3 Entrepreneurship, New Ventures, and Business Ownership

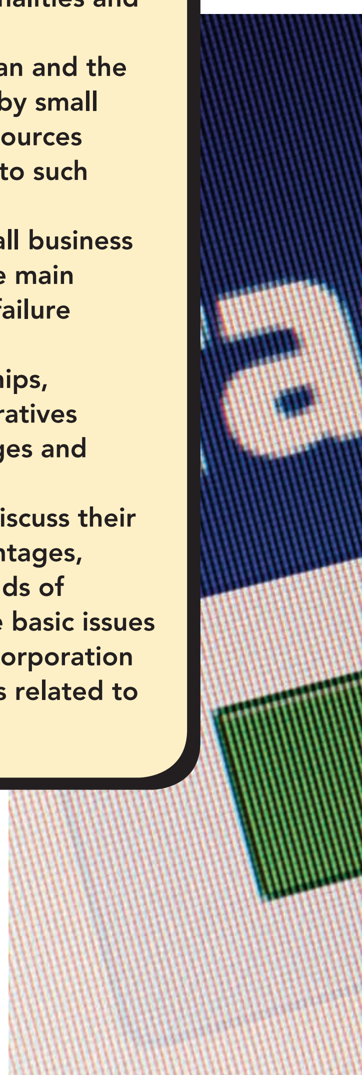
Harvard Dropout Turned Billionaire

Do you Facebook? An estimated 175 million people in the United States do, and almost half are college students. The immensely popular social-networking website was started by Harvard sophomore Mark Zuckerberg in February 2004 as a way for his classmates to network. The site proved to be so popular that he quickly opened it up to other schools. By November 2004, the site boasted 1 million users. A mere 18 months later, membership had ballooned to 7 million members at 2,100 colleges and 22,000 high schools. When it began accepting nonstudents in October 2006, membership doubled from 12 million to 24 million in just 8 months. Today, Facebook.com is one of the most visited sites on the Internet, running neck-and-neck with Google among U.S. college students. The total number of worldwide Facebook users was approaching 700 million in 2011.

Although Facebook began as a noncommercial enterprise, it wasn't long before Zuckerberg realized that if he had more cash he could convert it into a business. PayPal cofounder Peter Thiel invested $500,000 in 2004, and substantial investments of additional venture capital followed. The new company lost $3.6 million in fiscal 2005, but with projected revenues of $150 million in 2007, Microsoft paid $240 million for a 1.6 percent stake in the company, pushing its valuation to $15 billion. Bear in mind that Facebook is not a publicly

After reading this chapter, you should be able to:

1. Define *small business*, discuss its importance to the U.S. economy, and explain popular areas of small business.
2. Explain entrepreneurship and describe some key characteristics of entrepreneurial personalities and activities.
3. Describe the business plan and the start-up decisions made by small businesses and identify sources of financial aid available to such enterprises.
4. Discuss the trends in small business start-ups and identify the main reasons for success and failure among small businesses.
5. Explain sole proprietorships, partnerships, and cooperatives and discuss the advantages and disadvantages of each.
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.



traded company—its stock can't be purchased on the open market. It's all privately held, and that $15 billion figure reflects the prices being paid at the time for the company's preferred stock by Microsoft and other major investors.

But as a business, Facebook has a problem that is not widely known—it's actually finding it hard to make a profit. Approximately 85 percent of the company's total revenue comes from advertising (about $210 million in 2009), with another $35 million to $50 million coming from sales of virtual gifts—those little icons that pop up in certain Facebook programs and that users can exchange for about $1. In 2009, Facebook sold about $3 million worth of virtual gifts every month, but revenues for the year—about $260 million—fell short of the company's $300 million projection. It was time to get serious about profit.

If we look even more closely at these numbers, we notice an interesting phenomenon: User

WHAT'S IN IT FOR ME?

Mark Zuckerberg displayed many of the characteristics key to entrepreneurial success. Facebook also highlights some of the problems inherent in converting a great business idea into profits for owners. 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.

MyBizLab Where you see MyBizLab in this chapter, go to **www.mybizlab.com** for additional activities on the topic being discussed.

TomBham/Alamy

rates and revenues aren't going in the same direction. Since its inception, Facebook has had a problem with monetization—how to make a profit. It's a problem that Facebook shares with MySpace, which still commands a substantial share of the income from social networking. The solution, of course, is ad revenue—user fees are negligible, and even $3 million a month in virtual-gift sales won't begin to cover server costs. When they first appeared on the Internet scene, social networks seemed like turbocharged revenue generators, but both Facebook and MySpace have found that selling spots on web pages dedicated to personal profiles and group interchanges isn't as easy as it seemed.[1]

Our opening story continues on page 80.

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* defies easy definition. Locally owned and operated restaurants, dry cleaners, and hair salons are obviously small businesses, and giant corporations, such as Dell, Starbucks, Apple, and Best Buy, are clearly big businesses. Between these two extremes, though, fall thousands of companies that cannot be easily categorized.

