Chapter 3: Entrepreneurship, New Ventures, and Business Ownership

Chapter Overview

Have you ever wanted to be your own boss? Think of going to work when you want to. Think of how it would be to call your own shots. Although it’s anything but easy, starting your own business can be rewarding. The U.S. economic system welcomes entrepreneurship and offers various forms of business ownership. This chapter discusses small business, its importance to the U.S. economy, and the popular areas of small business. It looks at:

- Key characteristics of entrepreneurial personalities and activities
- Business plans
- Start-up decisions made by small businesses
- Sources of financial aid available
- Trends in small business start-ups
- Key reasons for success and failure among small businesses

Finally, the chapter discusses different forms of business ownership and the advantages and disadvantages of each, as well as the basic issues involved in managing a corporation and special issues related to corporate ownership.

Learning Objectives

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.

CHAPTER OUTLINE

Learning 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?

A **small business** is independent (that is, not part of a larger business) and has relatively little influence in its market. The U.S. Department of Commerce and the Small Business Administration (SBA), define the size of a business based on its industry and the number of employees. According to SBA standards, a small business can have as many as 1,500 employees.

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

Most U.S. businesses employ fewer than 20 people, and most U.S. workers are employed by small firms. The contribution of small business can be measured through its impact on job creation, innovation, and its importance to big business.

1. **Job Creation.** Small businesses are an important source of new jobs; in recent years, small businesses have accounted for 40 percent of all new jobs in the high-technology sectors of the economy alone.

2. **Innovation.** Small business produces 16 times as many patents per employee as large patenting firms.

3. **Contributions to Big Business.** Most products made by big businesses are sold to consumers by small ones.

B. Popular Areas of Small-Business Enterprise

Major small-business industry groups include the following:

1. **Services.** This is the fastest-growing segment of small business at approximately **56%.** Services range from marriage counseling to computer software to management consulting to professional dog walking.

2. **Retailing.** Retailers, which sell products made by other firms directly to consumers, account for **12 percent** of all firms with fewer than 20 employees; retail businesses let entrepreneurs focus limited resources on narrow market segments.

3. **Construction.** About **12 percent** of businesses with fewer than 20 employees are involved in construction. Projects are primarily locally based.

4. **Wholesaling.** Wholesalers buy products in bulk from manufacturers and sell them to retailers; wholesalers are the middlemen. About **5 percent** of all firms are in this category.

5. **Finance and Insurance.** These firms account for about **4 percent** of all firms with fewer than 20 employees. Many are affiliates of or agents for larger national firms. Small locally owned banks are also common in smaller communities and rural areas.

6. **Manufacturing.** More than any other industry, manufacturing lends itself to big business. Still, about **4 percent** of firms with fewer than 20 employees are involved in manufacturing and may outperform big firms in innovation-driven industries.

7. **Transportation.** About **3 percent** of all companies with fewer than 20 employees are in transportation and related businesses.

8. **Other.** The remaining **4 percent** or so of small businesses with fewer than 20 employees are in other areas, including research and development laboratories and independent media companies.

Learning Objective 3-2:

Explain entrepreneurship and describe some key characteristics of entrepreneurial personalities and activities.

Entrepreneurship

Entrepreneurs are people who assume the risk of business ownership. **Entrepreneurship** is the process of seeking business opportunities under conditions of risk. Many entrepreneurs are driven to launch new businesses by the goal of gaining independence from working for somebody else and securing a financial future for themselves. Many such entrepreneurs, however, may not aspire to grow the businesses much beyond their capacity to run them.

A. Entrepreneurial Characteristics

Successful entrepreneurs are often distinguished from others through a set of characteristics, including:

1. Resourcefulness
2. A concern for customer relations
3. A desire for autonomy
4. The ability to handle ambiguity
5. A desire for risk-taking

Learning Objective 3-3:

Describe the distinctive competence, 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

Entrepreneurs must make a number of decisions when they start their business. They must decide whether to buy an existing business or to start one from scratch. In addition, they must determine sources of financing needed and when to seek advice from others. Another integral part of starting a small business is a well-crafted business plan.

A. 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. **Identifying Niches in Established Markets:** An **established market** is one in which many firms compete according to relatively well-defined criteria. 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.

2. **Identifying New Markets:** Successful entrepreneurs excel at discovering whole new markets. Two ways this often happens are 1) transferring a product or service that is well established in one geographic market to a second market; and 2) creating an entire new industry.

