the chance to renew the subscription plan on a paid basis. “We knew it wouldn’t be terrible,” says Hastings, “but we didn’t know if it would be great.” In the first month, however, 80 percent of Netflix users who’d tried the no-cost subscription plan had renewed on a paid basis.

“Having unlimited due dates and no late fees,” said Hastings back in 2003, “has worked in a powerful way and now seems obvious, but at that time, we had no idea if customers would even build and use an online queue.” The “queue,” as any Netflix user will tell you, is the list of movies that the customer wants to watch. Netflix maintains your queue, follows your online directions in keeping it up to date, and automatically sends you the next movie you want each time you send one back.

The essence of queuing—and of the Netflix business model—is clearly convenience. Although the ability to enhance customer convenience, even when combined with cost savings, often gives a company a competitive advantage in its industry, it doesn’t always have the industry-wide effect that it’s had in the case of Netflix. Not only did the Netflix subscriber model



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what’s in it for me?

A recent Gallup poll suggests that almost half of the young people in the United States today are interested in entrepreneurship.[1] Even if you are not among that number, you will still be called on to interact with small businesses and entrepreneurs as a customer, as an investor, or as a client. You may also be trying to sell products or services to small businesses and entrepreneurs. One key to understanding entrepreneurship is to understand entrepreneurs themselves and what it takes for them to succeed. Reed Hastings displays many of the characteristics key to entrepreneurial success. Netflix also highlights some of the problems inherent in converting a great business idea into a profitable enterprise. If you ever aspire to start and run your own business, you can learn valuable lessons from the experiences of Hastings and his management team. As an investor, you should also be better prepared to assess the market potential for new and up-and-coming businesses. This chapter will discuss these and additional issues important for starting and owning a business, including the business plan, reasons for success and failure, and the advantages and disadvantages of different kinds of ownership. First, we'll start by defining a small business and identifying its importance in the U.S. economy.

improve the service provided by the industry in an unexpected way but ultimately it also weakened the competitive positions of companies already doing business in the industry—notably, Blockbuster. By 2010, Blockbuster had declared bankruptcy, and Dish Network acquired the company the following year. In the years since, all of Blockbuster's retail stores have been closed as well as its DVD rental-by-mail operation, although Dish Network still retains rights to the name. Investors who had purchased a share of Netflix stock in early 2009 for $36 found that their stock had grown to more than $440 by the beginning of 2015.

How had Hastings's upstart company managed to put itself in such an enviable position? For one thing, it got off to a fast start. In 1997, when DVDs were just being test-marketed in the United States, Hastings and Randolph decided that the new medium would eventually overtake videocassettes as the format of choice for both the home-movie industry and the home-movie renter. They were right, of course. By 2002, one in four U.S. households owned a DVD player, but the number today is close to 9 in 10. (In any case, it would have cost about $4 to mail a videocassette both ways, compared to the $0.78 that it costs to ship a DVD disc back and forth.)

More important, as the first company to rent movies by mail, Netflix was the first to establish a rental-by-mail customer base. At first, says Hastings, "people thought the idea was crazy. But it was precisely because it was a contrarian idea that [it] enabled us to get ahead of our competitors." As Netflix has continued to expand and nurture its subscriber base, it's also generated both brand recognition and brand loyalty. "Netflix has customer loyalty. It's a passion brand," explains Hastings, who hastens to add that keeping customers happy is crucial "because the more someone uses Netflix, the more likely they are to stay with us."

Today, Netflix continues to be at the forefront of innovation and has established a strong position in the emerging video-on-demand market. Netflix continues to innovate, developing original content such as the wildly popular *House of Cards* and *Orange Is the New Black*. (After studying this chapter, you should be able to respond to the set of discussion questions found at the end of the chapter.)

OBJECTIVE 3-1
Define *small business*, discuss its importance to the U.S. economy, and explain popular areas of small business.

What Is a Small Business?

The term *small business* is not easy to define. Locally owned-and-operated restaurants, dry cleaners, and hair salons are obviously small businesses, and giant corporations, such as Dell, Starbucks, Apple, Walmart, and Netflix, are clearly big businesses. Between these two extremes, though, fall thousands of companies that cannot be easily categorized.

Small Business Administration (SBA) *government agency charged with assisting small businesses*

Small Business *independently owned business that has relatively little influence in its market*

The U.S. Department of Commerce has traditionally considered a business to be small if it has fewer than 500 employees. The U.S. **Small Business Administration (SBA)**, a government agency that assists small businesses, has different standards based on industry. For instance, a manufacturer is considered to be small if it has 1,500 or fewer employees. A wholesaling firm is small if it has between 100 and 500 employees. Other industries, though, such as services, retailing, and construction, are classified based on revenue. Because strict numerical terms sometimes lead to contradictory classifications, we will consider a **small business** to be one that is independent (that is, not part of a larger business) and that has relatively little influence in its market. A small neighborhood grocer would be small, assuming it is not part of a chain and that market forces largely set the prices it pays to wholesalers and that it can charge its customers. Dell Computer was a small business when founded by Michael Dell in 1984, but today it's one of the world's largest computer companies and is not small in any sense of the term. Hence, it can negotiate from a position of strength with its suppliers and can set its prices with less consideration for what other computer firms are charging.

The Importance of Small Business in the U.S. Economy

As Figure 3.1 shows, most U.S. businesses employ fewer than 100 people, and most U.S. workers are employed by small business. Moreover, this same pattern exists across most free-market economies.

Figure 3.1(a) shows that 89.29 percent of all businesses employ 20 or fewer people. Another 8.88 percent employ between 20 and 99 people, and 1.52 percent employ between 100 and 499. Only about .16 of 1 percent employ 1,000 or more people. Figure 3.1(b) also shows that 17.74 percent of all workers are employed by firms with fewer than 20 people, and 17.11 percent are employed by firms with between 20 and 99 people. Another 14.52 percent are employed by firms with between 100 and 499 people. So, around half of all workers are employed by firms with 500 or fewer employees and the other half work for larger organizations. We can measure the contribution of small business in terms of its impact on key aspects of the U.S. economic system, including *job creation*, *innovation*, and their *contributions to big business*.

Job Creation Small businesses—especially in certain industries—are an important source of new (and often well-paid) jobs. In recent years, small businesses have accounted for around 40 percent of all new jobs in high-technology sectors of the economy.[2] Jobs are created by companies of all sizes, all of which hire and lay off workers. Although small firms often hire at a faster rate, they also tend to cut jobs at a higher rate. They are generally the first to hire in times of economic recovery, and big firms are generally the last to lay off workers during downswings.

However, relative job growth among businesses of different sizes is not easy to determine. For one thing, when a successful small business starts adding employees

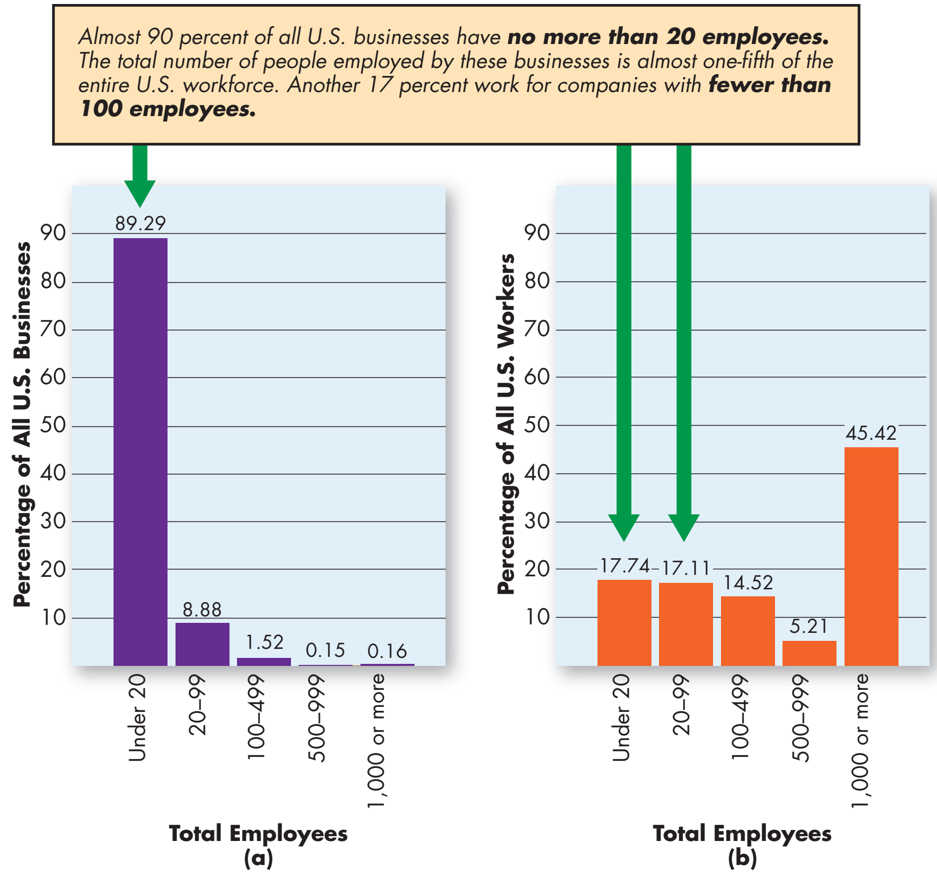

FIGURE 3.1 The Pervasiveness of Small Business in the United States
Source: Data from www.census.gov/

at a rapid clip, it may quickly cease being small. For example, Dell Computer had 1 employee in 1984 (Dell himself). But the payroll grew to 100 employees in 1986; 2,000 in 1992; more than 39,000 in 2004; 94,300 in 2010; and 111,300 in 2014. Although there was no precise point at which Dell turned from "small" into "large," some of the jobs it created could be counted in the small business sector and some in the large.

Innovation History reminds us that major innovations are as likely to come from small businesses (or individuals) as from big ones. Small firms and individuals invented the PC, the stainless-steel razor blade, the photocopier, and the jet engine and launched Facebook, Amazon, Starbucks, and eBay. Innovations are not always new products, though. Dell didn't invent the PC; he developed an innovative way to build it (buy finished components and then assemble them) and an innovative way to sell it (directly to consumers, first by telephone and now online). Similarly, Reed Hastings invented neither the DVD nor the DVD rental business, but he did introduce revolutionary new payment and delivery models. In general, small businesses produce 13 times as many patents per employee as large patenting firms.[3]

Contributions to Big Business Most of the products made by big businesses are sold to consumers by small ones. For example, most dealerships that sell Fords, Toyotas, and Volvos are independently operated. Even as more shoppers turn to online shopping, smaller businesses still play critical roles. For instance, most larger online retailers actually outsource the creation of their websites and the distribution of their products to other firms, many of them small or regional companies. Smaller businesses also provide data storage services for larger businesses. Moreover, small businesses provide big ones with many of their services and raw materials. Microsoft, for instance, relies on hundreds of small firms for most of its routine code-writing functions.

Popular Areas of Small Business Enterprise

Small businesses play a major role in services, retailing, construction, wholesaling, finance and insurance, manufacturing, and transportation. Generally, the more resources that are required, the harder a business is to start and the less likely it is that

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New businesses often emerge in response to emerging opportunities. For instance, an increase in the number of working families with pets has created an opportunity for professional dog walkers. Most dog walkers, in turn, are individual entrepreneurs.