The U.S. Department of Commerce considers a business "small" if it has fewer than 500 employees. The U.S. **Small Business Administration (SBA),** a government agency that assists small businesses, regards some companies with as many as 1,500 employees as small, but only if the business has relatively low annual revenues. 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 the prices it pays to wholesalers and that it can charge its customers are largely set by market forces. Dell Computer was a small business when founded by Michael Dell in 1984, but today it's number one in the personal computer market 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 85.95 percent of all businesses employ 20 or fewer people. Another 11.65 percent employ between 20 and 99 people, and 2.15 percent employ between 100 and 499. Only about one-tenth of 1 percent employ 1,000 or more people. Figure 3.1(b) also shows that 24.55 percent of all workers are employed by firms with fewer than 20 people, and 29.61 percent are employed by firms with between 20 and 99 people. Another 25.52 percent are employed by firms with between 100 and 499 people. Only 13.44 percent of all workers are employed by firms with 500 or more employees.

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*.

MyBizLab

Gain hands-on experience through an interactive, real-world scenario. This chapter's simulation entitled Are You an Entrepreneur? Getting Your Business Off the Ground is located at www.**mybizlab**.com.

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

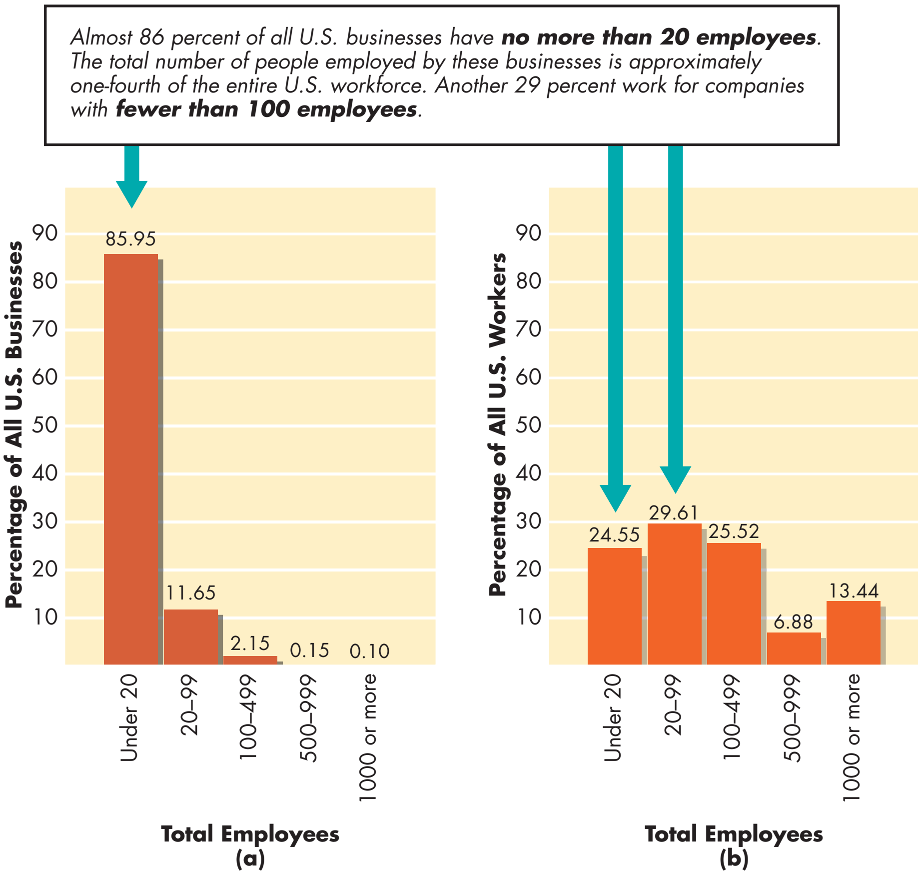


Figure 3.1 **The Importance Small Business in the United States**
Source: Data from **www.sba.gov**, accessed 3/6/2010, and U.S. Census Bureau, "Statistics About Business Size (including Small Business) from the U.S. Census Bureau," at **www.census.gov/epcd/www/smallbus.html**, accessed 4/25/2011.

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, while 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 at a rapid clip, it may quickly cease being small. For example, Dell Computer had 1 employee in 1984 (Michael Dell himself). But the payroll grew to 100 employees in 1986, 2,000 in 1992, more than 39,000 in 2004, and 94,300 in 2010. While 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 personal computer, the stainless-steel razor blade, the photocopier, the jet engine, and the self-developing photograph. Innovations are not always new products. Michael 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 via the Internet). Today, 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 the

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

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


Thomas Nord/Shutterstock

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.

Internet, 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.