3. **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. The ability to move quickly is key to taking advantage.

B. Crafting a Business Plan

A **business plan** summarizes business strategy for the new venture and shows how it will be implemented.

1. **Setting Goals and Objectives:** A business plan should discuss the entrepreneur's goals and objectives, the strategies used to obtain them, and how these strategies will be implemented.

2. **Sales Forecasting:** The sales forecast requires that the entrepreneur demonstrate an understanding of the market, the strengths and weaknesses of existing firms, and the means by which the new venture will compete. The sales forecast impacts many of the other decisions regarding the business.

3. **Financial Planning:** This is the entrepreneur's plan for turning all activities into dollars. It shows how much money is needed to open for business and how much is needed to keep it going until it starts earning a profit.

C. Starting the Small Business

Small business owners begin by understanding the true nature of their businesses.

1. **Buying an Existing Business:** Existing businesses have already proven their ability to attract customers and to establish rapport with lenders, suppliers, and the community. Most consultants recommend that entrepreneurs buy existing businesses because the odds of success are greater.

2. **Franchising:** A **franchise** agreement involves two parties, a *franchisee* (the local owner)

and a *franchiser* (the parent company). Franchisees benefit from the parent corporation's experience and expertise. The franchiser may pick the store location, negotiate the lease, purchase equipment, and supply financing. Franchisees invest in ready-made businesses but also receive expert help in running them. Startup costs vary quite widely. For example, a McDonald's franchise has an initial fee of at least $1 million, but a Fantastic Sam's hair salon is $185,000.

3. **Starting from Scratch:** Risks with this approach are greater than with buying an existing business. However, starting from scratch does allow the entrepreneur the satisfaction to grow an idea into a successful business. An entrepreneur must identify who and where the customers are, how much customers will pay for the product, how much of the product should be expected to sell, who the competitors are, and why customers will purchase this product rather than the competitors' products.

D. Financing the Small Business

Many sources for business financing are available. Personal resources account for more than two-thirds of all money invested; smaller portions of funding come from banks, independent investors, and government loans.

1. **Venture capital companies** are groups of investors seeking to profit on companies with rapid growth potential; money is invested in return for partial ownership. **Small business investment companies** are licensed to borrow money from the SBA and invest it in or loan it to small businesses.

2. **SBA Financial Programs:** Under the SBA's *7(a) loans program*, small businesses may borrow from commercial lenders with the SBA guaranteeing to repay a maximum of 75 percent of a loan over $150,000. The SBA's *special purpose loans* target businesses with special needs, such as those meeting international demands. For loans under $35,000, the SBA offers a *micro-loan program*.

   Aside from its financing role, the SBA offers management counseling programs at virtually no cost. One of the SBA's management counseling projects is its **Small Business Development Center (SBDC)** program.

3. **Other sources of financing** include overseas financing and online companies that focus on small businesses.

Learning Objective 3-4:

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

Trends, Successes, and Failures in New Ventures

A. Trends in Small-Business Start-Ups

Several factors account for the thousands of new business start-ups in the United States each year.

1. **Emergence of E-Commerce:** The rapid emergence of electronic commerce is the most significant recent trend. Because e-commerce provides new and different ways of doing business, it has enabled savvy entrepreneurs to create and expand businesses far easier and quicker than ever before.

2. **Crossovers from Big Business:** Many businesses are started by individuals who leave positions in large corporations to put their experience to work for themselves.

3. **Opportunities for Minorities and Women:** The number of businesses started by minorities and women is growing rapidly.

4. **Global Opportunities:** Many entrepreneurs are finding business opportunities throughout the world.

5. **Better Survival Rates:** New businesses now have a better chance of survival than ever before; the SBA estimates that over half of all new businesses can expect to survive for four years. One third make it for ten years or more.

B. Reasons for Failure

Four general factors contribute to small-business failure:

1. Managerial incompetence or inexperience
2. Neglect
3. Weak control systems
4. Insufficient capital

C. Reasons for Success

Four general factors contribute to small-business success:

1. Hard work, drive, and dedication
2. Market demand for the products or services being provided
3. Managerial competence
4. Luck

Learning Objective 3-5:

Explain sole proprietorships, partnerships, and cooperatives and discuss the advantages and disadvantages of each.

Noncorporate Business Ownership

A. Sole Proprietorships

A **sole proprietorship** is owned and usually operated by one person; about 74 percent of all U.S. businesses are sole proprietorships though they provide only 4 percent of total business revenues.