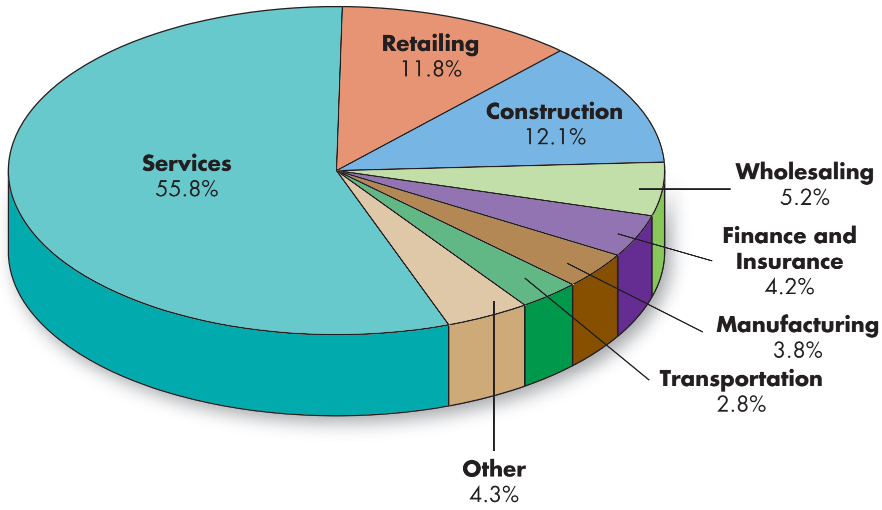

FIGURE 3.2 Small Business by Industry
Source: www.census.gov/econ/susb/

small firms dominate an industry. Remember, too, that *small* is a relative term. The criteria (number of employees and total annual sales) differ among industries and are often meaningful only when compared with truly large businesses. Figure 3.2 shows the distribution of all U.S. businesses employing fewer than 20 people across industry groups.

Services About 55.8 percent of businesses with fewer than 20 employees are involved in the service industry, which ranges from marriage counseling to computer software, from management consulting to professional dog walking. Partly because they require few resources (and hence don't cost as much to start), service providers are the fastest-growing segment of small business.

Retailing Retailers, which sell products made by other firms directly to consumers, account for about 11.8 percent of small businesses. Usually, people who start small retail businesses favor specialty shops, such as big men's clothing or gourmet coffees that let the owners focus limited resources on narrow or small market segments.

Construction About 12.1 percent of all U.S. businesses are involved in construction. Because many construction jobs are small local projects, such as a homeowner adding a garage or remodeling a room, local contractors are often best suited to handle them.

Wholesaling Small business owners often do well in wholesaling, which accounts for about 5.2 percent of businesses with fewer than 20 employees. Wholesalers buy products in bulk from manufacturers or other producers and store them in quantities and locations convenient for selling them to retailers.

Finance and Insurance Financial and insurance firms account for about 4.2 percent of small businesses. Most of these businesses, such as local State Farm Insurance offices, are affiliates of or agents for larger national firms. Small locally owned banks are also common in smaller communities and rural areas.

Manufacturing More than any other industry, manufacturing lends itself to big business, but it still accounts for about 3.8 percent of firms with fewer than 20 employees. Indeed, small manufacturers sometimes outperform big ones in such innovation-driven industries as electronics, equipment and machine parts, and computer software.

finding a better way

The Rise of Services


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Manufacturing is a form of business that combines and transforms resources into tangible outcomes that are then sold to others. Goodyear is a manufacturer because it combines rubber and chemical compounds and uses blending equipment and molding machines to create tires. Broyhill is a manufacturer because it buys wood and metal components, pads, and fabric and then combines them into furniture. And Apple is a manufacturer because it uses electronic, metal, plastic, and composite components to build smartphones, computers, and other digital products.

Manufacturing was once the dominant technology in the United States. During the 1970s, though, manufacturing entered a long period of decline, primarily because of foreign competition. U.S. firms had grown lax and sluggish, and new foreign competitors came onto the scene with better equipment, much higher levels of efficiency, and employees willing to work for lower wages. For example, steel companies in Asia were able to produce high-quality steel for much lower prices than large U.S. steel companies such as Bethlehem Steel and U.S. Steel. Faced with a battle for survival, some companies disappeared, but many others underwent a long and difficult period of change by eliminating waste and transforming themselves into leaner, more efficient, and responsive entities. They reduced their workforces dramatically, closed antiquated or unnecessary plants, and modernized their remaining plants. Over the last decade or so, however, their efforts have started to pay dividends because U.S. manufacturing has regained a competitive position in many different industries. Although low wages continue to center a great deal of global manufacturing in Asia, once-strong manufacturers are once again thriving in the United States.

During the decline of the manufacturing sector, a tremendous growth in the service sector, often fueled by visionary entrepreneurs, kept the overall U.S. economy from declining at the same rate. A service organization is one that transforms resources into an intangible output and creates time or place utility for its customers. For example, Netflix provides video rentals through mail order and online delivery options. Facebook offers its members a venue for networking and interacting with others. And your local hairdresser cuts your hair. In 1947, the service sector was responsible for less than half of the U.S. gross national product (GNP). By 1975, however, this figure reached 65 percent, and by 2006, it had surpassed 75 percent. The service sector has been responsible for almost 90 percent of all new jobs created in the United States since 1990.

Moreover, employment in service occupations is expected to continue to represent a larger share of employment in the U.S. economy. In 2002, 76.3 percent of U.S. workers were employed in the service sector and this grew to 79.9 percent in 2012. By 2022, it is expected that 80.9 percent of workers in this country will be employed in service jobs. Among all service jobs, it is expected that professional and business services and health care and social assistance will represent an increased share. Looking at the Bureau of Labor Statistics list of the fastest-growing occupations between 2012 and 2022, we see that almost all of these occupations are in the service sector, largely in the areas of professional and business services and health care and social assistance.

Managers have come to see that many of the tools, techniques, and methods that are used in a factory are also useful to a service firm. For example, managers of automobile plants and hair salons each have to decide how to design their facility, identify the best location for it, determine optimal capacity, make decisions about inventory storage, set procedures for purchasing raw materials, and set standards for productivity and quality. At the same time, though, service-based firms must hire and train employees based on a different skill set than is required by most manufacturers. For instance, consumers seldom come into contact with the Toyota employee who installs the seats in their car, so that person can be hired based on technical skills. But Toyota must also recruit people for sales and customer service jobs who not only know how to do a job but who can also effectively interface with a variety of consumers. In addition, most services are simultaneously produced and consumed, so traditional models of quality control need to be revisited. As the service economy grows, managers will need to learn more about how to effectively recruit, train, and reward employees in service jobs.[4]

Transportation About 2.8 percent of small companies are in transportation and related businesses, including many taxi and limousine companies, charter airplane services, and tour operators.

Other The remaining 4.3 percent or so of small businesses are in other industries, such as small research-and-development laboratories and independent media companies—start-up web channels, small-town newspapers, and radio broadcasters.

Entrepreneurship

OBJECTIVE 3-2
Explain entrepreneurship and describe some key characteristics of entrepreneurial personalities and activities.

We noted previously that Dell Computer started as a one-person operation and grew into a giant corporation. Dell's growth was spurred by the imagination and skill of Michael Dell, the entrepreneur who founded the company. **Entrepreneurs** are people, like Dell, who assume the risk of business ownership.[5] **Entrepreneurship** is the process of seeking business opportunities under conditions of risk. However, not all entrepreneurs have the same goals.

Entrepreneur *businessperson who accepts both the risks and the opportunities involved in creating and operating a new business venture*

Entrepreneurship *the process of seeking businesses opportunities under conditions of risk*

Entrepreneurship Goals

People may decide to pursue entrepreneurship for a variety of reasons. Many entrepreneurs seek to launch a new business with the goal of independence—independence from working for someone else, coupled with some reasonable degree of financial security. Such entrepreneurs want to achieve a safe and secure financial future for themselves and their families but do not necessarily aspire to grow their business beyond their capacity to run it. Consider Jack Matz, a former corporate executive in Houston who lost his job when his firm merged with another. Rather than look for another management position, Matz opened a photocopying and custom printing business near a local university. His goal was to earn enough money to lead a comfortable life until he retires in 10 years. The term *small business* is most closely associated with these kinds of enterprises.

Other entrepreneurs, however, launch new businesses with the goal of growth and expansion—that is, to transform their venture into a large business. This was Dell's vision when he started his business; likewise, when Howard Schultz took over Starbucks, he also had plans to grow and develop the fledgling coffee company into a much larger enterprise. Terms such as *new ventures* and *start-ups* are often used to refer to these kinds of businesses.

In still other cases, the goals of an entrepreneur may not always be clear in the early stages of business development. For instance, one entrepreneur might launch a business with little or no expectation that it will have huge growth potential but then find that it can grow dramatically. Mark Zuckerberg, for example, had no idea that his Facebook firm would grow to its present size. Another entrepreneur might start out with ambitious growth plans but find that expected opportunities cannot be realized: Perhaps there is no large market or another firm established dominance over that market first.

Entrepreneurial Characteristics

Regardless of their goals, many successful entrepreneurs share certain characteristics. Among these characteristics are resourcefulness and a concern for good, often personal, customer relations. Most of them also have a strong desire to be their own bosses. Many express a need to "gain control over my life" or "build for the family" and believe that building successful businesses will help them do it. They can also deal with uncertainty and risk.

Yesterday's entrepreneur was often stereotyped as "the boss"—self-reliant, male, and able to make quick, firm decisions. Today's entrepreneur is seen more often as an open-minded leader who relies on networks, business plans, and consensus. Past and present entrepreneurs also have different views on such topics as how to succeed, how to automate business, and when to rely on experience in the trade or on basic business acumen.[6]

Consider Yoshiko Shinohara, who had lost her father by the age of 8, was divorced by the age of 28, and never received a college education. At the age of 70, she is Chairman and Director of Tempstaff, a Japanese temp agency that she started out of her one-room apartment more than 35 years ago. Fueled by Japan's need for temps during a period of stagnation in the 1990s and Shinohara's ambition, Tempstaff is now a $3.1 billion company with a high-rise headquarters in Tokyo.[7]

Among other things, Shinohara's story illustrates what is almost always a key element in entrepreneurship: risk. Interestingly, most successful entrepreneurs seldom see what they do as risky. Whereas others may focus on possibilities for failure and balk at gambling everything on a new venture, most entrepreneurs are so passionate about their ideas and plans that they see little or no likelihood of failure. For example, when Shinohara started Tempstaff, few Japanese businesses understood or had even heard of the temporary worker concept. But Shinohara felt that she "had nothing to lose anyway" and preferred taking that risk to ending up "serving tea or just being a clerical assistant."[8]

OBJECTIVE 3-3
Describe distinctive competence, the business plan, and the start-up decisions made by small businesses and identify sources of financial aid available to such enterprises.