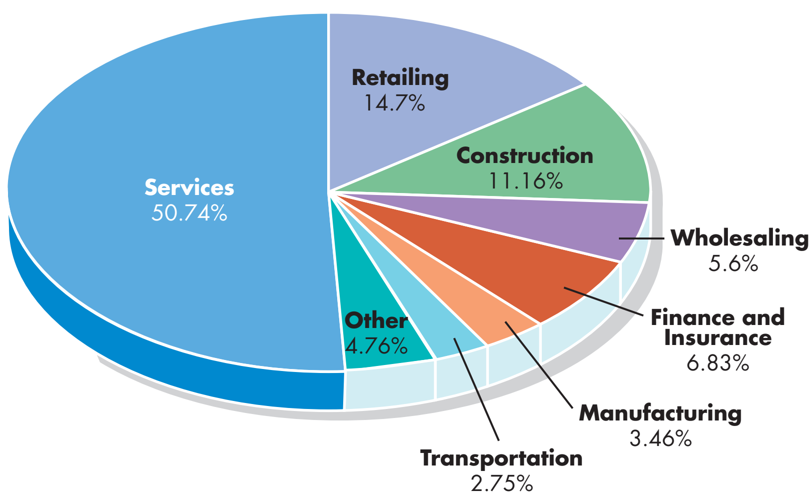
Popular Areas of Small-Business Enterprise

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 an industry is dominated by small firms. 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 50.74 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, 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 13 percent of these firms. Usually, people who start small retail businesses favor specialty shops—big men's clothing or gourmet coffees, for example—that let them focus limited resources on narrow or small market segments.

Figure 3.2 **Small Business by Industry**
Source: U.S. Census Bureau, "Statistical Abstract of the United States," at *http://www.census.gov/prod/www/statistical-abstract.html.*



MANAGING IN TURBULENT TIMES

The Wide World of Risk

One reason why globalization has become such a factor in everyday business life is the expanded reach and power of multinational companies. Many large corporations have actually become engines for innovation as well as growth, adapting to new markets and new economic circumstances. In a highly interconnected world, however, it's often hard to figure out the complex ownership and organizational structures of many global corporations. Sometimes, for example, their branding strategies and management structures lead people to think that they're local companies when, in fact, the real source of corporate power may lie thousands of miles away on another continent. One thing's for sure: If you're going to be dealing with a company overseas, you'd better have a good idea of where and how decisions are made, and who has the real power to make them.

Remember, too, that different cultures have different attitudes when it comes to entrepreneurship. In some countries and cultures, like that of the United States, there's a lively entrepreneurial spirit. Businesspeople are open to taking risks, and if they fail, they tend to pick themselves up and move on to something else. In some Asian countries, the entrepreneurial spirit is often tempered by the need for consensus and getting everyone on board. This approach requires a lot of patience and the ability to compromise.

Baris Simsek/iStockphoto.com

Knowing the cultural forces that shape both a business organization and people's attitudes toward risk, success, and failure is an elementary but important component of international business.

MyBizLab

Construction About 14.7 percent of all U.S. businesses are involved in construction. Because many construction jobs are small local projects, like 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 5.6 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 6.83 percent. 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 3.46 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.

Transportation About 2.75 percent of these small companies are in transportation and related businesses, including many taxi and limousine companies, charter airplane services, and tour operators.

Other The remaining 4.76 percent or so are in other industries, such as small research-and-development laboratories and independent media companies, like start-up web channels, small-town newspapers, and radio broadcasters.

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

Entrepreneurship

We noted earlier 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 Michael Dell, who assume the risk of business ownership. **Entrepreneurship** is the process of seeking business opportunities under conditions of risk. However, not all entrepreneurs have the same goals.

For instance, 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 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 business near a local university. His goal is 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 Michael Dell's vision when he started his business; likewise, when Howard Schultz took over Starbucks, he too 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 really is no large market or another firm establishes dominance over that market first.

Entrepreneurial Characteristics

Regardless of their goals, many successful entrepreneurs share certain characteristics—for example, 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. Although today's entrepreneur may be male, she is just as likely to be female. 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.[4]

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 president of Tempstaff, a Japanese temp agency that she started out of her one-room apartment more than 30 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 $1.5 billion company with a high-rise headquarters in Tokyo.[5]

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."[6]

Starting and Operating a New Business

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

The Internet has 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. They must 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.

Crafting a Business Plan

The starting point for virtually every new business is a **business plan** in which the entrepreneur describes her or his business strategy for the new venture and demonstrates how it will be implemented.[7] A real benefit of a business plan is the fact that in the act of preparing it, the would-be entrepreneur must 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.

Setting Goals and Objectives A business plan describes the match between the entrepreneur's abilities and experiences and the requirements for producing and/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 While 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

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

Business Plan document in which the entrepreneur summarizes her or his business strategy for the proposed new venture and how that strategy will be implemented first researching markets. Simply asserting that the new venture will sell 100,000 units per month is not credible. Instead, 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.[7]

Starting the Small Business

An old 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 Next, the entrepreneur 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, Ramada, and Blockbuster 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).[8]

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 a carbon copy of every other outlet, failure is less likely. Recent statistics show that franchising is on the upswing, having increased by over 20 percent during the past decade.

Perhaps the most significant disadvantage in owning a franchise is start-up cost. Franchise prices vary widely. The fee for a Fantastic Sam's hair salon is $30,000; however, the franchisee must also invest additional funds in building and outfitting the salon. A McDonald's franchise has an initial fee of $45,000 but again requires the additional funds to construct and outfit a restaurant; the costs generally run the total outlay to around $1 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 in order 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, Wal-Mart, Microsoft, and Facebook 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. 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 2008–2010 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 over 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.