1. **Advantages of Sole Proprietorships:** Freedom, ease in forming, low start-up costs, and tax benefits are the advantages of this form of ownership.

2. **Disadvantages of Sole Proprietorships:** Unlimited liability, lack of continuity, and a possible lack of resources and/or managerial and financial limitations from the single individual are the major drawbacks of this form of organization.

B. Partnerships

A **general partnership,** the most common type, is a sole proprietorship multiplied by the number of partner-owners. Partners may invest unequal sums of money. In most cases, partners share the profits equally or in proportion to their investment in the partnership.

1. **Advantages of Partnerships:** The ability to grow with the addition of new talent and money, few legal requirements, and tax advantages are benefits of this form of ownership.

2. **Disadvantages of Partnerships:** Unlimited liability in that each partner may be liable for the debts incurred in the name of the partnership, lack of continuity, and difficulty of transferring ownership are the major drawbacks of this form of ownership.

3. **Alternatives to General Partnerships:** Because of the disadvantages of partnerships, general partnerships are the least popular forms of business. **Limited partnerships** have been formed to compensate for some of these disadvantages. This type of agreement allows for **limited partners** who cannot share in a firm's management and are liable only to the limits of a partner's investment. There is, however, a requirement that there is at least one **general partner** who actively manages a firm and has unlimited liability for the debt.

   Master Limited Partnerships is a form of ownership that sells shares to investors who are repaid from the firm's profits. The master partner retains at least 50 percent ownership and runs the business.

C. Cooperatives

Cooperatives combine the freedom of sole proprietorships with the financial power of corporations. These groups of sole proprietorships or partnerships agree to work together for their common benefit. They give members greater production power, greater marketing power, or both, though they are limited to serving the specific needs of their members.

Learning 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.

Corporations

Both large and small corporations account for 17 percent of all businesses, but generate about 81 percent of all sales revenues in the United States.

A. The Corporate Entity

Characteristics of **corporations** include legal status as separate entities, property rights and obligations, and indefinite life spans. Corporations may sue and be sued; buy, hold, and sell property; make and sell products to customers; commit crimes, and be tried and punished for them.

1. **Advantages of Incorporation.** These include **limited liability,** continuity, and the ability to raise money.

2. **Disadvantages of Incorporation.** Ease of transferring ownership, legal requirements and regulations, and start-up cost are drawbacks of incorporation. In addition, **double taxation** plagues a corporation, because a regular corporation must pay income taxes on profits and stockholders must pay taxes on income returned by their investments.

B. Types of Corporations

Stock is held by only a few people and is not available for sale to the public in a **closely held** (or **private) corporation.** When shares are publicly issued, the firm becomes a **publicly held** (or **public**) **corporation.** The **S corporation** is a hybrid of a private corporation and partnership. In a **limited liability corporation,** owners are taxed like partners, with each paying personal taxes only. **Professional corporations** are most likely comprised of doctors, lawyers, accountants, or other professionals. A **multinational** (or **transnational**) **corporation** spans national boundaries.

C. Managing a Corporation

Once the corporate entity comes into existence, it must be managed by people who understand the principles of corporate governance. Defined by the firm’s bylaws, corporate governance involves stockholders, the board of directors, and corporate officers.

1. **Stock Ownership and Stockholders’ Rights. Stockholders** are the owners of a corporation**.** 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.

2. **Board of Directors.** The **board of directors** is the governing body of the corporation and communicates with stockholders and other stakeholders, sets policies, and is legally responsible for corporate actions.

3. **Officers.** Appointed by the board of directors, **officers** oversee the day-to-day operations of the corporation. The chief executive officer, or CEO, oversees overall operations.

D. Special Issues in Corporate Ownership

1. **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.**

2. **Employee Stock Ownership Plans (ESOPs): ESOPs** allow employees to own a significant share of the corporation through trusts established on their behalf.

3. **Institutional Ownership: Institutional investors** include mutual funds and pension funds that buy enormous blocks of stock.

4. **Mergers and Acquisitions:** A **merger** occurs when two firms combine to create a new company; in an **acquisition,** one firm buys another outright. Many deals that are loosely called mergers are really acquisitions.

5. **Divestitures and Spin-Offs:** A **divestiture** occurs when a firm sells off unrelated and/or underperforming businesses. When a firm sells part of itself to raise capital, the strategy is known as a **spin-off.**