Starting and Operating a New Business

First the Internet and more recently social media have dramatically changed the rules for starting and operating a small business. Setting up is easier and faster than ever, there are more potential opportunities than at any other time, and the ability to gather and assess information is at an all-time high. Today, for example, many one-person retailers do most of their business—both buying and selling—on Internet auction sites, such as eBay.

Even so, would-be entrepreneurs must make the right start-up decisions. For instance, they need to have a clear vision of why their business will succeed. They must also decide how to get into business—should they buy an existing business or build from the ground up? They must know when to seek expert advice and where to find sources of financing. If, for example, a new firm needs financial backing from investors or a line of credit from vendors or distributors, the entrepreneur must have in place a comprehensive, well-crafted business plan. Creating a business plan, in turn, begins with understanding the potential firm's distinctive competences.

Understanding Distinctive Competencies

An organization's distinctive competencies are the aspects of business that the firm performs better than its competitors. The distinctive competencies of small business usually fall into three areas: (1) the ability to identify new niches in established markets, (2) the ability to identify new markets, and (3) the ability to move quickly to take advantage of new opportunities.

Established Market *one in which many firms compete according to relatively well-defined criteria*

Niche *a segment of a market that is not currently being exploited*

Identifying Niches in Established Markets

An **established market** is one in which many firms compete according to relatively well-defined criteria. For example, the video rental market was well established when Hastings decided to launch Netflix. Blockbuster was the dominant firm, but many independent video rental firms were also prospering. Retail outlets kept an inventory of video products available for rent. Customers drove or walked to the stores, paid a fee, and took a video home. They kept it for a defined period of time and then returned it to the store (with a late fee, if they kept it too long). A **niche** is simply a segment of a market that is not currently being exploited. In general, small entrepreneurial businesses are better at discovering these niches than are larger organizations. Large organizations usually have so many resources committed to older, established business practices that they may be unaware of new opportunities. Entrepreneurs can see these opportunities and move quickly to take advantage of them. Hastings's decision to rent by mail allowed Netflix to exploit a niche.

Entrepreneurs Dave Gilboa and Neil Blumenthal founded Warby Parker, a business that sells prescription eyewear through the mail. The entrepreneurs realized that most consumers disliked the experience of going to an optical shop to try on glasses and then were irritated at the price of those glasses. So, Warby Parker offers lower-priced glasses with hip designs and a money-back guarantee. Astute marketing then allowed them to get a quick start with their niche business, selling more than 50,000 pairs of glasses and generating profits after only a single year of operation.[9] Warby Parker has now established itself as a leading eyewear retailer.

Identifying New Markets Successful entrepreneurs also excel at discovering whole new markets. Discovery can happen in at least two ways. First, an entrepreneur can transfer a product or service that is well established in one geographic market to a second market. This is what Marcel Bich did with ballpoint pens, which occupied a well-established market in Europe before Bich introduced them in the United States more than 50 years ago. Bich's company, Société Bic, eventually came to dominate the U.S. market.

Second, entrepreneurs can sometimes create entire industries. Entrepreneurial inventions of the dry paper copying process and the semiconductor have created vast new industries. Not only were the first companies to enter these markets successful (Xerox and National Semiconductor, respectively) but their entrepreneurial activity also spawned the development of hundreds of other companies and hundreds of thousands of jobs. Again, because entrepreneurs are not encumbered with a history of doing business in a particular way, they are usually better at discovering new markets than are larger, more mature organizations.

First-Mover Advantages A **first-mover advantage** is any advantage that comes to a firm because it exploits an opportunity before any other firm does. Sometimes large firms discover niches within existing markets or new markets at just about the same time as small entrepreneurial firms, but they cannot move as quickly as small companies to take advantage of these opportunities. Many of the "app" developers for smartphones exploit first-mover advantage.

First-Mover Advantage *any advantage that comes to a firm because it exploits an opportunity before any other firm does*

There are numerous reasons for the difference. For example, many large organizations make decisions slowly because each of their many layers of hierarchy has to approve an action before it can be implemented. Also, large organizations may sometimes put a great deal of their assets at risk when they take advantage of new opportunities. Every time Boeing decides to build a new model of a commercial jet, it is making a decision that could literally bankrupt the company if it does not turn out well. The size of the risk may make large organizations cautious. The dollar value of the assets at risk in a small organization, in contrast, is quite small. Managers may be willing to "bet the company" when the value of the company is only $100,000. They might be unwilling to "bet the company" when the value of the company is $1 billion.

Crafting a Business Plan

After the would-be entrepreneur has defined a potential distinctive competence and made the decision to proceed, the next step is formulating a **business plan** in which the entrepreneur describes his or her business strategy for the new venture and demonstrates how it will be implemented.[10] A real benefit of a business plan is the fact that in the act of preparing it, the would-be entrepreneur is forced to develop the business idea on paper and firm up his or her thinking about how to launch it before investing time and money in it. The idea of the business plan isn't new. What is new is the use of specialized business plans, mostly because creditors and investors demand them as tools for deciding whether to finance or invest.

Business Plan *document in which the entrepreneur summarizes his or her business strategy for the proposed new venture and how that strategy will be implemented*

Setting Goals and Objectives A business plan describes the match between the entrepreneur's abilities and experiences and the requirements for producing or marketing a particular product. It also defines strategies for production and marketing, legal elements and organization, and accounting and finance. In particular, a business plan should answer three questions: (1) What are the entrepreneur's goals and objectives? (2) What strategies will be used to obtain them? (3) How will these strategies be implemented?

Sales Forecasting Although a key element of any business plan is sales forecasts, plans must carefully build an argument for likely business success based on sound logic and research. Entrepreneurs, for example, can't forecast sales revenues without first researching markets. Simply asserting that the new venture will sell 100,000 units per month is not credible; the entrepreneur must demonstrate an understanding of the current market, of the strengths and weaknesses of existing firms, and of the means by which the new venture will compete. Without the sales forecast, no one can estimate the required size of a plant, store, or office or decide how much inventory to carry and how many employees to hire.

Financial Planning Financial planning refers to the entrepreneur's plan for turning all other activities into dollars. It generally includes a cash budget, an income statement, balance sheets, and a breakeven chart. The cash budget shows how much money you need before you open for business and how much you need to keep the business going before it starts earning a profit.

Starting the Small Business

A Chinese proverb says that a journey of a thousand miles begins with a single step. This is also true of a new business. The first step is the individual's commitment to becoming a business owner. In preparing a business plan, the entrepreneur must choose the industry and market in which he or she plans to compete. This choice means assessing not only industry conditions and trends but also one's own abilities and interests. Like big business managers, small business owners must understand the nature of the enterprises in which they are engaged.

Buying an Existing Business After an entrepreneur has forecast sales and completed the financial planning, then he or she must decide whether to buy an existing business or start from scratch. Many experts recommend the first approach because, quite simply, the odds are better: If it's successful, an existing business has already proven its ability to attract customers and generate profit. It has also established relationships with lenders, suppliers, and other stakeholders. Moreover, an existing track record gives potential buyers a much clearer picture of what to expect than any estimate of a start-up's prospects.

Ray Kroc bought McDonald's as an existing business, added entrepreneurial vision and business insight, and produced a multinational giant. Both Southwest Airlines and Starbucks were small but struggling operations when entrepreneurs took over and grew them into large businesses. About 35 percent of all new businesses that were started in the past decade were bought from someone else.

Franchising Most McDonald's, Subway, 7 Eleven, RE/Max, Holiday Inn, and Dunkin' Donuts outlets are franchises operating under licenses issued by parent companies to local owners. A **franchise** agreement involves two parties, a *franchisee* (the local owner) and a *franchiser* (the parent company).[11]

Franchise *arrangement in which a buyer (franchisee) purchases the right to sell the good or service of the seller (franchiser)*

Franchisees benefit from the parent corporation's experience and expertise, and the franchiser may even supply financing. It may pick the store location, negotiate the lease, design the store, and purchase equipment. It may train the first set of employees and managers and issue standard policies and procedures. Once the business is open, the franchiser may offer savings by allowing the franchisee to purchase from a central location. Marketing strategy (especially advertising) may also be handled by the franchiser. In short, franchisees receive—that is, invest in—not only their own ready-made businesses but also expert help in running them.

Franchises have advantages for both sellers and buyers. Franchises can grow rapidly by using the investment money provided by franchisees. The franchisee gets to own a business and has access to big-business management skills. The franchisee does not have to build a business step by step, and because each franchise outlet is probably similar to other outlets, failure is less likely. Recent statistics show that franchising is on the upswing. For instance, franchise businesses added 247,000 jobs in 2014 and generated economic output of $889 billion. The franchise sector will contribute an estimated 3 percent of the U.S. GDP in 2015.[12]

Perhaps the most significant disadvantage in owning a franchise is the start-up cost. Franchise prices vary widely. The fee for a Fantastic Sam's hair salon is $185,000; however, the franchisee must also invest additional funds in building and outfitting the salon. A McDonald's franchise has an initial fee of at least $1 million, but again requires the additional funds to construct and outfit a restaurant; the costs generally run the total outlay to over $2 million. And professional sports teams (which are also franchises) can cost several hundred million dollars. Franchisees may also be obligated to contribute a percentage of sales to parent corporations. From the perspective of the parent company, some firms choose not to franchise to retain more control over quality and earn more profits for themselves. Starbucks, for instance, does not franchise its coffee shops. (Starbucks does have licensing agreements where other firms operate Starbucks kiosks and other niche outlets; it does not, though, franchise individual free-standing coffee shops to individuals.)

Starting from Scratch Despite the odds, some people seek the satisfaction that comes from planting an idea and growing it into a healthy business. There are also practical reasons to start from scratch. A new business doesn't suffer the ill effects of a prior owner's errors, and the start-up owner is free to choose lenders, equipment, inventories, locations, suppliers, and workers. Of all new businesses begun in the past decade, about 64 percent were started from scratch. Dell Computer, Walmart, Microsoft, Amazon, and Twitter are among today's most successful businesses that were started from scratch by an entrepreneur.

But as we have already noted, the risks of starting a business from scratch are greater than those of buying an existing firm. New business founders can only make projections about their prospects. Success or failure depends on identifying a genuine opportunity, such as a product for which many customers will pay well but which is currently unavailable. To find openings, entrepreneurs must study markets and answer the following questions:

- Who and where are my customers?
- How much will those customers pay for my product?
- How much of my product can I expect to sell?
- Who are my competitors?
- Why will customers buy my product rather than the product of my competitors?

Financing the Small Business

Although the choice of how to start a business is obviously important, it's meaningless unless you can get the money to finance your ideas. Among the more common sources for funding are family and friends, personal savings, lending institutions, investors, and governmental agencies. Lending institutions are more likely to help finance the purchase of an existing business because the risks are better understood. Individuals starting new businesses will probably have to rely on personal resources. One of the many causes of the 2008–2011 recession was a sharp reduction in the availability of credit, including funds to help start new businesses. This credit crunch, in turn, limited both new start-up funding and funding for existing businesses wanting to make new investments.

According to the National Federation of Independent Business, personal resources, not loans, are the most important sources of money. Including money borrowed from friends and relatives, personal resources account for more than two-thirds of all money invested in new small businesses, and one-half of that is used to purchase existing businesses. Getting money from banks, independent investors, and government loans requires extra effort. At a minimum, banks and private investors will want to review business plans, and government loans have strict eligibility guidelines.