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

Other Sources of Investment **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.

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 a maximum of 75 percent. The SBA's *special purpose loans* target businesses with specific needs, such as meeting international demands or implementing pollution-control measures. For loans under $35,000, 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.[9]

Other SBA Programs 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.

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

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 there are generally between 600,000 and 650,000 new businesses launched in the United States. On the other hand, there are also between 500,000 and 600,000 failures each year as well.[10] In 2009, for instance, 627,200 new firms started operations and another 595,600 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 electronic 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.com, and eBay owe their very existence to the Internet. Figure 3.3 underscores this point by summarizing the growth in online commerce from 2003 through 2010.

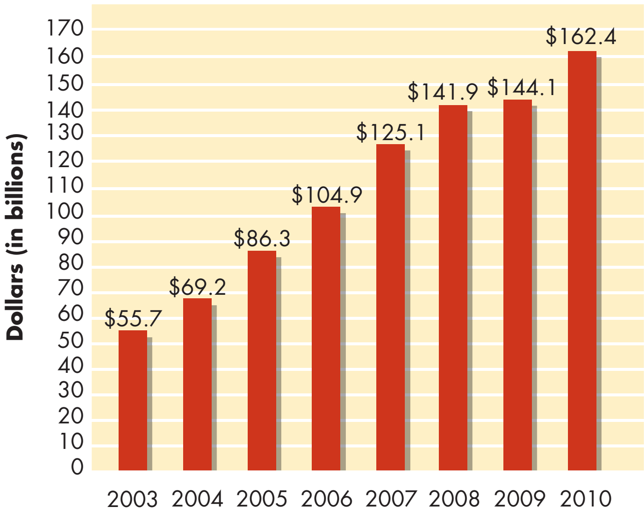


Figure 3.3 Growth of Online Retail Spending

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.[9] 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 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, 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.[11] The number of businesses owned by African Americans increased by 48 percent during the most recent five-year period for which data are available and now totals about 2 million. The number of Hispanic-owned businesses has grown 31 percent and now totals about 2.25 million. Ownership among Asians has increased 24 percent and among Pacific Islanders 64 percent.[12]

Almost 8 million businesses are now owned by women. Together, they generate a combined $200 trillion in revenue a year and employ about 10 million workers.[13] Figure 3.4 shows some of the reasons women cite for starting their own businesses.

Global Opportunities Many entrepreneurs are also finding new opportunities in foreign markets. Doug Mellinger is founder and CEO of 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 helps him attract foreign programmers and does everything it can to make things easier. Today, PRT has customers and suppliers from dozens of nations.

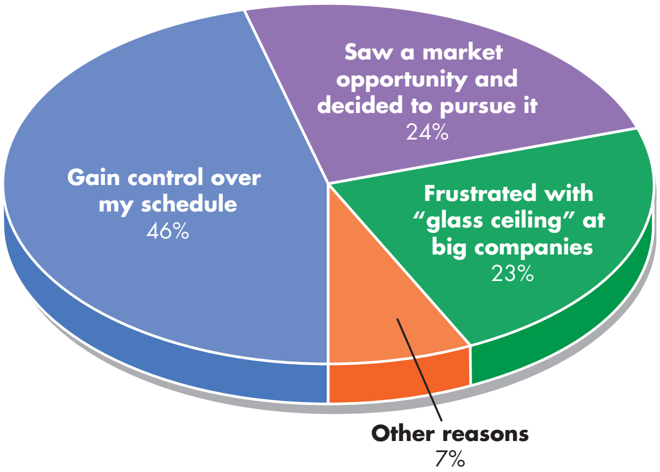
Better Survival Rates More people are encouraged to test their skills as entrepreneurs because the small-business failure rate has declined. During the 1960s and 1970s, less than half of all new start-ups survived more than 18 months; only one in five lasted 10 years. Now, however, 44 percent can expect to survive for at least four years.[14]

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

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

Figure 3.4 Reasons Women Give for Starting Businesses



Reasons for Failure

Unfortunately, over half of all new businesses 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 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.com 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.[15]

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. Gladys Edmunds, a single mother in Pittsburgh, wanted to open a travel agency but did not have enough money to get started. So, she washed laundry, made chicken dinners to sell to cab drivers, and sold fire extinguishers door to door to earn

ENTREPRENEURSHIP AND NEW VENTURES

Being Savvy and Lucky Make a Great Combination

One day a few years ago an ex-Marine named Reed Hastings rented a movie from his neighborhood video rental store. After watching the movie, he discovered that he had misplaced the plastic case for the videocassette. It took him several days to locate it but by then he had racked up some hefty late fees. Hastings dropped off the movie on his way to the gym for a workout, and left fuming over the fees. A bit later, as he was walking on the gym's treadmill he had an inspiration: maybe a video rental business could be run just like a gym, where members play a flat monthly fee but then get to use the gym as much as they wanted. From this basic idea came one of today's hottest businesses—Netflix.

Hastings launched Netflix in 1997, offering members unlimited video rentals through the mail with no late fees. Customers pay a monthly service charge and register online to receive movies of their choice. Whenever they receive a movie, they can keep it as long as they like with no additional fees. Whenever they send a movie back to Netflix—whether its two days or two months later—they get their next movie. Over 17 million subscribers belong to Netflix, and the company has successfully fended off threats from Blockbuster, Amazon, and Google.

But new threats are on the horizon. More and more home viewers are shifting away from renting movies through the mail and instead are buying streaming video. Netflix was actually one of the first businesses to move into this emerging market and currently has the largest market share. At the same time, though, streaming video requires entirely new licensing agreements with content providers like Disney, CBS, and Sony. While these and other firms have remained partners with Netflix, they are also keeping their options open. Meanwhile, other streaming video competitors emerge almost daily and who knows when one of these companies might develop a new business model that can offset Netflix's current advantages.

For his part, though, Reed Hastings continues to enjoy the fruits of his brilliant idea. In 2010, for example, he received a base salary as Netflix's CEO of over $2.5 million. In addition, he is also the company's largest individual shareholder. In this case, then, a mix of entrepreneurial savvy and some old-fashioned good luck have combined to provide another great success story in the history of American entrepreneurship.[16]

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w51/ZUMA Press/Newscom

start-up money. Today, Edmunds Travel Consultants employs eight people and earns about $6 million a year.[17]

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.

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.[13]

4 *Luck.* After Alan McKim started Clean Harbors, an environmental cleanup firm in New England, he struggled to keep his business afloat. Then the U.S. government committed $1.6 billion to toxic waste cleanup—McKim's specialty. He 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.

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

The **sole proprietorship** is owned and usually operated by one person. About 72 percent of all U.S. businesses are sole proprietorships; however, they account for only about 5 percent of total business revenues. Though usually small, they may be as large as steel mills or department stores.

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 it 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.

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.

TABLE 3.1 Comparative Summary: Three Forms of Business

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

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*).

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 than 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.

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

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

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

Alternatives to General Partnerships Because of these disadvantages, general partnerships are among the least popular forms of business. Roughly 1.79 million U.S. partnerships generate only 5.8 percent of total sales revenues.[15] 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.

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, while 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

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

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 4.93 million corporations in the United States. As you can see from Figure 3.5, they account for about 20 percent of all U.S. businesses but generate about 85 percent of all sales revenues.[18] Almost all large businesses use this form, and corporations dominate global business. As we will see, corporations need not be large—indeed, many small businesses also elect to operate as corporations.

According to the most recent data, Wal-Mart, the world's largest corporation, posted annual revenue of over $408 billion, with total profits of over $100 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 $1.4 billion on annual sales of $2.4 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 General Motors and IBM. 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 GM would share the characteristics of all **corporations:** legal status as separate entities, property rights and obligations, and indefinite life spans.

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 defined the corporation as a legal person. Corporations may, therefore, perform the following activities:

- Sue and be sued
- Buy, hold, and sell property

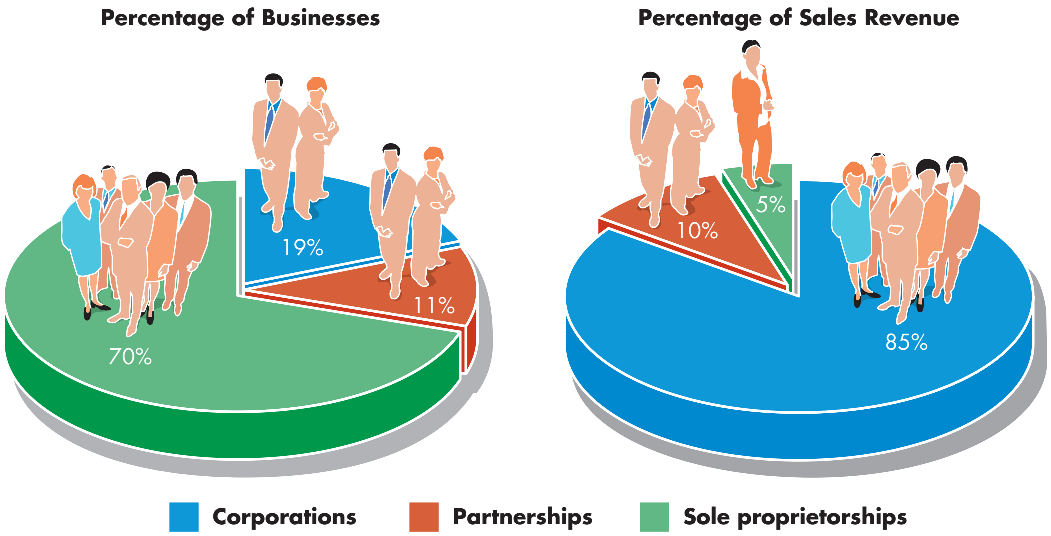

Figure 3.5 Proportions of U.S. Firms in Terms of Organization Type and Sales Revenue

- Make and sell products
- Commit crimes and be tried and punished for them

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.

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.

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

Cooperative form of ownership in which a group of sole proprietorships and/or partnerships agree to work together for common benefits

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

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

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

The biggest disadvantage of incorporation, however, is **double taxation.** First, a corporation pays income taxes on company profits. In addition, stockholders then 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.