Venture Capital Company *group of small investors who invest money in companies with rapid growth potential*

Venture capital companies are groups of small investors seeking to make profits on companies with rapid growth potential. Most of these firms do not lend money. They invest it, supplying capital in return for partial ownership (like stocks, discussed later in this chapter). They may also demand representation on boards of directors. In some cases, managers need approval from the venture capital company before making major decisions. In most cases, venture capitalists do not provide money to start a new business; instead, once a business has been successfully launched and its growth potential established, they provide the funds to fuel expansion. Of all venture capital currently committed in the United States, about 30 percent comes from true venture capital firms. Steve Case, founder of AOL, operates a successful venture capital company. He looks to invest in new start-ups that have a great business idea, a passionate entrepreneur, and a solid and well-crafted business plan.[13]

Small Business Investment Company (SBIC) *government-regulated investment company that borrows money from the SBA to invest in or lend to a small business*

Small business investment companies (SBICs) also invest in companies with potential for rapid growth. They are federally licensed to borrow money from the SBA and to invest it in or lend it to small businesses, and they are themselves investments for their shareholders. Past beneficiaries of SBIC capital include Apple Computer, Intel, and FedEx. The government also sponsors *minority enterprise small business investment companies (MESBICs).* As the name suggests, MESBICs target minority-owned businesses.

SBA Financial Programs

Since its founding in 1953, the SBA has sponsored financing programs for small businesses that meet standards in size and independence. Eligible firms must be unable to get private financing at reasonable terms. The most common form of SBA financing, its *7(a) loans programs*, allows small businesses to borrow from commercial lenders and guarantees to repay up to 85 percent of loans of up to $150,000 and 75 percent of loans of more than $150,000.[14] The SBA's *special purpose loans* target businesses with specific needs, such as meeting international demands or implementing pollution-control measures. For loans under $50,000, the SBA offers the *micro loan program*. The *Certified Development Company (504) program* offers fixed interest rates on loans from nonprofit community-based lenders to boost local economies.[15]

Small Business Development Center (SBDC) *SBA program designed to consolidate information from various disciplines and make it available to small businesses*

The SBA also helps entrepreneurs improve their management skills. The Service Corps of Retired Executives (SCORE) is made up of retired executives who volunteer to help entrepreneurs start new businesses. The **Small Business Development Center (SBDC)** program consolidates information from various disciplines and institutions for use by new and existing small businesses.

Other Sources of Financing

Some entrepreneurs find financing from overseas investors. James Buck developed a new implantable heart device to treat certain heart conditions but could not find adequate funding to start his business. He ended up looking to investors in Asia and obtained $5 million from the government of Malaysia.[16]

The Internet has also opened doors to new financing options. For instance, Kabbage.com is an online company that provides cash advances to small business.[17]

Trends, Successes, and Failures in New Ventures

OBJECTIVE 3-4
Discuss
the trends in small business start-ups and identify the main reasons for success and failure among small businesses.

For every Sam Walton, Mark Zuckerberg, Mary Kay Ash, or Bill Gates—entrepreneurs who transformed small businesses into big ones—there are many entrepreneurs who fail. Each year, generally between 610,000 and 835,000 new businesses are launched in the United States. On the other hand, between 605,000 and 805,000 businesses fail each year.[18] In 2014, for instance, approximately 668,000 new firms started operations and another 691,000 closed down. In this section, we look first at a few key trends in small business start-ups. Then we examine some of the reasons for success and failure in small business undertakings.

Trends in Small Business Start-Ups

As noted previously, thousands of new businesses are started in the United States every year. Several factors account for this trend, and in this section, we focus on five of them.

Emergence of E-commerce The most significant recent trend is the rapid emergence of e-commerce. Because the Internet provides fundamentally new ways of doing business, savvy entrepreneurs have created and expanded new businesses faster and easier than ever before. Such leading-edge firms as Google, Amazon, and eBay owe their existence to the Internet. Figure 3.3 underscores this point by summarizing the growth in e-commerce from 2003 through 2010.

Crossovers from Big Business More businesses are being started by people who have opted to leave big corporations and put their experience to work for themselves. In some cases, they see great new ideas that they want to develop. Others get burned out in the corporate world. Some have lost their jobs, only

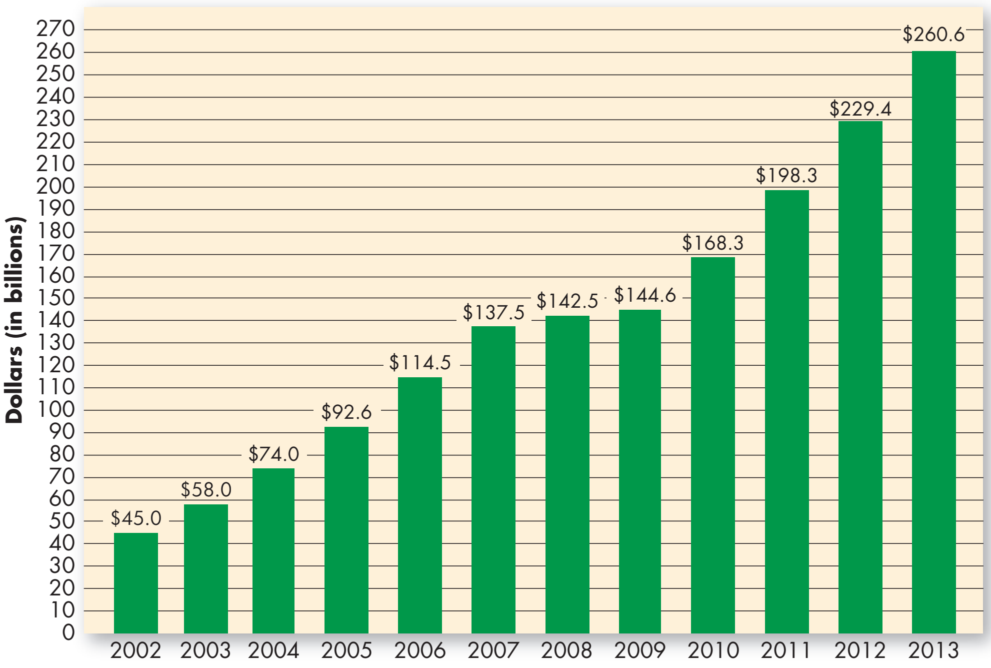

FIGURE 3.3 Growth of Online Retail Spending
Source: http://www.census.gov/retail/

to discover that working for themselves was a better idea anyway. John Chambers spent several years working at IBM and Wang Laboratories/GLOBAL before he decided to try his hand at entrepreneurship. After resigning from Wang in 1991, he signed on to help Cisco, then a small and struggling firm. Under his leadership and entrepreneurial guidance, Cisco has become one of the largest and most important technology companies in the world.

Opportunities for Minorities and Women More small businesses are also being started by minorities and women.[19] The number of businesses owned by African Americans increased by 60 percent during the most recent five-year period for which data are available and now is about 2 million. The number of Hispanic-owned businesses has grown 44 percent and now is about 2.25 million. Ownership among Asians has increased 41 percent and among Pacific Islanders 35 percent.[20]

Almost 9.1 million businesses are also now owned by women, and they generate a combined $1.4 trillion in revenue a year and employ about 7.9 million workers.[21] Figure 3.4 shows some of the reasons women cite for starting their own businesses. Anne Beiler bought a small Amish-owned pretzel stand to support her family when her husband decided to become a no-fee marriage counselor. She worked long hours and continued to tinker with both her menu and pretzel recipes until things began to take off. Today, her firm is known as Auntie Anne's Soft Pretzels, has 1,200 locations, and generates over $400 million in annual revenues.[22]

Global Opportunities Many entrepreneurs are also finding new opportunities in foreign markets. Doug Mellinger founded PRT Group, a software development company. One of Mellinger's biggest problems was finding trained programmers. There aren't enough U.S.-based programmers to go around, and foreign-born programmers face strict immigration quotas. So Mellinger set up shop on Barbados, a Caribbean island where the government helped him attract foreign programmers and did everything it could to make things easier. Today, PRT has customers and suppliers from dozens of nations.

Better Survival Rates More people are encouraged to test their skills as entrepreneurs because the small business failure rate has declined. During the 1960s and 1970s, less than half of all new start-ups survived more than 18 months; only one in five lasted 10 years. Now, however, over half can expect to survive for at least 4 years and a third survive for 10 years or longer.[23]

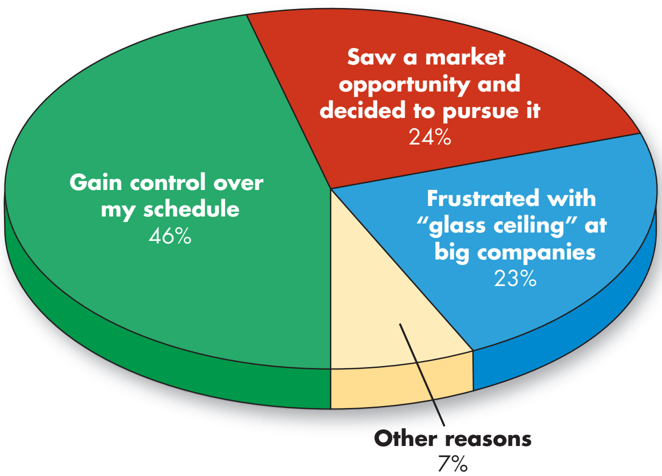

FIGURE 3.4 Reasons Women Give for Starting Businesses

managing in turbulent times

The Wide World of Risk

Dan Monick/Corbis

When a well-established individual or business needs a loan, they generally head to the bank. Armed with a credit score and a financial history, they are generally able to borrow money to grow their business. But what happens when someone needs just a little money to get started, but they lack any type of credit history or even a banking relationship? It's exactly this situation that has created the new world of micro-lending—very small loans made to individuals to start a new business. The challenge is particularly pronounced in developing nations, where budding entrepreneurs need just one or two hundred dollars to get their business off the ground. The concept of micro-lending has caught on, but lenders still look for some kind of data to determine who is the best candidate for even the smallest of loans. Shivani Siroya had a career that included working both as an investment banker and United Nations researcher. In April 2011, she founded Inventure, a California-based tech company that leverages mobile technology to create credit scores for unbanked individuals in India, Kenya, and South Africa.