- 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.

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	Dell Computer 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

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

Managing a Corporation

Creating any type of corporation can be complicated, due to 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**—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 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.

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.

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

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

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

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

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

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

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.

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.

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.

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 over $400 billion, much of it invested in stocks. Institutional investors own almost 55 percent of all the stock issued in the United States.

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 recently merged to create the world's largest airline. 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 two years to integrate their respective operations into a unified new firm.

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 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.

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 and/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.

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

Officers top management team of a corporation

Chief Executive Officer (CEO) top manager who is responsible for the overall performance of a corporation

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

Merger the union of two corporations to form a new corporation

Acquisition the purchase of one company by another

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

TomBham/Alamy

Continued from page 60

Conjuring Up Profits?

Facebook has been trying to figure how to best link members and advertisers since 2007. Its first effort, called Facebook Platform, involved allowing developers to build their own businesses on a platform supported by Facebook. By October, the Facebook site had been flooded with more than 4,000 social apps, and the wave of attention—coupled with an upsurge in the number of Facebook users—sealed the investment deal with Microsoft. The next phase, called Beacon, consisted of linking ads with a user's photo when that user bought a product or expressed an opinion about it. Ads and photos were then sent automatically to all the user's Facebook "friends"—the accumulated network of people with whom a user shares comments, photos, and profiles. Advertisers responded quite favorably to the Beacon initiative, and marketers from several companies—including Blockbuster, Condé Nast, and Coke—announced that they intended to make spending on social-networking sites a priority.

The Beacon process called for getting the user's permission to broadcast a commercial message to all his or her friends—but not for consulting those friends, who were unable to avoid any commercial messages. Not surprisingly, critics of the initiative quickly expressed concern about privacy issues, and within a month, the company was presented with a petition containing the names of 50,000 users who objected to its tactics in rolling out the advertising plan. For one thing, it seems that Facebook didn't actually *ask* users' permission to piggyback ads on their personal messages. Rather, it posted less-than-conspicuous notices of its intent to do so and then proceeded to assume that everyone who ignored them was giving tacit permission. In addition, Facebook neglected to inform advertisers that users had to take overt action to opt out of Beacon.

Facebook's "social-advertising" strategy has since evolved into a process called *hypertargeting*, which allows advertisers to select an audience—say, Florida college students who watch the cable TV sports network ESPN—and target simple ads at its members. In February 2009, Facebook announced an initiative called Engagement Ads, which is designed to attract advertisers to the site's potential for market research rather than sales.

Critics point out, however, that Facebook users aren't very good candidates for survey responses. In particular, they tend to use the site strictly for the activities that attracted them to it in the first place—commenting on friends' photos, leaving wall posts, and adding the applications that they want. "Social networks are some of the stickiest sites out there," says advertising consultant Andrew Chen. "They have very low click-through rates." In other words, users stick to the site and don't click on the ads. In fact, while 79 percent of all Internet users click through, only 57 percent of users on sites such as Facebook and MySpace leave the lively interactive environments of the host sites. It's a proclivity that doesn't bode well for monetization in the online social-networking business. The business model, adds Chen, "has to mature significantly before any sort of real revenue or value can be created."

QUESTIONS FOR DISCUSSION

1. Why do you think Facebook has been so successful?
2. Facebook is a corporation. Why do you think the firm uses this form of ownership?
3. What threats might derail Facebook's success? What steps might the firm take today in order to thwart those threats?
4. Suppose Mark Zuckerberg asked you for advice on how to generate more profits from Facebook. What would you tell him?

SUMMARY OF LEARNING OBJECTIVES

MyBizLab

1. Define *small business*, discuss its importance to the U.S. economy, and explain popular areas of small business. (pp. 60–64)

A *small business* is independently owned and managed and has relatively little influence in its market. The importance of small business includes (1) *job creation*, (2) *innovation*, and (3) *contributions to big business*. The major small-business industry groups are (1) *services*, (2) *retailing*, (3) *construction*, (4) *wholesaling*, (5) *finance and insurance*, (6) *transportation*, and (7) *manufacturing*.

2. Explain entrepreneurship and describe some key characteristics of entrepreneurial personalities and activities. (pp. 64–65)

Entrepreneurs are people who assume the risk of business ownership. *Entrepreneurship* is the process of seeking business opportunities under conditions of risk. Some entrepreneurs have a goal of independence and financial security, while 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.

3. Describe the business plan and the start-up decisions made by small businesses and identify sources of financial aid available to such enterprises. (pp. 65–68)

The starting point for virtually every new business is a *business plan*, in which the entrepreneur summarizes business strategy for the new venture and shows how it will be implemented. 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.

Common funding sources include personal funds, family and friends, savings, lenders, investors, and governmental agencies. *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. Lending institutions are more likely to finance an existing business than a new business because the risks are better understood.

4. Discuss the trends in small business start-ups and identify the main reasons for success and failure among small businesses. (pp. 68–71)

Five factors account for the fact that thousands of new businesses are started in the United States every year: (1) *the emergence of e-commerce*; (2) *entrepreneurs who cross over 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*.