To collect data that could be used for credit decisions on micro-loans, Inventure developed an application that can be downloaded to Android phones. The app monitors the length of users' phone calls and tracks their financial transactions. Using a proprietary algorithm, Inventure evaluates over 10,000 indicators of responsibility. For example, applicants whose average phone calls were longer than four minutes were thought to have stronger relationships, making them a better credit risk. Using this and other more complex data, Inventure accepted half of its applicants, making small loans, often between \$20 and \$100, and charging just 5 percent interest. Even more impressive was the repayment rate of 85 percent in the company's first year of operation.[24]

Reasons for Failure

Unfortunately, even though survival rates have improved, almost half of all new businesses still will not enjoy long-term success. Why do some succeed and others fail? Although no set pattern has been established, four general factors contribute to failure:

1. ***Managerial incompetence or inexperience.*** Some entrepreneurs put too much faith in common sense, overestimate their own managerial skills, or believe that hard work alone ensures success. If managers don't have a sound business plan, don't know how to make basic business decisions, or don't understand basic management principles, they aren't likely to succeed in the long run.
2. ***Neglect.*** Some entrepreneurs try to launch ventures in their spare time, and others devote only limited time to new businesses. But starting a small business demands an overwhelming time commitment. If you aren't willing to put in the time and effort that a business requires, you aren't likely to survive.
3. ***Weak control systems.*** Effective control systems keep a business on track and alert managers to potential trouble. If your control systems don't signal impending problems, you may be in serious trouble before you spot more obvious difficulties. For instance, some businesses fail because they do a poor job of managing their credit collection policies. Anxious to grow, they may be too liberal in extending credit to their customers and then end up not being able to collect all the money that is owed to them.
4. ***Insufficient capital.*** Some entrepreneurs are overly optimistic about how soon they'll start earning profits. In most cases, it takes months or even years. Amazon

didn't earn a profit for 10 years but obviously still required capital to pay employees and to cover other expenses. Experts say you need enough capital to operate at least six months without earning a profit; some recommend enough to last a year.[25]

Reasons for Success

Four basic factors are also typically cited to explain small business success:

1. ***Hard work, drive, and dedication.*** Small business owners must be committed to succeeding and willing to spend the time and effort to make it happen. Tai Lee wanted to open a restaurant in College Station, Texas, but did not have sufficient capital. He partnered with a local investor and opened Veritas Wine and Bistro in 2009. In the early days, he typically spent 14 hours a day managing the restaurant, handling the cooking, and greeting customers. His wife also worked beside him, waiting on customers and taking reservations. This schedule persisted for over three years. Eventually, though, Veritas took off and became a big success. Today, Tai owns two restaurants and has a gourmet food truck that has received national acclaim.
2. ***Market demand for the products or services being provided.*** Careful analysis of market conditions can help small business owners assess the probable reception of their products. Attempts to expand restaurants specializing in baked potatoes, muffins, and gelato often struggle, but hamburger and pizza chains continue to expand. In the case of Veritas, College Station had relatively few fine dining options and that segment of the market was clearly underserved.
3. ***Managerial competence.*** Successful owners may acquire competence through training or experience or by drawing on the expertise of others. Few, however, succeed alone or straight out of college. Most spend time in successful companies or partner with others to bring expertise to a new business. Tai Lee studied both business and culinary arts before opening Veritas. He also sought advice from other successful entrepreneurs.
4. ***Luck.*** After Alan McKim started Clean Harbors, an environmental cleanup firm in New England, he struggled to keep his business afloat and was running low on capital. Before his funding was exhausted, though, the U.S. government committed $1.6 billion to toxic waste cleanup—McKim's specialty. He quickly landed several large government contracts and put his business on solid financial footing. Had the government fund not been created at just the right time, McKim might well have failed. Similarly, Netflix might not have succeeded if it had not started just as customers were shifting away from video cassettes to DVDs.

OBJECTIVE 3-5
Explain
sole proprietorships, partnerships, and cooperatives and discuss the advantages and disadvantages of each.

Noncorporate Business Ownership

Whether they intend to launch a small local business or a new venture projected to grow rapidly, all entrepreneurs must decide which form of legal ownership best suits their goals: *sole proprietorship*, *partnership*, or *corporation*. Because this choice affects a host of managerial and financial issues, few decisions are more critical. Entrepreneurs must consider their own preferences, their immediate and long-range needs, and the advantages and disadvantages of each form. Table 3.1 compares the most important differences among the three major ownership forms.

Sole Proprietorships

Sole Proprietorship *business owned and usually operated by one person who is responsible for all of its debts*

The **sole proprietorship** is owned and usually operated by one person. About 74 percent of all U.S. businesses are sole proprietorships; however, they account for only about 4 percent of total business revenues. Though usually small, they may be as large as steel mills or department stores.

table 3.1 Comparative Summary: Three Forms of Business Ownership

Business Form	Liability	Continuity	Management	Sources of Investment
Proprietorship	Personal, unlimited	Ends with death or decision of owner	Personal, unrestricted	Personal
General Partnership	Personal, unlimited	Ends with death or decision of any partner	Unrestricted or depends on partnership agreement	Personal by partner(s)
Corporation	Capital invested	As stated in charter, perpetual or for specified period of years	Under control of board of directors, which is selected by stockholders	Purchase of stock

Advantages of Sole Proprietorships Freedom may be the most important benefit of sole proprietorships. Because they own their businesses, sole proprietors answer to no one but themselves. Sole proprietorships are also easy to form. Sometimes, you can go into business simply by putting a sign on the door. The simplicity of legal setup procedures makes this form appealing to self-starters and independent spirits, as do low start-up costs.

Another attractive feature is the tax benefits extended to businesses that are likely to suffer losses in their early stages. Tax laws permit owners to treat sales revenues and operating expenses as part of their personal finances, paying taxes based on their personal tax rate. They can cut taxes by deducting business losses from income earned from personal sources other than the business.

Disadvantages of Sole Proprietorships A major drawback is **unlimited liability**; a sole proprietor is personally liable for all debts incurred by the business. If the company fails to generate enough cash, bills must be paid out of the owner's pocket. Another disadvantage is lack of continuity; a sole proprietorship legally dissolves when the owner dies. Although the business can be reorganized by a successor, executors or heirs must otherwise sell its assets.

Unlimited Liability *legal principle holding owners responsible for paying off all debts of a business*

Finally, a sole proprietorship depends on the resources of one person whose managerial and financial limitations may constrain the business. Sole proprietors often find it hard to borrow money to start up or expand. Many bankers fear that they won't be able to recover loans if owners become disabled or insolvent.

Partnerships

The most common type of partnership, the **general partnership**, is similar to a sole proprietorship but is owned by more than one person. Partners may invest equal or unequal sums of money. In most cases, partners share the profits equally or in proportion to their investment. In certain cases, though, the distribution of profits may be based on other things. A locally prominent athlete, for instance, may lend her or his name to the partnership and earn profits without actually investing funds. And sometimes one partner invests all of the funds needed for the business but plays no role in its management. This person is usually called a *silent partner*. Another partner might invest nothing but provide all the labor. In this case, the financial investor likely owns the entire business, and the labor partner owns nothing. But over time, and as specified in a contract, the labor partner gradually gains an ownership stake in the business (usually called *sweat equity*).

General Partnership *business with two or more owners who share in both the operation of the firm and the financial responsibility for its debts*

Advantages of Partnerships The most striking advantage of general partnerships is the ability to grow by adding new talent and money. Because banks prefer to make loans to enterprises that are not dependent on single individuals, partnerships find it easier to borrow money when compared to sole proprietorships. They can also invite new partners to join by investing money.

Like a sole proprietorship, a partnership can be organized by meeting only a few legal requirements. Even so, all partnerships must begin with an agreement of some kind. In all but two states, the Revised Uniform Limited Partnership Act requires the filing of specific information about the business and its partners. Partners may also agree to bind themselves in ways not specified by law. In any case, an agreement should answer questions such as the following:

- Who invested what sums?
- Who will receive what share of the profits?
- Who does what, and who reports to whom?
- How may the partnership be dissolved? In the event of dissolution, how will assets be distributed?
- How will surviving partners be protected from claims made by a deceased partner's heirs?

The partnership agreement is strictly a private document. No laws require partners to file agreements with any government agency. Nor are partnerships regarded as legal entities. In the eyes of the law, a partnership is just two or more people working together. Because partnerships have no independent legal standing, the Internal Revenue Service (IRS) taxes partners as individuals.

Disadvantages of Partnerships For general partnerships as for sole proprietorships, unlimited liability is the greatest drawback. Each partner may be liable for all debts incurred by the partnership. If any partner incurs a business debt, all partners may be liable, even if some of them did not know about or agree to the new debt.

Partnerships also share with sole proprietorships the potential lack of continuity. When one partner dies or leaves, the original partnership dissolves, even if one or more of the other partners want it to continue. But dissolution need not mean a loss of sales revenues. Survivors may form a new partnership to retain the old firm's business.

A related disadvantage is difficulty in transferring ownership. No partner may sell out without the consent of the others. A partner who wants to retire or to transfer interest to a son or daughter must have the other partners' consent.

Alternatives to General Partnerships Because of these disadvantages, general partnerships are among the least popular forms of business. Roughly 3.5 million U.S. partnerships generate only 15 percent of total sales revenues. To resolve some of the problems inherent in general partnerships, especially unlimited liability, some partners have tried alternative agreements. The **limited partnership** allows for **limited partners** who invest money but are liable for debts only to the extent of their investments. They cannot, however, take active roles in business operations. A limited partnership must have at least one **general (**or **active) partner**, mostly for liability purposes. This is usually the person who runs the business and is responsible for its survival and growth.

Limited Partnership *type of partnership consisting of limited partners and a general (or managing) partner*

Limited Partner *partner who does not share in a firm's management and is liable for its debts only to the limits of said partner's investment*

General (or **active) Partner** *partner who actively manages a firm and who has unlimited liability for its debts*

Master Limited Partnership *form of ownership that sells shares to investors who receive profits and that pays taxes on income from profits*

Under a **master limited partnership**, an organization sells shares (partnership interests) to investors on public markets such as the New York Stock Exchange. Investors are paid back from profits. The master partner retains at least 50 percent ownership and runs the business, and minority partners have no management voice. (The master partner differs from a general partner, who has no such ownership restriction.) The master partner must regularly provide minority partners with detailed operating and financial reports.

Cooperatives

Cooperatives *form of ownership in which a group of sole proprietorships or partnerships agree to work together for common benefits*

Sometimes, groups of sole proprietorships or partnerships agree to work together for their common benefit by forming cooperatives. **Cooperatives** combine the freedom of sole proprietorships with the financial power of corporations. They give members greater production power, greater marketing power, or both. On the other hand, they are limited to serving the specific needs of their members. Although cooperatives make up only a minor segment of the U.S. economy, their role is still important in agriculture. Ocean Spray, the Florida Citrus Growers, Riceland, and Cabot Cheese are among the best-known cooperatives.

Corporations

OBJECTIVE 3-6

Describe corporations, discuss their advantages and disadvantages, and identify different kinds of corporations; explain the basic issues involved in managing a corporation and discuss special issues related to corporate ownership.

There are about 6 million corporations in the United States. As you can see from Figure 3.5, they account for about 17 percent of all U.S. businesses but generate about 81 percent of all sales revenues.[26] Almost all large businesses use this form, and corporations dominate global business. As we will see, corporations need not be large; many small businesses also elect to operate as corporations.

According to the most recent data, Walmart, the world's largest corporation, posted annual revenue of over $477 billion, with total profits of more than $16 billion. Even "smaller" large corporations post huge sales figures. The New York Times Company, though five hundredth in size among U.S. corporations, posted a profit of $38 million on revenues of $1.6 billion. Given the size and influence of this form of ownership, we devote a great deal of attention to various aspects of corporations.