Four 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*.

5. Explain sole proprietorships, partnerships, and cooperatives and discuss the advantages and disadvantages of each. (pp. 72–74)

The *sole proprietorship* is owned and usually operated by one person. There are tax benefits for new businesses that are likely to suffer losses in early stages. A major drawback is *unlimited liability*. Another disadvantage is lack of continuity. Finally, a sole proprietorship depends on the resources of a single individual. The *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. A partnership is not a legal entity. It is just two or more people working together. Partners are taxed as individuals, and *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. *Cooperatives* combine the freedom of sole proprietorships with the financial power of corporations.

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. 74–79)

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. Finally, corporations have advantages in raising money. By selling stock, they expand the number of investors and the amount of available funds. Legal protections 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*. Different kinds of corporations help businesses take advantage of incorporation without assuming all of the disadvantages.

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*. The *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. 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

acquisition (p. 78)
board of directors (p. 78)
business plan (p. 65)
chief executive officer (CEO) (p. 78)
closely held (or private) corporation (p. 76)
cooperative (p. 74)
corporate governance (p. 77)
corporation (p. 74)
divestiture (p. 79)
double taxation (p. 76)
employee stock ownership plan (ESOP) (p. 78)
entrepreneur (p. 64)
entrepreneurship (p. 64)
franchise (p. 66)
general (or active) partner (p. 74)
general partnership (p. 73)
institutional investor (p. 78)
joint venture (p. 78)
limited liability (p. 75)
limited liability corporation (LLC) (p. 77)
limited partner (p. 74)
limited partnership (p. 74)
master limited partnership (p. 74)
merger (p. 78)
multinational (or transnational) corporation (p. 77)
officers (p. 78)
professional corporation (p. 77)
publicly held (or public) corporation (p. 76)
S corporation (p. 77)
small business (p. 60)
Small Business Administration (SBA) (p. 60)
Small Business Development Center (SBDC) (p. 68)
small-business investment company (SBIC) (p. 68)
sole proprietorship (p. 72)
spin-off (p. 79)
stockholder (or shareholder) (p. 77)
strategic alliance (p. 78)
tender offer (p. 75)
unlimited liability (p. 72)
venture capital company (p. 68)

QUESTIONS AND EXERCISES

QUESTIONS FOR REVIEW

1. Why are small businesses important to the U.S. economy?
2. Which industries are easiest for start-ups to enter? Which are hardest? Why?
3. What are the primary reasons for new business failure and success?
4. What are the basic forms of noncorporate business ownership? What are the key advantages and disadvantages of each?

QUESTIONS FOR ANALYSIS

5. Why might a closely held corporation choose to remain private? Why might it choose to be publicly traded?
6. If you were going to open a new business, what type would it be? Why?
7. Would you prefer to buy an existing business or start from scratch? Why?
8. Under what circumstances might it be wise for an entrepreneur to reject venture capital? Under what circumstances might it be advisable to take more venture capital than he or she actually needs?

APPLICATION EXERCISES

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?
10. Identify two or three of the fastest growing businesses in the United States during the last year. What role has entrepreneurship played in the growth of these firms?

BUILDING YOUR BUSINESS SKILLS

Working the Internet

Goal

To encourage you to define the opportunities and problems for new companies doing business on the Internet.

Background Information

Let's say that you and two partners plan to launch a new business. Using a virtual storefront on the Internet, you intend to offer local delivery services for books and magazines. Customers can select books and magazines after perusing any online retailer's listings. But rather than placing an order with that retailer, which then entails paying postage and waiting several days for delivery, customers can place their order with your local company. You will purchase the desired item from a local discounter, deliver it within two hours, and collect a full retail price from the customer. Your profit margin will be the difference between the discount price you pay and the full retail price you collect from your customers.

Method

Step 1

Join with two other students and assume the role of business partners. Start by discussing this idea among yourselves. Identify as many strengths and weaknesses as possible for your potential new venture.

Step 2

Based on your assessment, now determine the importance of the following new business issues:

- Analyzing your competitive marketplace and how you should go about promoting your service
- Identifying sources of management advice as expansion proceeds
- The role of technology consultants in launching and maintaining a website
- Customer-service policies and costs in a virtual environment
- The primary pitfalls that could derail your business

FOLLOW-UP QUESTIONS

1. Do you think this business would be successful? Why or why not?
2. Based on your analysis, what future developments could most affect your business? How might you best prepare yourself for these developments?
3. Do you think that operating a virtual storefront will be harder or easier than doing business from a traditional brick-and-mortar operation? Explain your answer.

EXERCISING YOUR ETHICS: INDIVIDUAL EXERCISE

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 partners both work four days each week except when busy seasons require both of them to be in the store. 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 buys the merchandise and maintains up-to-date contacts with suppliers; he also handles personnel matters (hiring and training employees). Connie manages the inventory, buys shipping supplies, keeps the books, and manages the finances. Mark does more selling, with Connie helping out only during busy seasons. 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. Then she indicated that she wanted to cut back further, to just two days. "In that case," Mark replied, "we'll have to make some changes."