The Corporate Entity

When you think of corporations, you probably think of giant operations such as Walmart, Google, or Apple. The very word *corporation* inspires images of size and power. In reality, however, your corner newsstand has as much right to incorporate as a giant automaker. Moreover, the newsstand and Apple would share the characteristics of all **corporations**: legal status as separate entities, property rights and obligations, and indefinite life spans.

Corporation *business that is legally considered an entity separate from its owners and is liable for its own debts; owners' liability extends to the limits of their investments*

In 1819, the U.S. Supreme Court defined a corporation as "an artificial being, invisible, intangible, and existing only in contemplation of the law." The court

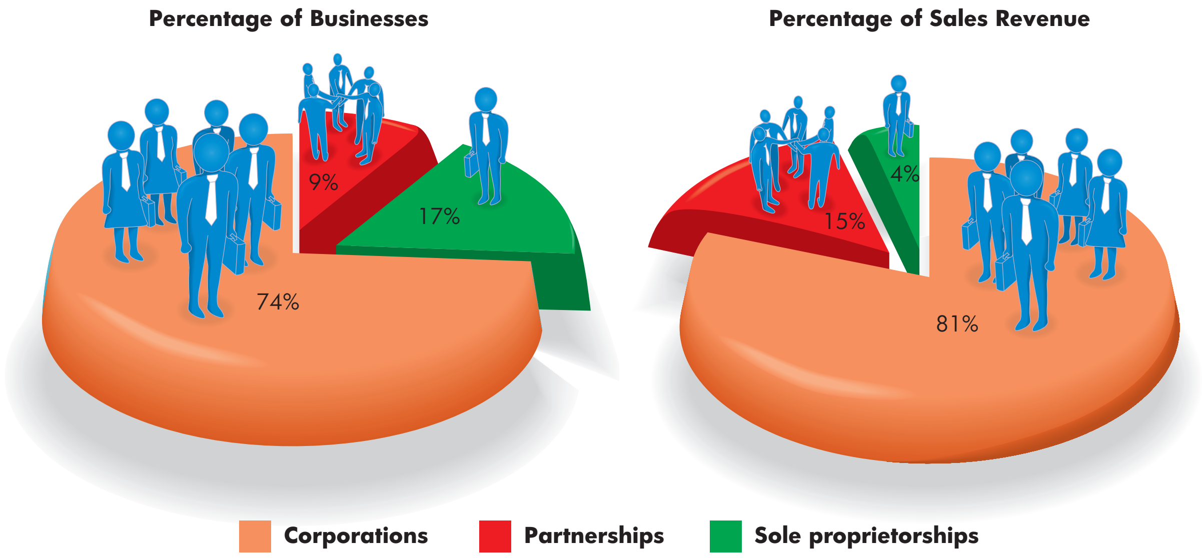

FIGURE 3.5 Proportions of U.S. Firms in Terms of Organization Type and Sales Revenue

Sources: http://www.census.gov/compendia/statab/2012/tables/12s0744.pdf, http://www.irs.gov/pub/irssoi/08coccr.pdf, http://www.irs.gov/pub/irssoi/08pareturnsnap.pdf, http://www.irs.gov/pub/irssoi/10sumbulsolprop.pdf defined the corporation as a legal person. Corporations may, therefore, perform the following activities:

- Sue and be sued
- Buy, hold, and sell property
- Make and sell products
- Commit crimes and be tried and punished for them

Limited Liability *legal principle holding investors liable for a firm's debts only to the limits of their personal investments in it*

Advantages of Incorporation The biggest advantage of corporations is **limited liability**; investor liability is limited to personal investment (through stock ownership, covered later) in the corporation. In the event of failure, the courts may seize and sell a corporation's assets but cannot touch the investors' personal possessions. If, for example, you invest $1,000 in stock in a corporation that ends up failing, you may lose your $1,000, but no more. In other words, your liability is limited to the $1,000 you invested.

Another advantage is continuity. Because it has a legal life independent of founders and owners, a corporation can, at least in theory, continue forever. Shares of stock may be sold or passed on to heirs, and most corporations also benefit from the continuity provided by professional management. Finally, corporations have advantages in raising money. By selling stock, they expand the number of investors and the amount of available funds. Continuity and legal status tend to make lenders more willing to grant loans.

Tender Offer *offer to buy shares made by a prospective buyer directly to a target corporation's shareholders, who then make individual decisions about whether to sell*

Double Taxation *situation in which taxes may be payable both by a corporation on its profits and by shareholders on dividend incomes*

Disadvantages of Incorporation Although a chief attraction is ease of transferring ownership, this same feature can create complications. For example, using a legal process called a **tender offer**, an offer to buy shares made by a prospective buyer directly to a corporation's shareholders, a corporation can be taken over against the will of its managers. Another disadvantage is start-up cost. Corporations are heavily regulated, and incorporation entails meeting the complex legal requirements of the state in which the firm is chartered.

The biggest disadvantage of incorporation, however, is **double taxation**. In addition to income taxes on company profits, stockholders also pay taxes on income returned by their investments in the corporation. Thus, the profits earned by corporations are taxed twice—once at the corporate level and then again at the ownership level. Because profits are treated as owners' personal income, sole proprietorships and partnerships are taxed only once.

The advantages and disadvantages of corporate ownership have inspired laws establishing different kinds of corporations. Most are intended to help businesses take advantage of the benefits of the corporate model without assuming all the disadvantages. We discuss these corporate forms next.

Types of Corporations

We can classify corporations as either *public* or *private*. But within these broad categories, we can identify several specific types of corporations, some of which are summarized in Table 3.2.

Closely Held (or **Private**) **Corporation** *corporation whose stock is held by only a few people and is not available for sale to the general public*

Publicly Held (or **Public**) **Corporation** *corporation whose stock is widely held and available for sale to the general public*

S Corporation *hybrid of a closely held corporation and a partnership, organized and operated like a corporation but treated as a partnership for tax purposes*

- The most common form of U.S. corporation is the **closely held (**or **private) corporation**. Stock is held by only a few people and is not available for sale to the public. The controlling group of stockholders may be a family, a management group, or even the firm's employees. Most smaller corporations fit this profile.
- When shares are publicly issued, the firm becomes a **publicly held (**or **public) corporation**. Stock is widely held and available for sale to the public. Many large businesses are of this type.
- The **S corporation** (more fully called the *Subchapter S corporation*) is a hybrid of a closely held corporation and a partnership. It is organized and operates like a corporation,

table 3.2 Types of Corporations

Type	Distinguishing Features	Examples
Closely Held	Stock held by only a few people Subject to corporate taxation	Blue Cross/Blue Shield MasterCard Primestar
Publicly Held	Stock widely held among many investors Subject to corporate taxation	Apple Starbucks Texas Instruments
Subchapter S	Organized much like a closely held corporation Subject to additional regulation Subject to partnership taxation	Minglewood Associates Entech Pest Systems Frontier Bank
Limited Liability	Organized much like a publicly held corporation Subject to additional regulation Subject to partnership taxation	Pacific Northwest Associates Global Ground Support Ritz Carlton
Professional	Subject to partnership taxation Limited business liability Unlimited professional liability	Norman Hui, DDS & Associates B & H Engineering Anderson, McCoy & Oria
Multinational	Spans national boundaries Subject to regulation in multiple countries	Toyota Nestlé General Electric

but it is treated like a partnership for tax purposes. To qualify, firms must meet stringent legal conditions. For instance, stockholders must be individual U.S. citizens.

- Another hybrid is the **limited liability corporation (LLC)**. Owners are taxed like partners, each paying personal taxes only. However, they also enjoy the benefits of limited liability accorded to publicly held corporations. LLCs have grown in popularity in recent years, partially because of IRS rulings that allow corporations, partnerships, and foreign investors to be partial owners.

Limited Liability Corporation (LLC) *hybrid of a publicly held corporation and a partnership in which owners are taxed as partners but enjoy the benefits of limited liability*

- **Professional corporations** are most likely composed of doctors, lawyers, accountants, or other professionals. Although the corporate structure means protection from unlimited financial liability, members are not immune from unlimited liability. Professional negligence by a member can entail personal liability on an individual's part.

Professional Corporation *form of ownership allowing professionals to take advantage of corporate benefits while granting them limited business liability and unlimited professional liability*

- As the term implies, the **multinational (or transnational) corporation** spans national boundaries. Stock may be traded on the exchanges of several countries, and managers are likely to be of different nationalities.

Multinational (or Transnational) Corporation *form of corporation spanning national boundaries*

Managing a Corporation

Creating any type of corporation can be complicated because of the various legal conditions that must be met. In addition, once the corporate entity comes into existence, it must be managed by people who understand the principles of **corporate governance**,

Corporate Governance *roles of shareholders, directors, and other managers in corporate decision making and accountability*

entrepreneurship and new ventures

More Than Just a Burger and Fries

In 2001, restauranteur Danny Meyer opened a hot dog cart in New York City's Madison Square Park. He hoped to attract more people to the area and provide additional opportunities for employees at his nearby restaurant. That little hot dog cart quickly grew into the fast-casual restaurant Shake Shack. According to Meyer, "We entertained a bunch of names for the kiosk (most of them pretty bad—like Custard's First Stand, Dog Run, and Madison Mixer) and ultimately settled on Shake Shack." The company website explains their niche: "This modern-day "roadside" burger stand serves up the most delicious burgers, hot dogs, frozen custard, shakes, beer, wine and more. An instant neighborhood fixture, Shake Shack welcomed people from all over the city, country, and world who gathered together to enjoy fresh, simple, high-quality versions of the classics in a majestic setting. The rest, as they say, is burger history." The company prides itself by using only Angus beef that has been vegetarian fed, humanely raised, and antibiotic-free.

From this single location, the restaurant grew. Meyer took on investors to fuel the expansion, including two limited partnerships, Green Equity Investors and Select Equity Group, and a private equity backer, Jonathan Sokoloff. Expansion was focused in several key U.S. locations: New York, Massachusetts, Chicago, and Washington, DC. The only restaurant west of the Mississippi is located in Las Vegas, Nevada. Internationally, the company had 13 locations by the beginning of 2015, including London, Moscow, and Dubai. The restaurants are so popular that people often line up for more than an hour in hopes of getting one of their famed burgers and crinkle-cut fries.

John Angelillo/UPI/Newscom

With an eye on expanding from the current 63 restaurants to 450 locations, the company had an initial public offering of stock in January 2015. At the time of the IPO, Danny Meyer owned 21 percent of the company's stock, with two limited partnerships, Green Equity Investors and Select Equity Group, owning 38.3 percent. Jonathan Sokoloff (a private equity backer) owned 26 percent. The company offered 5 million new shares of stock for sale at a price of $21 per share. Through this IPO, Shake Shack raised $105 million dollars to fuel expansion. The company hopes to open at least 10 new restaurants each year. Days after the IPO, the company's stock had more than doubled from its issue price and Meyer's stock alone was worth more than $340 million. Select Equity Group, one of the initial investors, sold their interest of more than 4 million shares just days after the IPO, realizing millions of dollars of return on their investment. And all of this started with a hot dog cart in the park.[27]

the roles of shareholders, directors, and other managers in corporate decision making and accountability. In this section, we discuss the principles of *stock ownership* and *stockholders' rights* and describe the role of *boards of directors*. We then examine some special issues related to corporate ownership.