Mark insisted that profit sharing be adjusted to reflect his larger role in running the business. He proposed that Connie's monthly salary be cut in half (from $4,000 to $2,000). Connie agreed. He recommended that the $2,000 savings be shifted to his salary because of his increased workload, but this time Connie balked, arguing that Mark's current $4,000 salary already compensated him for his contributions. She proposed to split the difference, with Mark getting a $1,000 increase and the other $1,000 going into the firm's cash account. Mark said no and insisted on a full $2,000 raise. To avoid a complete falling out, Connie finally gave in, even though she thought it unfair for Mark's salary to jump from $4,000 per month to $6,000. At that point, she made a promise to herself: "To even things out, I'll find a way to get $2,000 worth of inventory for personal use each month."

QUESTIONS TO ADDRESS

1 Identify the ethical issues, if any, regarding Mark's and Connie's respective positions on Mark's proposed $2,000 salary increase.

2 What kind of salary adjustments do you think would be fair in this situation? Explain why.

3 There is another way for Mark and Connie to solve their differences: Because the terms of participation have changed, it might make sense to dissolve the existing partnership. What do you recommend in this regard?

EXERCISING YOUR ETHICS: TEAM EXERCISE

Public or Private? That Is the Question

The Situation

The Thomas Corporation is a very well-financed, private corporation with a solid and growing product line, little debt, and a stable workforce. However, in the past few months, there has been a growing rift among the board of directors that has created considerable differences of opinion as to the future directions of the firm.

The Dilemma

Some board members believe the firm should "go public" with a stock offering. Since each board member owns a large block of corporate stock, each would make a considerable amount of money if the company went public.

Other board members want to maintain the status quo as a private corporation. The biggest advantage of this approach is that the firm maintains its current ability to remain autonomous in its operations.

The third faction of the board also wants to remain private, but clearly has a different agenda. Those board members have identified a small public corporation that is currently one of the company's key suppliers. Their idea is to buy the supplying company, shift its assets to the parent firm, sell all of its remaining operations, terminate employees, and then outsource the production of the parts it currently buys from the firm. Their logic is that the firm would gain significant assets and lower its costs.

Team Activity

Assemble a group of four students and assign each group member to one of the following roles:

- An employee at the Thomas Corporation
- A customer of the Thomas Corporation
- An investor in the Thomas Corporation
- A board member who has not yet decided which option is best

ACTION STEPS

1. Before hearing any of your group's comments on this situation, and from the perspective of your assigned role, which option do you think is best? Write down the reasons for your position.
2. Before hearing any of your group's comments on this situation, and from the perspective of your assigned role, what are the underlying ethical issues, if any, in this situation? Write down the issues.
3. Gather your group together and reveal, in turn, each member's comments on the situation. Next, reveal the ethical issues listed by each member.
4. Appoint someone to record main points of agreement and disagreement within the group. How do you explain the results? What accounts for any disagreement?
5. From an ethical standpoint, what does your group conclude is the most appropriate action that should have been taken by the Thomas Corporation in this situation?
6. Develop a group response to the following question: What do you think most people would do in this situation?

VIDEO EXERCISE MyBizLab

WILD PLANET

Learning Objectives

The purpose of this video is to help you:

1. Define entrepreneurship and describe the entrepreneurial personality.
2. Identify the sources of financing for small businesses.
3. List the advantages and disadvantages of the primary forms of business ownership.

Synopsis

Wild Planet is a strong player in the toy industry, focusing on toys that are fun, imaginative, and unique. Wild Planet offers toys for children of all ages, even adults. Some of their most popular toys include Aquapets, Crayon Town activity sets, and Squatz Fizz-and-Find collectible toys. The Spy Gear TRAKR is a remote controlled vehicle that transmits color video as well as audio, perfect for every aspiring spy. Daniel Grossman began the company in 1993, already having experience in the toy industry. Starting out as a small business, he was unable to produce toys in-house. He focused on design and contracted out production operations overseas, where the cost of production was much lower. Wild Planet's success is largely due to the creativity of the design team, who work collaboratively to develop fun and distinctive products. Today, Wild Planet's toys can be found in over 50 countries, in small specialty stores as well as mast-market retailers.

DISCUSSION QUESTIONS

1. What is an entrepreneur? Do you think that Daniel Grossman possesses the characteristics commonly associated with entrepreneurs? Why or why not?
2. How did Wild Planet get its initial financing? Is this typical of small business?
3. What are the primary advantages and disadvantages of organizing as a sole proprietorship or partnership? Why do you think that Wild Planet decided not to chose either of these forms?
4. What are the advantages and disadvantages of organizing as a corporation? How do these relate to Wild Planet and their decision on a form of ownership?
5. DBA ultimately decided to organize as a private corporation. What factors led to this decision?

Online Exploration

Wild Planet's success is built on creativity and innovation, as well as the ability to adapt and change over time. After visiting the company's website, www.wildplanet.com, you will be able to find out more about their latest products, as well as management team. As the company grows, the company could choose to go public and sell stock. What are the advantages and disadvantages of going public to the owners and employees of Wild Planet? Do you think that this is a viable option? Why or why not?

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