Corporate governance is established by the firm's bylaws and usually involves three distinct bodies. **Stockholders (or shareholders)** are the owners of a corporation, investors who buy ownership shares in the form of stock. The *board of directors* is a group elected by stockholders to oversee corporate management. Corporate *officers* are top managers hired by the board to run the corporation on a day-to-day basis.

Stockholder (or **Shareholder)** *owner of shares of stock in a corporation*

Stock Ownership and Stockholders' Rights

Corporations sell shares, called *stock*, to investors who then become stockholders, or shareholders. Profits are distributed among stockholders in the form of *dividends*, and corporate managers serve at stockholders' discretion. In a closely held corporation, only a few people own stock. Shares of publicly held corporations are widely held.

Board of Directors *governing body of a corporation that reports to its shareholders and delegates power to run its day-to-day operations while remaining responsible for sustaining its assets*

Boards of Directors

The governing body of a corporation is its **board of directors**. Boards communicate with stockholders and other stakeholders through such channels as an annual report, a summary of a firm's financial health. They also set policy on dividends, major spending, and executive compensation. They are legally responsible and accountable for corporate actions and are increasingly being held personally liable for them.

Officers Although board members oversee operations, most do not participate in day-to-day management. Rather, they hire a team of managers to run the firm. This team, called **officers**, is usually headed by the firm's **chief executive officer (CEO)**, who is responsible for overall performance. Other officers typically include a *president*, who is responsible for internal management, and *vice presidents*, who oversee various functional areas such as marketing and operations.

Officers *top management team of a corporation*

Special Issues in Corporate Ownership

In recent years, several issues have grown in importance in the area of corporate ownership, including *joint ventures and strategic alliances, employee stock ownership plans*, and *institutional ownership*. Other important issues in contemporary corporate ownership involve *mergers, acquisitions, divestitures*, and *spin-offs*.

Joint Ventures and Strategic Alliances In a **strategic alliance**, two or more organizations collaborate on a project for mutual gain. When partners share ownership of what is essentially a new enterprise, it is called a **joint venture**. The number of strategic alliances has increased rapidly in recent years on both domestic and international fronts. For example, General Motors and Ford recently announced a new strategic alliance to jointly develop 10-speed transmissions for automobiles.[28] Ford also has joint ventures with Volkswagen (in South America) and Mazda (in Japan).

Strategic Alliance *strategy in which two or more organizations collaborate on a project for mutual gain*

Joint Venture *strategic alliance in which the collaboration involves joint ownership of the new venture*

Employee Stock Ownership Plans An **employee stock ownership plan (ESOP)** allows employees to own a significant share of the corporation through trusts established on their behalf. Current estimates count about 11,500 ESOPs in the United States. The growth rate in new ESOPs has slowed a bit in recent years, but they still are an important part of corporate ownership patterns in the United States.

Employee Stock Ownership Plan (ESOP) *arrangement in which a corporation holds its own stock in trust for its employees, who gradually receive ownership of the stock and control its voting rights*

Institutional Ownership Most individual investors don't own enough stock to exert influence on corporate managers. In recent years, however, more stock has been purchased by **institutional investors**. Because they control enormous resources, these investors—especially mutual and pension funds—can buy huge blocks of stock. The national teachers' retirement system (TIAA CREF) has assets of more than $400 billion, much of it invested in stocks. Institutional investors own almost 55 percent of all the stock issued in the United States.

Institutional investor *large investor, such as a mutual fund or a pension fund, that purchases large blocks of corporate stock*

Mergers, Acquisitions, Divestitures, and Spin-Offs Another important set of issues includes mergers, acquisitions, divestitures, and spin-offs. Mergers and acquisitions involve the legal joining of two or more corporations. A divestiture occurs when a corporation sells a business operation to another corporation; with a spin-off, it creates a new operation.

Mergers and Acquisitions (M&As) A **merger** occurs when two firms combine to create a new company. For example, United Airlines and Continental merged to create one of the world's largest airlines. The new airline bears the United name but retains the equipment design of Continental. Continental's CEO assumed control of the new company. The firm took more than two years to integrate their respective operations into a unified new firm. Even more recently, American Airlines and US Airlines announced that they, too, were merging and as of this writing are finalizing their integration plans.

Merger *the union of two corporations to form a new corporation*

In an **acquisition**, one firm buys another outright. Many deals that are loosely called mergers are really acquisitions. Why? Because one of the two firms will usually control

Acquisition *the purchase of one company by another* the newly combined ownership. In general, when the two firms are roughly the same size, the combination is usually called a merger even if one firm is taking control of the other. When the acquiring firm is substantially larger than the acquired firm, the deal is really an acquisition. So-called M&As are an important form of corporate strategy. They let firms increase product lines, expand operations, go international, and create new enterprises. Halliburton Corporation recently acquired Boots and Coots, an oil-field firefighting business, and more recently announced plans to buy Baker Hughes.

Divestitures and Spin-Offs Sometimes, a corporation decides to sell a part of its existing business operations or set it up as a new and independent corporation. There may be several reasons for such a step. A firm might decide, for example, that it should focus more specifically on its core businesses, and thus it will sell off unrelated or underperforming businesses. Such a sale is called a **divestiture**. When a firm sells part of itself to raise capital, the strategy is known as a **spin-off**. A spin-off may also mean that a firm deems a business unit more valuable as a separate company. The Limited, for example, spun off three of its subsidiaries, Victoria's Secret, Bath & Body Works, and White Barn Candle Co., to create a new firm, Intimate Brands, which it then offered through an Initial Public Offering (IPO). The Limited retained 84 percent ownership of Intimate Brands while getting an infusion of new capital.

Divestiture *strategy whereby a firm sells one or more of its business units*

Spin-off *strategy of setting up one or more corporate units as new, independent corporations*

summary of learning objectives

OBJECTIVE 3-1

Define ***small business*****, discuss its importance to the U.S. economy, and explain popular areas of small business.** **(pp. 106–111)**

A *small business* is independently owned and managed and has relatively little influence in its market. Most U.S. businesses are small businesses and employ fewer than 20 people. Small businesses are vitally important to the economy because of (1) *job creation*, (2) *innovation*, and (3) *contributions to big business*. The most common types of small businesses are firms engaged in (1) *services*, (2) *retailing*, and (3) *construction.* Services comprise the largest sector, in part because most service businesses require relatively little capital to start. In contrast, there are relatively fewer small businesses who manufacture products because the start-up costs are often high.

OBJECTIVE 3-2

Explain entrepreneurship and describe some key characteristics of entrepreneurial personalities and activities. **(pp. 111–112)**

Entrepreneurs are people who assume the risk of business ownership. Some entrepreneurs have a goal of independence and financial security, and others want to launch a new venture that can be grown into a large business. Most successful entrepreneurs are resourceful and concerned for customer relations. They have a strong desire to be their own bosses and can handle ambiguity and surprises. Today's entrepreneur is often an open-minded leader who relies on networks, business plans, and consensus and is just as likely to be female as male. Finally, although successful entrepreneurs understand the role of risk, they do not necessarily regard what they do as being risky.

OBJECTIVE 3-3

Describe distinctive competence, the business plan, and the start-up decisions made by small businesses and identify sources of financial aid available to such enterprises. **(pp. 112–117)**

A new business must first understand its potential distinctive competence, such as the ability to identify a niche (or unmet need) in an established market. Another distinctive competence is the ability to serve a new unexploited market. Still another is the ability to move quickly to take advantage of new opportunities, often called "first-mover advantage."

After identifying a potential distinctive competence, the next step in entrepreneurship is developing a business plan. A *business plan* summarizes business strategy for the new venture and shows how it will be implemented. The key elements of a business plan are setting goals and objectives, sales forecasting, and financial planning. Business plans are increasingly important because creditors and investors demand them as tools for deciding whether to finance or invest.

Entrepreneurs must also decide whether to buy an existing business, operate a franchise, or start from scratch. Entrepreneurs who choose to buy an existing business have better chances for success compared to those who start from scratch because of existing relationships with vendors and customers. Franchises provide considerable support in setup and operation, but franchise costs can be high and severely cut into profits. Starting a business from scratch can be the most risky, yet rewarding, way to start a new business.

To start a new business, it is essential to have money to finance the operation. Common funding sources include personal funds, family and friends, savings, lenders, investors, and governmental agencies. Lending institutions are more likely to finance an existing business than a new business because the risks are better understood. *Venture capital companies* are groups of small investors seeking to make profits on companies with rapid growth potential. Most of these firms do not lend money but rather invest it, supplying capital in return for partial ownership. New businesses may also seek funding from small business investment companies (SBICs) as well as through Small Business Administration (SBA) programs.

OBJECTIVE 3-4

Discuss the trends in small business start-ups and identify the main reasons for success and failure among small businesses. (pp. 117–120)

Five trends have helped facilitate the growth in new businesses started in the United States every year. These trends are: (1) *the emergence of e-commerce*, (2) *crossovers from big business*, (3) *increased opportunities for minorities and women*, (4) *new opportunities in global enterprise*, and (5) *improved rates of survival among small businesses*.

However, more than half of all small businesses fail. Four basic factors contribute to most small business failure: (1) *managerial incompetence or inexperience*, (2) *neglect*, (3) *weak control systems*, and (4) *insufficient capital*. Likewise, four basic factors explain most small business success: (1*) hard work, drive, and dedication*, (2) *market demand for the products or services being provided*, (3) *managerial competence*, and (4) *luck*.

OBJECTIVE 3-5

Explain sole proprietorships, partnerships, and cooperatives and discuss the advantages and disadvantages of each. (pp. 120–123)

A *sole proprietorship* is a business that is owned by one person. The most significant advantage to organizing as a sole proprietorship is the freedom to make decisions. In addition, it is relatively easy to form and operate a sole proprietorship. There are tax benefits for new businesses that are likely to suffer losses in early stages because these losses can offset income from another business or job on the tax return of a sole proprietor. A major drawback is *unlimited liability*, which is the legal concept that makes the owners of a sole proprietorship personally responsible for all its debts. Another disadvantage is that a sole proprietorship lacks continuity; when the owner dies or leaves the business, it does not continue to exist. Finally, a sole proprietorship depends on the resources of a single individual.

A *general partnership* is a sole proprietorship multiplied by the number of partner owners. The biggest advantage is its ability to grow by adding new talent and money. Partners report their share of the partnership's income and it is taxed on their individual tax return. Like a sole proprietorship, *unlimited liability* is a drawback. Partnerships may lack continuity, and transferring ownership may be hard. No partner may sell out without the consent of the others. There are also special forms of partnerships, most notably limited partnerships and master limited partnerships.

Cooperatives combine the freedom of sole proprietorships with the financial power of corporations. A cooperative is a group of sole proprietorships or partnerships working together to gain greater production or marketing power.

OBJECTIVE 3-6

Describe corporations, discuss their advantages and disadvantages, and identify different kinds of corporations; explain the basic issues involved in managing a corporation and discuss special issues related to corporate ownership. (pp. 123–128)

All *corporations* share certain characteristics: legal status as separate entities, property rights and obligations, and indefinite life spans. They may sue and be sued; buy, hold, and sell property; make and sell products; and commit crimes and be tried and punished for them. The biggest advantage of incorporation is *limited liability*: Investor liability is limited to one's personal investments in the corporation. Another advantage is continuity; a corporation can last indefinitely and does not end with the death or withdrawal of an owner. Finally, corporations have advantages in raising money. By selling stock, they expand the number of investors and the amount of available funds. Continuity and the ability to sell stock tend to make lenders more willing to grant loans.

One disadvantage is that a corporation can be taken over against the will of its managers. Another disadvantage is start-up cost. Corporations are heavily regulated and must meet complex legal requirements in the states in which they're chartered. The greatest potential drawback to incorporation is *double taxation* of profits. Profits are taxed first at the level of the corporation and then taxed as dividends when distributed to the stockholders. Corporations may be either private or public. A private, or closely held, corporation has only a small number of owners and shares of stock are not available to the general public. Public corporations are able to sell their stock on the stock exchanges and have the ability to raise large amounts of capital. Special forms of ownership, such as S corporations, LLCs, and professional corporations, combine limited liability of a corporation with tax treatment of partnerships.

Corporations sell shares, called *stock*, to investors who then become *stockholders* (or shareholders) and the real owners. Profits are distributed among stockholders in the form of *dividends*, and managers serve at their discretion. The governing body of a corporation is its *board of directors*. Most board members do not participate in day-to-day management but rather hire a team of managers. This team, called *officers*, is usually headed by a *chief executive officer (CEO)* who is responsible for overall performance.

Several issues have grown in importance in the area of corporate ownership. In a *strategic alliance*, two or more organizations collaborate on a project for mutual gain. When partners share ownership of a new enterprise, the arrangement is called a *joint venture*. An *employee stock ownership plan (ESOP)* allows employees to own a significant share of the corporation through trusts established on their behalf. More stock is now being purchased by *institutional investors*. A *merger* occurs when two firms combine to create a new company, and in an *acquisition*, one firm buys another outright. A *divestiture* occurs when a corporation sells a part of its existing business operations or sets it up as a new and independent corporation. When a firm sells part of itself to raise capital, the strategy is known as a *spin-off*.

key terms

MyBizLab

To complete the problems with the ✪, go to EOC Discussion Questions in the MyLab.

questions & exercises

QUESTIONS FOR REVIEW

✪ **3-1.** Identify six areas where small businesses are significant in most economies.

3-2. What is the most significant reason for the large numbers of small business start-ups and successes?

3-3. What is a niche market and why is it attractive to small businesses?

3-4. What is sole proprietorship business ownership? What are the key advantages and disadvantages?

QUESTIONS FOR ANALYSIS

3-5. How does today's view of the entrepreneur differ from that the accepted view of yesterday's entrepreneur?

3-6. What is the relative significance of the four major reasons due to which businesses fail?

3-7. Would you prefer to buy an existing business or start from scratch? Why?

3-8. Why might a closely held corporation choose to remain private? Why might it choose to be publicly traded?

APPLICATION EXERCISES

3-9. Interview the owner/manager of a sole proprietorship or a general partnership. What characteristics of that business form led the owner to choose it? Does he or she ever contemplate changing the form of the business?

3-10. Although more than half of all small businesses don't survive five years, franchises have a much better track record. However, it can be difficult to buy a franchise. Research a popular food industry franchise, such as Panera Bread, Sonic, California Tortilla, or Subway, and detail the requirements for net worth and liquid cash for the franchisee as well as up-front and annual fees.

building a business: continuing team exercise

Assignment

Meet with your team members and discuss your new business venture within the context of this chapter. Develop specific responses to the following:

3-11. To what extent do each of you really want to be an entrepreneur?

3-12. For the specific business you are starting (in this exercise), does it make more sense to start from scratch, to buy an existing business, or to buy a franchise? Why?

3-13. How will you most likely finance your new venture?

3-14. What factors will most likely contribute to your success? What factors might cause your business to fail? Is there a way to minimize or eliminate these risk factors?

3-15. What form of ownership will your group use? What are the advantages and disadvantages of this approach?

team exercise

A TASTY IDEA

Background Information

Suppose that you and three friends from college would like to open a new restaurant. Collectively, you have almost 20 years of experience in the restaurant industry and, with lots of new houses in the area, you think that there's an opportunity to make a lot of money if you can offer interesting food at good prices. You've even identified a great location, but you realize that it's going to take a lot of money to get this business off the ground. As recent college graduates, you don't have a lot of money, so you're looking for the best source of funding. Realistically, you realize that you're going to need at least $100,000 to sustain operations until your business starts to return a profit.

Team Activity

STEP 1

Individually or in a group of two or three students, brainstorm a list of options for financing. You'll want to do some online research to find out more about some of the loan programs identified in the text.

STEP 2

For each of the funding options, develop a list of pros and cons. Be sure to consider all the implications of each form of financing, including interest rates, repayment options, and eligibility requirements.

FOLLOW-UP QUESTIONS

3-16. Before getting financing, what will be expected of you and your business partners?

3-17. Which source of financing would be best for you and your partners? Why?

3-18. What form of business ownership would be most appropriate for your new restaurant and why?

exercising your ethics

BREAKING UP IS HARD TO DO

The Situation

Connie and Mark began a 25-year friendship after finishing college and discovering their mutual interest in owning a business. Established as a general partnership, their home furnishings center is a successful business sustained for 20 years by a share-and-share-alike relationship. Start-up cash, daily responsibilities, and profits have all been shared equally. The partnership agreement was general and doesn't require specific work hours. The partners both average four days a week in the store except in particularly busy seasons. Shared goals and compatible personalities have led to a solid give-and-take relationship that helps them overcome business problems while maintaining a happy interpersonal relationship.

The division of work is a natural match and successful combination because of the partners' different but complementary interests. Mark is a natural salesman and has most of the face-to-face contact with customers; he also handles personnel matters (hiring and training employees). Connie manages the inventory, buys shipping supplies, keeps the books, and oversees the finances. Both partners share in decisions about advertising and promotions.

The Dilemma

Things began changing two years ago when Connie became less interested in the business and got more involved in other activities. Whereas Mark's enthusiasm remained high, Connie's time was increasingly consumed by travel, recreation, and community service activities. At first, she reduced her work commitment from four to three days a week. Although not physically present as many hours, she was attentive to e-mails and often worked from home ordering inventory and paying bills. Then she indicated that she wanted to cut back further, to just two days. At first, the store continued to operate pretty well, but problems began to arise. With Connie spending less time managing the inventory, Mark found that they often had empty spaces on the showroom floor. Furthermore, Connie had less time to focus on their financial situation and suppliers starting complaining about late payments on invoices. While Connie feels that her contributions are still substantial, Mark feels that their 50/50 is no longer fair. Connie, on the other hand, believes that she's keeping up her end of the bargain and doesn't want to make any changes to the partnership agreement.

QUESTIONS TO ADDRESS

3-19. What are the reasons the business has been successful? How did each partner contribute to the success?

3-20. Looking ahead, what are the biggest risks to their venture?

3-21. Is it fair for Connie to work fewer hours than Mark? What changes could they make to create equity and fairness in their agreement?

cases

It All Started with a Late Fee

Continued from page 106

At the beginning of this chapter, you read about how the idea for Netflix came about and how the company chose their business model. Using the information presented in this chapter, you should now be able to answer the following questions:

QUESTIONS FOR DISCUSSION

3-22. What are some of the primary reasons Netflix has been successful?

3-23. Netflix is a corporation. Why do you think the firm uses this form of ownership?

3-24. What threats might derail Netflix's success? What steps might the firm take today to thwart those threats?

3-25. Suppose Reed Hastings asked you for advice on how to make Netflix better. What would you tell him?

Ice Cream Headache

If you have ever visited a Cold Stone Creamery, you are familiar with the seemingly endless list of ice creams and toppings, as well as prepared cakes and other confections. You may not be aware, however, that Cold Stone is a franchise sold by Kahala Brands, whose other franchisee opportunities include Blimpie's sandwich shops and Samurai Sam's Teriyaki Grills.[29] Cold Stone has approximately 1,400 locations in 20 countries. In case you are considering opening your own Cold Stone, you might be interested in the conditions of ownership. Those who wish to purchase a Cold Stone franchise must show that they are financially sound, with at least $125,000 of cash available and a $250,000 net worth. The up-front franchise fee is $27,000 and the franchise is good for a ten-year term. Cold Stone provides plenty of assistance in selecting a location and opening a store, but start-up costs are estimated to be over $250,000. The company estimates that the average time to open a location is four to twelve months, which presents a real challenge for a new franchise owner. Once in operation, franchisees will pay a royalty fee of 6 percent of gross sales and an advertising fee of 3 percent of gross sales.[30]

Cold Stone's parent organization provides support in site selection, lease terms, and equipment selection. They provide 11 days of training at the company's headquarters and three additional days of training at the franchisee's location. Once the business is up and running, they provide continued support through newsletters and annual meetings, cooperative advertising arrangements, and a toll-free hotline. In 2015, Entreprenuer.com ranked Cold Stone Creamery #54 in its list of Top 500 franchise opportunities.[31]

Revenues for Cold Stone franchises have declined in recent years. In 2005, the typical location earned approximately $400,000 in revenues, but this number dipped to $352,000 in 2011. Tough economic times cut into discretionary spending, hurting the ice cream business. In 2012, a group of Cold Stone Creamery franchise owners threatened to file suit against the company, alleging that the company was not delivering on promised marketing campaigns. In addition, there was an ongoing dispute over revenue and interest from unused gift cards. Tensions between franchisors and franchisees are becoming increasingly common. Eric Stites, managing director of *Franchise Business Review,* reflects, "When franchises aren't making money, that's when you see them form associations and sue the franchiser." Franchises in the food industry seem to have been hurt especially hard. Although the initial investment is often close to $450,000, annual profits average only $88,382. Although a bowl of ice cream will brighten almost anyone's day, a Cold Stone Franchise may not be a sure thing.[32]

QUESTIONS FOR DISCUSSION

3-26. What would be the advantages of buying a Cold Stone Creamery franchise as opposed to starting a business from scratch?

3-27. What are the disadvantages of buying a Cold Stone Creamery franchise?

3-28. While franchise owners must have at least $125,000 of cash available, average start-up costs are more than double this amount. What are the most likely sources of funding for a franchise?

3-29. How would you research a franchise purchase before making the decision to invest?

3-30. Do you think that you would be interested in owning a Cold Stone Creamery franchise? Why or why not?

MyBizLab

Go to the Assignments section of your MyLab to complete these writing exercises.

3-31. Research suggests that certain characteristics are common for most entrepreneurs. Pick three and explain why they are important for an entrepreneurial mind-set. Compare and contrast how some might be more important than others given different situations. Are there situations where these characteristics might hinder successful entrepreneurship? Explain your answers.

3-32. What are the three primary forms of business ownership? Provide a description of each as well as the most significant advantages and disadvantages. When is each form most appropriate or desirable?

end notes

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[20]Hoy, Peter. "Minority and Women Owned Businesses Skyrocket," *Inc.* (May 1, 2006), pp. 20–24.

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